Contingency Planning: Lessons from 2011

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CRO FORUM

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1. Introduction

1.1. Purpose of the Paper

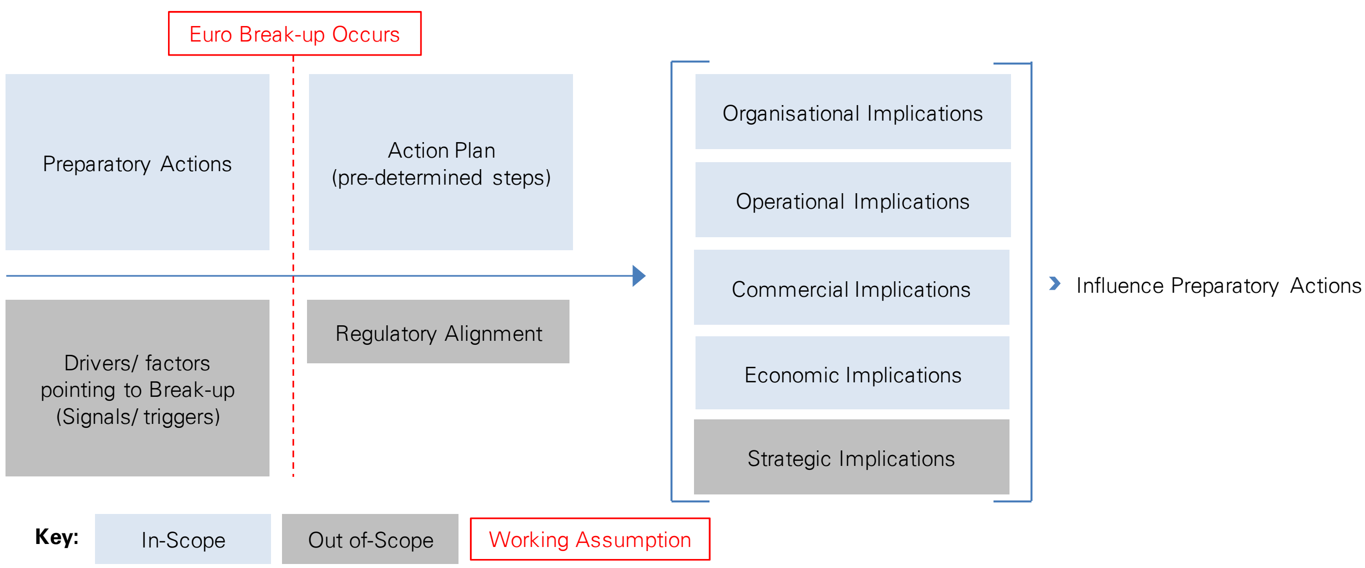
The Euro area crisis of 2011 has stirred up a certain amount of thought and publication on how to deal with the potential consequences of a possible break-up of the monetary union. In light of these events, the CRO Forum investigates the potential risk management considerations that companies could take with the objective of limiting the potential impact by providing considerations to improve companies' responsiveness to adversity.

The purpose of this work is not to contemplate how a currency break up could occur nor is it intended to write a step by step plan (recipe) of how to react to such a scenario that may unfold. Rather, the purpose of this work is to develop a risk framework of factors for management to consider that could guide companies in dealing with such a scenario. The example of the possible Euro currency break-up is used to illustrate this. This paper is therefore a series of considerations to guide companies in preparing for and managing through such a crisis.

This paper is drafted with a specific focus on the implications and measures pertaining to the insurance industry. The specific target audience therein is Chief Risk Officers, Senior Management and Risk Professionals in general. We would like to iterate that the paper deals with the issues in as far as they can be anticipated. We do however recognise that there are also known unknowns which would require special attention beyond the scope of this paper.

1.2. Scope

The chart below outlines the scope of this paper...



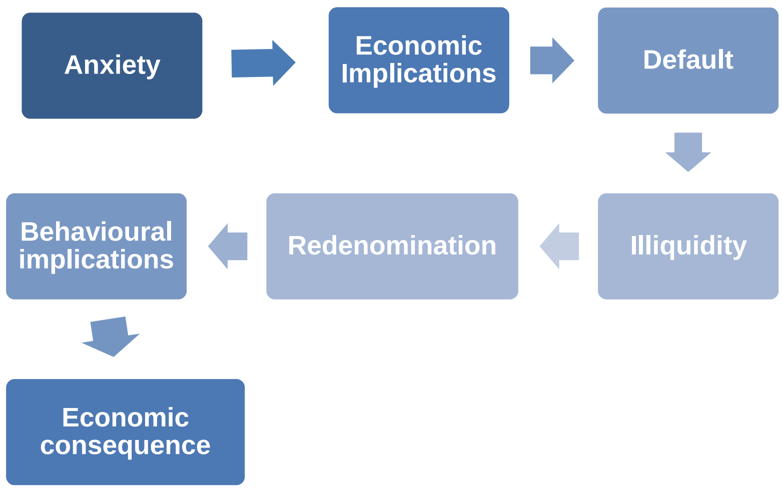
For purposes of this paper, **we do not focus on the probability of a currency break-up, nor on the various possible forms of break-up**. The paper focuses on the factors that would be common to various forms of a currency crisis. The risk management considerations provided could then be interpreted depending on the complexity and severity the most extreme being a possible break-up.

When referring to a potential break-up of the euro, the paper refers to a split or collapse of the European Monetary Union (EMU). We therefore assume that, despite a break-up of the EMU, the European Union (EU) could still exist.

2. Implications of a Euro Break-up

History has not provided any precedents for what may unfold as a result of a possible euro break-up. Over the past century, a few currency unions have dissolved, but none were even close to the highly-integrated trade and monetary nature as that of the European Union. After the hindsight acknowledgement of the level of contagion (evidenced by the collapse of a few key financial players during the 2008 crisis), one can only approach this potential break-up with care and diligent caution.

The following diagram illustrates a possible unravelling of the break-up, so as to identify some of the more likely risks and issues to be considered for contingency planning.



It is important to be mindful that some of these steps could occur simultaneously or in a different order. For instance, an unexpected redenomination would lead to some form of default – changing its position in the sequence above.

Market concerns will exacerbate the drivers of a possible Euro break-up. This period (even without a subsequent break-up) will pose certain risks.

- Market sentiment has impacted the perceived threat of a possible break-up of the euro. It is important to be aware of these factors, as this will have an impact on insurers' current balance sheets.
- In the period leading up to a possible break-up, an orderly exit from the euro – in which firms will have ample notice of events unfolding - will have different implications than a disorderly break-up where one or more countries decide to exit with no notice and are willing to break EU law in the process.

Should a break-up of the euro occur, defaults and debt restructuring will likely follow. Initial defaults/restructurings will be associated to sovereign debt, but legal implications and consequences of the currency break-up, and the reactions of counterparts could result in broader losses.

- The potential default and/or exit of a sovereign state would likely cause contagion across the financial sector with the possibilities of downgrades that could deepen the financial crisis.
- A break-up of the euro would worsen sovereign and commercial debt write-downs and is likely to trigger further defaults. The precise impact depends on jurisdiction, governing law and specific provisions and

definitions in existing documentation (including insurance contracts) and emergency laws which will likely be put in place either by the European Union and/or individual states.

- Credit risk would increase due to (inter-alia) limited access to or loss of cash and bank deposits, with parties (including banks) being unlikely to be able to honour their obligations, and loss of protection from existing derivatives.

Illiquidity could be triggered by (or precede) redenomination and associated lack of trust in the market-place will encumber the normal flow of cash within the economy. Any further actions of individual states and corporations will intensify this impact.

- Availability of bank credit, facilities and guarantees may dry up resulting in funding difficulties and potential defaults. Commercial disruption will be inevitable due to a lack of finance to support new commercial initiatives and due to new tariffs and controls.
- Interaction with the banking system - such as understanding what cash is held where - will trigger discussions regarding netting (albeit across different contracts).
- In times of crisis, regulators may put up capital flow barriers trapping excess capital in certain legal entities where excess capital exists. It is prudent to use the working assumption that capital will not be transferable from legal entities.
- Furthermore, regulatory regimes outside of Europe could also impose barriers and restrictions to limit their exposure to the break-up in the euro.

Redenomination would result in contractual and legal complexities that are accompanied by numerous operational complexities and risks.

- Many companies have multiple jurisdictions and multiple contract forms – it will be difficult to manage what business lies within a specific jurisdiction and what regulation would apply for this jurisdiction after a euro break-up.
- Despite the limited ability of an EU member state to impose capital and exchange controls (constrained by Lisbon Treaty), restrictions will likely be permitted on grounds of public finance and security.
- Redenomination also brings numerous operational complexities and risks. Impact will span across IT and settlement systems, as well as various contractual arrangements of the company.

The snowball effects of the overall behavioural actions and mood set by various stakeholders - such as banks, customers, and regulators - could add to the complexity and financial impact on organisations.

- There is likely to be widespread contagion. Behaviour will be difficult to predict, but one could expect – given the fact that multiple institutions will face counterparty issues – that the overall impact would be severe.
- Interaction with the banking sector is critical given the likelihood of a significant tightening up of liquidity and increased legal complexity.
- Consumer fear and social unrest could trigger behaviour to the further detriment of insurers. An increase in redemptions/surrenders, loss of sales, and an increase in claims are all plausible consequences.
- The interaction between various parties could result in reputational concerns. Specific risks to reputation are illegality or unenforceability of contracts and penalties or prosecutions for breach of regulation.

- Social stress and unrest could have strong repercussions commercially and operationally - when it comes to strikes and riots that lead to (contingent) business interruptions - affecting the operations of subsidiary entities operating in the affected country, and commercially leading to additional claims.

Such a crisis could have severe economic and potential reputational consequences. The above combination will likely result in sombre economic conditions - for at least the medium term.

- Structurally low interest rates combined with widening of credit default swap spreads and volatility across asset classes will raise challenges for the profitability and solvency of insurers with longer term guarantees.
- Furthermore, general demand for insurance could reduce. Alternatively there may also be an increase in certain protection insurance.
- Trade barriers are likely to be enacted as countries exit - particularly if the circumstances are where the Euro collapses by virtue of a series of countries exiting.
- Regulators may translate a euro break-up into capital charges for bonds issued by states within the EMU – further impacting insurers solvency and requiring more own funds to be held.

3. Operational Considerations

Having understood some of the possible risks and consequences arising from a break-up of the euro, the following step is to look into the sensible risk management considerations companies should make to protect themselves and increase their responsiveness to a possible break-up. In this section the considerations are structured as follows:

- Organisation: This section explains how companies could adapt organisationally in order to manage through a euro currency crisis. This involves a streamlined governance structure in order to stay ahead of unfolding events bearing in mind the national legal constraints on key persons and companies. Structure, roles, responsibilities and delegated authority are defined in this section, as well as required communication during this period;
- Commercial: This section identifies various key commercial considerations that may present themselves during a euro currency crisis which will need to be addressed in a more urgent manner (as opposed to an operational manner). This involves balance sheet decisions, product sales and treatment of commitments. It is important to note that the contractual, legal, and reputational elements will be a key determinant of the degree of commercial impact;
- Operations and IT: This section provides guidelines on the operational transformation that would be needed in a possible new world where the euro no longer exists (or exists along-side numerous additional currencies). This would be a highly complex, time consuming and resource intensive exercise. Additionally, operational effectiveness will be required to adequately deal with the contractual and legal components.

For these business components, there may be considerations and planning that could be undertaken today so as to improve responsiveness and management of one's financial position – should a crisis occur.

On the whole, we believe that all decisions and considerations should be done considering the reputational consequences of actions and impact to society and other stakeholders as a whole.

3.1. Organisational

3.1.1.Governance

In order to effectively deal with a euro currency crisis, a streamlined governance model will be required to enable quick acknowledgement of emerging issues and respond appropriately. This involves the creation of special teams led by a Euro Crisis Team (ECT) with clear responsibilities and authority as well as streamlining communication within the company to ensure awareness of decisions and alignment in execution.

By declaring a crisis event, the pre-defined group-level ECT is to be assembled. In times of crisis, a dynamic yet encompassing decision making structure is needed in order to respond to arising issues quickly. The ECT may be comprised of the CEO, CFO, CRO, heads of Finance, Treasury, Capital and liquidity management, General Counsel, Head of Regulatory Affairs, Head of Investment Management, and representation from local units (such as local CEOs, CFOs or CROs).

The responsibilities of the ECT could include (*inter-alia*):

- Management of crisis issues at group level;
- Decisions that must be made in concert across the group (e.g. a force majeure on certain counterparties or more broadly on all payments in Europe);
- Coordination of efforts and execution between the group-level crisis management team and the local-level teams;
- Coordination of efforts and execution between the various crisis teams;
- Delineation and delegation of duties recognising legal and regulatory constraints applying at group and national level;
- Managing internal and external communication and information flow (employees, 3rd party providers, business partners, customer, regulators, investors, rating agencies, other companies, etc).

3.1.2.Communication

Continuous communication with all stakeholders is needed to avoid panic or rash decisions without all the facts from all stakeholders including customers, distribution and other counterparties. In addition, one would need to closely manage relationships with the group regulator as well as local regulators, rating agencies and investors.

Companies will need to ensure close group-level and local-level coordination on communication to ensure timely, relevant and non-conflicting messages to stakeholders. The ECT would oversee communication with external group-level stakeholders including regulators, rating agencies, investors and the public at large. The local-level ECTs would oversee communication with local regulators, distribution, customers and publicly within the local entity. Again, it is important that messages are consistent and synchronized across the group. To accomplish this, major communication initiatives will require approval of the group-level ECT.

It is important to know when a euro currency crisis begins (when a company engages in a crisis management situation). In order to avoid confusion a designated crisis coordinator, who has the responsibility and authority to declare a crisis situation, could be appointed.

A dry run exercise/scenario, which simulates a euro break up scenario, can be conducted for a part of the actions mentioned above. Experiences can be used to enhance crisis management.

3.2. Commercial

This section explains certain key commercial implications that may arise during a euro currency crisis which would be addressed in a more urgent manner. This involves balance sheet decisions, product sales, and treatment of various contracts. Potential further organisational structure changes are further elaborated so as to be able to deal with commercial issues.

3.2.1. Balance sheet management

In order to strengthen balance sheet management, additional dedicated teams could be formed under the group-level ECT. Examples of these teams could be: a group-level liquidity crisis management team, a group-level capital preservation management team, and a group-level portfolio exposure management team. It may be beneficial to have similar teams within business units in order to coordinate with business operations.

Companies will need to take inventory on existing contracts and categorize under the areas of legal jurisdiction and control. This includes corporate level contracts, counterparty contracts, contracts with distribution, and insurance policy forms going forward.

Key focus areas include:

- Defensive positioning of the portfolio, mitigating especially default and currency risk;
- Close monitoring of capital and liquidity position;
- It is critical that companies ensure that their exposure (both to and from the counterparty in question) is known so that they can protect their interests. This will be particularly important in relation to banks where numerous exposures from bonds, loans, cash accounts, derivatives, securities lending, etc may exist. Companies should carefully consider the possibility of delaying settlements of any amounts owed to the counterparty bearing in mind wider implications of liquidity and contagion until the full picture is known and the aggregate exposure can be negotiated with liquidators of the counterparty;
- Understand the liabilities in defaulting country / exiting country, which give rise to exposures where premium and claim currencies might be different and therefore the foreign exchange risk is increased. These circumstances would arise where, for example, an insurance company was providing cover to a Greek multi-national operating in locations across Europe and therefore having to accept payment in Drachma but pay claims in another (appreciated) currency.

3.2.2. Product sales and other contracts

Another important consideration is the pressure on the capital position. It may be necessary to temporarily suspend new contracts or policy sales due to capital constraints (a defensive play). At the same time, certain types of contracts or policy sales may be desired in order to alleviate liquidity pressure – so long as they are not capital intensive (as this could turn to liquidity issues in the future). **Good judgment – and consideration of potential reputational consequence - in this area is crucial.**

Potential temporary suspension of product sales or delay in entering new contracts is important to remain realistic as to the extreme nature of actions that may be necessary. With the uncertainty of redenomination terms and provisions for existing contracts, it may be necessary to suspend entering any new contracts or selling insurance products until sufficient clarity is available.

Furthermore, derivative contracts for hedging purposes that require collateral obligations or margin calls may need to be closed as the cost of liquidity could outweigh the effect of the hedge.

Local circumstances will be crucial to this consideration and as a result, much of this decision should rest with the local-level ECT. However, in order to protect a group-wide portfolio, a decision may be needed in the group-level ECT. In any case, the group-level and local-level ECTs will need to coordinate closely on this matter.

3.2.3.Contract continuity risk

When considering the contractual risks associated to counterparties, one could distinguish between (i) noise and potential interference with contractual terms [the 'smoke effect'], and (ii) trigger of contractual breach ['contractual triggers'].

'Smoke Effect': This would be a phase in which circumstances could frustrate the provisions and terms of a contract potentially making it unenforceable. These circumstances could include:

- Payment obligations being redenominated (from Euro to another currency);
- Dislocation in the euro monetary constitution renders the euro as an inadequate price source or reference rate; and
- Imposition of exchange controls which would make payment by one party illegal.

'Contractual breach': Contractual terms and provisions would differ by instrument, so each exposure and instrument should be evaluated separately. Events that are likely to cause a breach of trigger are:

- Event of default – for example in case of payment in different currency (without official redenomination);
- Illegality – 'illegality' clauses could be triggered by exchange controls allowing early termination;
- Force Majeure - this would allow one to bypass technical default on obligations but at the same time protect one's interests for the interim period where a redenomination of the euro to local currency was underway or if a liquidity crisis that one could no longer manage were to occur;
- Currency Indemnity – where judgement currency is no longer the euro, would be difficult to enforce; and
- Currency expropriation – whereby the government of a state seizes currency deposits.

Companies should continually monitor the influences and triggers that put contractual continuity at risk. Responsive action to various circumstances will likely make a difference in terms of the final outcome.

Consider, for instance, force majeure particularly with regard to premium debtors (or other assets) – this could act as a double-edged sword. Whilst a premium debtor for an insurance contract denominated in Euros might find that the costs of the contract have effectively increased significantly (after re-denomination of their national currency and subsequent devaluation), if the government of the exiting country implements capital and / or foreign exchange controls, the insurance firm's counterparty could look to use the Force Majeure clause.
Being aware of this possibility, and monitoring the respective 'smoke effects' (where a member of the Euro zone appears to be heading for an exit) will help companies appropriately deal with and/or reduce credit terms.

Companies should investigate whether events could trigger or justify a suspension of commitments under existing contracts in order to balance and safeguard rights of all stakeholders in the company and of the financial system as a whole.

This would require close alignment with the regulatory and/or supervisory authorities.

3.3. Operational

Operational transformation would be a highly complex, time consuming and resource-intensive exercise, involving contract/operational issues to balance sheets, business models, and systems as well as a number of other operational issues. In addition during a period of crisis, the workload - vis-á-vis business as usual - will increase for all key individuals and those whose functions are affected.

Systems are designed assuming the euro exists, and some may handle a limited or "pre-determined" number of currencies. Companies' own systems and systems of 3rd parties may not be prepared to adapt to redenomination of currency or able to handle the increased number of currencies that numerous re-denominations may inflict. In addition, internal systems may no longer be able to "connect" effectively with external systems as a result of redenomination.

Business interruptions and business continuity management for local subsidiaries in the exiting country may have repercussions on the functioning of the entire group, depending on size/importance of the affected entity in relation to the entire company

3.4. Other Considerations

The potential strategic implications for companies can be crucially important, and careful thought regarding a company's specific position and vulnerability is required. A potential euro break-up will have differing impacts on organisations depending on their structure with respect to the main source/ countries of break-up.
As strategic implications would be managed via companies' Boards - and not through a crisis management process – this element remains outside the scope of this paper.
We note, however, that each company should consider a specific list of points to take up with their Boards regarding strategy and the potential impact of a euro break-up.

Insurers should be aware of the regulatory implications of such a crisis. As European insurers are embarking on the implementation of Solvency II, companies should consider what could happen under a break-up scenario.

- With a framework being sensitive to local asset performance, it would be sensible to assume that one swap curve does not fit all.
- Default experience during the crisis may result in more prudent charges for sovereign debt.
- Treatment of currency risk and transferability could also come into question with regulators seeking new ways to prepare for such monetary union break-ups.

Close collaboration with regulatory officials and the industry would be required.

4. Preparatory Actions

In this section, the paper provides a series of risk management considerations (or a company checklist) to guide companies in the event of such a crisis. These preparatory actions are provided as guidance to companies who should address their specific planning to their company contingency strategy and specificities.

4.1. Organisational

The following list of measures related to the organisation may enable swift action and response to a crisis (list not exhaustive):

- Create a communication plan for relevant staff. Content and distribution list can be largely created in advance;
- In order to recognize an unfolding of a potential euro crisis, certain triggers or signals will emerge. These triggers or signals can be (partly) identified in advance which can result in a more timely response;
- Create a charter which clearly defines members, frequency, needed information and roles and responsibilities;
- Create a charter which clearly defines the roles, responsibilities and delegation mechanism for the ECT;
- Identify all critical processes and procedures within a euro crisis situation. Specify a euro crisis situation in one's business continuity framework; and
- Investigate staff capacity needs in a euro crisis situation.

4.2. Commercial

The following list of potential measures is related to commercial implications (list not exhaustive):

- Investigate what actions can be taken to guarantee sufficient capital and liquidity in the event of a euro break up. Assess if current policies (worst case scenarios) are adequate - and to some extent take into account - a euro break up;
- Investigate the possibility and effect of a multiple downgrade;
- Investigate potential defensive positioning of the portfolio, mitigating especially default and currency risk;
- Capital and liquidity positions may need to be closely managed at various levels within the organisation;
- For sufficient euro crisis management, the ECT has specific information needs:
  - Detailed market information (intra) daily provided by investment management divisions;
  - Daily detailed portfolio information entities containing euro breakup sensitivities (all possible counterparty defaults must be included);
  - Check if this information is already available including needed frequency. If not, information should be created.
- Investigate whether new and/or existing contracts can be adjusted where necessary

4.3. Operational

Key questions regarding operations to be addressed include:

- What changes could be made to internal methodologies?
- What changes could be made to internal processes?

- What changes could be made to one's balance sheet in terms of hedge programs, ALM position, capital position, liquidity management, and IFRS accounts?
- What changes should be made to internal models?
- What changes should be made to internal reporting?
- What changes should be made to external reporting?
- What communication is needed to accompany changes to the above?

Key questions regarding systems and IT to be addressed include:

- Can internal systems handle multiple currencies?
- Are internal systems ready for currency redenomination?
- Are 3rd party systems ready?
- Are 3rd party systems ready for connectivity?

4.3.1. Operational approach to Contracts

Companies should consider the impact of - and the company's own operational requirements associated to - the following list of transactions (non-exhaustive list):

1. Policy liabilities: Redenomination may result in a change in the value of policy liabilities. Transfers of funds may become subject to exchange controls/limitations. Validity of rights and obligations in euro may be questioned.

2. Derivative contracts: Agreements should be reviewed and may need to be revised, in particular financial covenants, rating triggers, margin obligations, events of default provisions, accelerations, cross-default clauses, material adverse change clauses, illegality clauses (the inability to make valid payments in euro under a contract), mandatory prepayment clauses, representations and warranties. Transfers of funds may become subject to exchange controls/limitations. Validity of rights and obligations in euro may be questioned.

3. Reinsurance contracts: especially in the weaker countries, may be subject to redenomination risk and may cause a mismatch with the covered risks. In addition, exchange controls/restriction may limit the effective exercise of rights and obligations under reinsurance contracts. As with other contracts, event of default clauses, cross-default clauses, illegality clauses, material adverse change clauses etc. need to be checked.

4. Funding agreements (loan facilities, bonds, hybrid securities, commercial paper, credit facilities, etc): Agreements need to be reviewed and may need to be revised, in particular financial covenants, rating triggers, margin obligations, events of default provisions, accelerations, cross-default clauses, material adverse change clauses, illegality clauses, mandatory prepayment clauses, representations and warranties. Transfers of funds may become subject to exchange controls/limitations. Validity of rights and obligations in euro may be questioned.

5. Guarantees, letters of comfort, net worth maintenance agreements, letters of credit: Rights and obligations may be exposed to redenomination risk; transfers of funds may become subject to exchange

controls/limitations; validity of rights and obligations in euro may be questioned; additional margin obligations may be triggered.

6. Property leases: Rights and obligations may be exposed to redenomination risk; transfers of funds may become subject to exchange controls/limitations; validity of rights and obligations in euro may be questioned; Deposits, guarantees in local currency may be required.

7. Bank accounts: Transfer of funds from vulnerable countries may be required as these may become subject to devaluation. Set-off clauses need to be reviewed. Exchange controls may complicate the transfer of local bank deposits.

8. Securities lending agreements: Rights and obligations may be exposed to redenomination risk; transfers of funds may become subject to exchange controls/limitations; validity of rights and obligations in euro may be questioned. Agreements need to be reviewed and may need to be revised, in particular financial covenants, margin obligations, events of default provisions, accelerations, cross-default clauses, material adverse change clauses, illegality clauses (the inability to make valid payments in euro under a contract), mandatory prepayment clauses, representations and warranties.

9. Collateral agreements: Redenomination may cause additional margin calls. Exchange controls may impact the operation of collateral agreements. Collateral may need to be posted in new currency.

10. Intra-company loans and commitments: Rights and obligations pursuant to intra-company loans and commitments may be affected by redenomination and exchange controls and by decisions of the regulators.

11. 3rd party contracts (asset managers, distribution agreements, other): Rights and obligations pursuant to 3rd party contracts may be affected by redenomination and exchange controls. Special care is needed for sensitive contracts for 3rd party asset management and distribution contracts. The list of other contracts may be less significant but the list may be extensive ranging from audit/advisory contracts to contracts for services of equipment.

12. Employment contracts and Pension arrangements: Employees (both within the EU and outside) may be impacted by redenomination of currency. Pension arrangements covering a single jurisdiction or multiple jurisdictions may be impacted by redenomination. Employees and employers (both from within the EU and outside) may be impacted by redenomination.

4.3.2. Other Operational areas for considerations

1. Hedge programs: Euro-based hedge programs would need to be reviewed if currency re-denomination would occur. Asset, liability and derivative valuations may be affected. As a result, the hedge strategy may need to be altered. As a consequence, associated processes, models and the derivative program itself will need to be reviewed for necessary changes.

2. Asset-Liability Management: (ALM) processes would need to adapt to all redenomination circumstances. In addition, care will be needed to ensure that ALM processes and objectives are achievable in new capital

markets that would undergo re-development as a result of the crisis. As mentioned above, commutation of certain contracts may need to be sought in conjunction with local regulators. Actuarial assumptions and their associated models will need to be revisited – particularly in the areas of policyholder behaviour (lapses, withdrawal activity, renewals, conversions, premium persistency, policy loan utilization, etc) as well as product expenses.

3. Liquidity and cash management: Liquidity and cash management may undergo a "regime shift" where previous assumptions may no longer be valid – especially under extreme adverse scenarios. Pre-emptive measures would include reconsideration of key liquidity assumptions in order to determine what additional steps are needed pre-crisis to ensure continuity in liquidity through a euro break up scenario.

4. Methodology and assumptions for regulatory balance sheets, companies' internal risk management frameworks and IFRS: Methodology and assumptions changes required to adapt to a world where the euro no longer exists may be extensive. Base yield curves, liquidity premium, own credit spread, volatility surfaces (equity and interest rate), currencies, correlations and their extrapolation given potentially "frozen" and "incomplete" markets may require revamping of methodology. The potential accounting, statutory (capital), rating agency (capital) and economic implications can be dramatic.

The CRO Forum is a group of professional risk managers that focus on developing and promoting industry best practices in risk management.

The CRO Forum intends to represent large insurance company views, with three core aims:

- Championing best practice in risk management to advance business;
- Alignment of regulatory requirements with best practice in risk management; and
- Providing insights on emerging and long-term risks.

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