



Insurers' Risk Management Systems - Preparing for Recovery:

In light of the heightened regulatory interest in Recovery and Resolution, this CRO Forum Paper highlights the good risk management practices that insurers should undertake to avoid the requirement for resolution

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CRO FORUM

1. Executive Summary

Key messages and conclusions raised in this paper include:

- Extraordinary conditions may pose threats to insurance entities or groups.
- The focus of risk management must be on preventing adversity/extraordinary conditions resulting in failure. This can be achieved via risk mitigation and risk monitoring - ensuring that the entity has the ability to adapt to adverse conditions by accurately taking account of the events and appropriately responding to them.
- The nature of the traditional insurance model is to take on risks from policyholders and manage/pool these risks. This means that facing risks / adverse market situations should be 'business as usual' for insurers.
- Due to the generally long term nature of insurance and the prolonged time period in which situations, develop, a focus on detailed or prescriptive plans for recovery or resolution is unlikely to be appropriate for the particular crisis that actually develops, nor if insolvency looms.
- Insurers should therefore focus on developing a strong set of generic processes or guidelines that can be triggered to enable an agile and effective response in stressed circumstances. In this paper we tie in this set of tools/processes into a 'continuum analysis' that supports robust recovery preparation. These processes should specifically focus on capital and liquidity management and ensure an effective governance approach under adversity.
- Insurers should ensure that they have strong systems and processes in place to be able to react to an ongoing stress/crisis in the form of strong governance, clear decision-making bodies and clear communication.
- It will be important that supervisors are aware of the steps that insurers may take in various circumstances and that supervisors cooperate effectively both within the supervisory college and with insurers to assist effective responses.
- There are a wide range of resolution mechanisms that can be implemented should the insurers process and actions be insufficient to react to a crisis.

2. Introduction

2.1. Background

The recent and on-going financial crisis has drawn attention to the ability of the financial sector to respond effectively to protect its business, its customers and provide confidence in the wider financial system. As a result of the need by governments to inject public money to protect banks and their functioning within the economy, there has been considerable focus on the need for recovery and resolution plans for banks.¹ Annex 1 provides further background to these developments.

Although there have been specific exceptions, insurance business has generally continued through the crises without the need for government support. This is in part due to the nature of the business, the risk management systems developed by insurers and the forward looking aspects of risk management that are being increasingly promoted by the current and developing regulatory regimes for insurance. Examples of this are the focus on Own Risk and Solvency Assessment (ORSA) in Solvency 2, the US Solvency Modernisation Initiative and across the globe.

The nature of the insurance business model, including the pre-funded nature of the business, the nature of insurance liabilities, asset liability matching (ALM) and diversification of risk, generally provide insurers with time to react to evolving or sudden crises. This has enabled insurers to take necessary actions to recover or provided the opportunity for supervisors to effectively resolve, mitigate the impact for policyholders and protect tax payers from being required to provide support.

2.2. Purpose of the Paper

In light of the focus on recovery and resolution in the banking sector, the CRO Forum considers the actions that insurance entities and groups could take to enable them to respond quickly and effectively to an evolving or sudden crisis as the basis for an appropriate framework for insurers.

This paper aims to complement the existing analysis and material from the insurance industry and supervisors² that consider the role of insurance in the financial system and particularly how insurers are resolved in the case of failure. The analysis of insurance failure or near failure highlight:

- that crises within insurance entities develop over time, even if trigger events may be sudden, providing opportunity for mitigating actions to protect policyholders and wider continuity; and
- that prevention through effective risk management by insurers offers the most effective protection for policyholders and governments and therefore should be the focus of attention.

This paper will therefore:

- Provide an overview of the nature of the insurance business model;
- Provide a summary of the features of insurance risk management that can enable insurers to appropriately anticipate and respond effectively to stressed conditions, including examples of forward-looking tools/steps; and
- Provide recommendations of considerations for insurers in developing their continuum analysis to facilitate effective reactions tailored to the specific stressed conditions affecting the insurer.

¹ The European Commission recently published its crisis management measures to avoid future bail outs of banks.

² The Geneva Association paper 'Insurance and resolution in light of the systemic risk debate' February 2012, The Geneva Association paper 'Consideration for identifying systemically important financial institutions in insurance' April 2011 (this paper included a report 'An Analysis of the AIG collapse: understanding systemic risk and its relation to insurance'). The IAIS report on Insurance and Financial Stability November 2011 . The report on prudential supervision of insurance undertakings ('the Sharma report) December 2002 by the London Working Group of the Conference of Insurance Supervisors of Europe.

The paper is supplemented with annexes that cover:

- An update on the current requirements and practice around the development of recovery and resolution plans in the banking sector;
- A summary of the existing and developing insurance regulation regarding risk management and governance; and
- Examples of existing recovery and resolution mechanisms available in the insurance industry.

As such, the focus of the paper is on prevention rather than resolution. There are existing mechanisms that have enabled supervisors to manage the effective resolution of insurers. The topics covered in this paper should, through the existing (and developing) frameworks of prudential supervision, minimise the impact of a failure of an insurer on policyholders and public finances. Given past analysis of failure and near failure of insurers coupled with the experience of the crisis, it is evident that existing resolutions regimes are effective in reducing the need for government support. Steps that can be taken by companies as part of their on-going risk management, such as continuum analysis, will improve the scope of action for supervisors - should resolution become necessary.

3. Traditional Insurance Model

The nature of the insurance business model has enabled the insurance industry to act as a stabiliser in a financial crisis:

- Due to the long-term obligations, risk management of insurers has by necessity a long term horizon;
- Given the role of insurance (particularly protection) is to 'pool risks' so that obligations are satisfied by pools of contributions, 'big is good' for insurers. The potential externalities and thus the need for recovery and resolution (R&R) measures is not linked to size as a determining factor;
- Due to their business model, an insurance crisis plays out over a long time horizon. A typical insurance crisis does not have to be solved over a week-end;
- Insurers and insurance groups therefore do not need prefabricated R&R plans that can be implemented quasi-automatically once a pre-defined trigger point is reached; and
- The need for asset-liability matching means that assets and liabilities are typically linked. This provides the basis for crisis management tools for companies and supervisors, such as a (voluntary or forced) portfolio transfer. These tools facilitate a separation of good business from bad business and thus accomplish a similar goal to the bridge bank concept frequently contemplated under R&R in banking.

For more detailed information on this, the papers of the Geneva Association and IAIS provide useful summaries of the specific characteristics of insurance and the insurance business model³. These characteristics have allowed insurance business to continue through the recent crisis with minimal support of governments and are the basis for the internal risk management considerations for the recovery of an insurer from stressed conditions. The risk management systems of insurers and insurance regulation have developed in recognition of the specific elements of the insurance business model.

³ The Geneva Association paper 'Insurance and resolution in light of the systemic risk debate' February 2012, The Geneva Association paper 'Consideration for identifying systemically important financial institutions in insurance' April 2011 (this paper included a report 'An Analysis of the AIG collapse: understanding systemic risk and its relation to insurance').

4. Contribution of Risk Management

Managing risk in adverse conditions is not a new phenomenon for insurers. Insurers have developed a range of tools and techniques, such as risk selection, reserving/pricing practices, reinsurance, new business volume management, stress & scenario testing, and contingency planning to inform management preparation for such environments. These are further promoted by current regulatory reform initiatives (e.g. Solvency II, but also international initiatives under the auspices of the IAIS or the Solvency Modernisation initiative by the NAIC). This is examined in more detail in Annex 2.

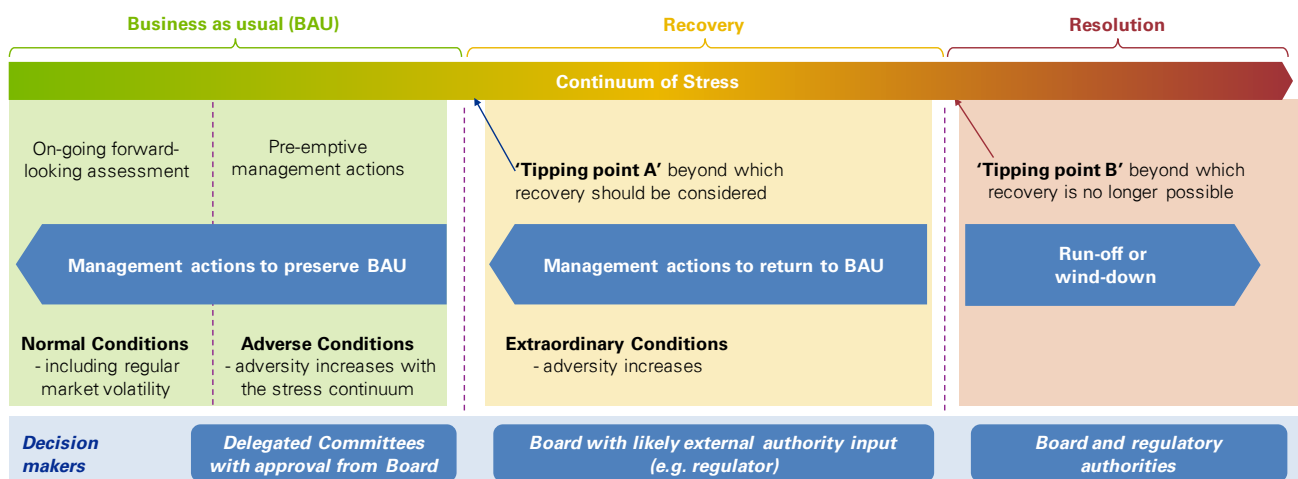
An insurer's risk management system must provide for the identification and quantification of risk under a wide range of outcomes using techniques which are appropriate to the nature, scale and complexity of those risks. As part of this, insurers set out:

- Explanations of how the insurer assesses risk, supported by documentation, providing appropriately detailed descriptions and explanations of the risks covered, the measurement approaches used, and the key assumptions made.
- Risk management policies, which outline how all relevant and material categories of risk are managed, both in the insurer's business strategy and its day-to-day operations. Policies should describe the relationships between the insurer's tolerance limits, regulatory capital requirements, economic capital, and the processes and methods for monitoring risk. This should include an explicit ALM policy, which clearly specifies the nature, role and extent of ALM activities and their relationship with product development, pricing functions and investment management.

4.1. Continuum Analysis

There are a number of tools that can be used to identify and prepare for adverse conditions. These form what we refer to as 'continuum analysis'. This is a framework that includes the processes, guidelines and reference points that enable management to react effectively and appropriately to the specific circumstances affecting their business. This includes emerging good practice, whereby risk analysis and contingency planning assist in the evaluation and deployment of management actions.

Once either an internal or external event triggers an early warning signal or key capital / liquidity measures fall below agreed ranges, the designated process owner rapidly activates the initial stage of reaction following agreed procedures. This is fully integrated and aligned with the risk management framework, the Financial Crisis Action Plan (FCAP) and regular capital and liquidity assessments. The chart below illustrates the phases of continuum analysis, in light of the various stages of increasing stress.



Risk appetites, steps for identification and monitoring, forward looking scenarios and stress testing provide a framework of tools that enable an insurer to assess the necessary and appropriate actions for particular circumstances given the relative position on the continuum. Continuum analysis brings together many of the existing tools insurers use for stress and scenario testing analysis that form an important part of their risk management framework and an integral component of their ORSA. This will become one of the primary tools used to better understand the risks they face and how these can be managed.

Techniques such as stress and scenario analysis, including reverse stress testing can usefully form part of the continuum analysis. Reverse stress testing can provide management with an idea of the conditions that may result in the ruin for the insurer. This encourages management to consider the preparatory actions that should be taken to reduce the exposure of the insurer to these conditions. These tests can serve as powerful tools but should allow for flexibility to be adapted to an entity's/group's specific situation.

4.2. Risk Appetite

A risk appetite framework supports management in appropriately monitoring and managing the risk exposures of the insurer. It requires the insurer to identify the key risks, the relative impact of situations that are developing and the relative effectiveness of management reactions to changes in the risks and exposures.

Risk appetite is closely linked to the strategic direction of an insurer. A well defined and communicated business strategy provides the basis of a risk management system and an informed dialogue with supervisors and other stakeholders. From a group perspective, there are often clear links between group and solo entity business plans with clearly defined Key Performance Indicators (KPIs) providing feedback mechanisms.

4.3. Identification and Monitoring

Identification and monitoring of the economic, market and regulatory environment as well as a constant monitoring of the risks for the insurer/insurance group are paramount to an effective risk management system. This is a core element of an insurer's risk management system that may be complemented by the following practices (inter alia):

- **Emerging risk radar** – regular analysis and documentation of emerging risks that an insurer faces using a framework like PESTLE^[1], which considers risks beyond the traditional risk classifications, such as social trends, e.g. implications of the popularity of Facebook or Twitter. Existing tools, such as scenario analysis, are applied to likely future states of external and (group) internal political and cultural risks, to explore how these would affect, correlate with, or be influenced by socio-economic developments, sociological and demographic changes and trends, technological advancements and their effects on the market situation, and the operating environment. The risks can be ranked on the emerging risk radar, using criteria like severity and probability to inform senior management of the developing risk landscape.
- **Risk registers** – ongoing recording of the risks that an insurer faces where these are described against a set of categories. Most insurers maintain a risk register which forms an important role in identifying and monitoring key risks across the business. Insurers also regularly review their risk registers and risk universes, updating them based on materiality thresholds that have been agreed in line with their risk appetite frameworks and limits. By involving business line heads in the regular review of the risk registers, a culture of risk awareness has grown, such that risk

^[1] PESTLE - Political, Economic, Sociological, Technological, Legal, Environmental.

management is no longer the prerogative of Boards and Executive Management, middle level managers and other key personnel are now actively involved.

- **Scenario database** – some insurers maintain a database of scenarios they have evaluated and found to be particularly relevant to their situation. This may include assessing the scenarios with the potential of rendering the business, or the business model, unviable. By understanding what may destroy franchise value, insurers can be better prepared to understand the impact and prepare in advance to mitigate such outcomes.
- **War-gaming** - using the input from the firm's risk registers, existing analysis and external inputs, such as analyst or regulatory reports, firms undertake war-gaming sessions which are intended to allow business subject matter experts to think widely about potential adverse (or windfall) scenarios, potential interactions between seemingly unrelated scenarios and debate the potential impacts. This process often leads to new scenarios being identified.

Based on such identification and monitoring, insurers are well positioned to understand and prepare for the impact of stressed conditions.

4.4. Scenarios and Stress Testing

As part of the continuum analysis, stress and scenario testing provides a basis for understanding the impact and opportunities that arise from particular sources or factors. These tests help identify the sensitivity of the solvency coverage ratio to, for example, falling equity markets, or to increasing spreads in corporate bond investments.

The analysis of scenarios and stress tests is undertaken over an extended business time horizon and often involve changes in more than one factor at the same time or in a time series. It is important to understand where scenarios fit within the continuum analysis and to consider a range of scenarios so that the full range of consequences can be analysed.

By considering the cause, consequence and impact of an event at different points over the time horizon, an insurer can:

- better understand the potential interaction of risks,
- how these develop into potential financial losses
- what escalation steps and corresponding actions should be taken; and
- the effectiveness of particular management actions to address them.

Scenarios should be developed in-house from the perspective of the group as a whole and its interactions with the key subsidiaries. These tests will also provide insight into the effectiveness of the risk management and risk appetite framework by understanding at what point the internal triggers may have been breached. The risk appetite and an insurer's risk capacity should be reviewed in light of the scenario and stress testing, and developments regarding the insurer's risk profile.

To complement the above analysis, insurers employ a range of mechanisms to ensure the full range of potential material/key risks (including those deemed remote) are identified and tracked with potential mitigating responses pre-planned and, as far as possible, tested. Some emerging good practice and tools that can be used are:

- **Management action catalogues** – this contains a catalogue of both pre-emptive and contingent actions that are available to an insurer. Within the catalogue are contained detail on some of the risks, challenges and governance process associated with implementing these actions. Senior management should be involved in populating the catalogue via identifying the actions they could /

would take in adverse situations and consider when during a scenario they would take these. This may also include identifying possible third party impacts that could arise (e.g. a planned portfolio transfer may no longer be able to proceed as planned as the third party becomes affected by the stressed conditions themselves).

- **Crisis action plans** – each insurer will have crisis action plans, designed in conjunction with the risk management framework, that are intended to be a formalised process for monitoring risks and escalating to decision making bodies. Examples of these would be Business Continuity Plans or FCAP.
- **Contingency plans** – plans created for dealing with certain events/scenarios which go above the detail contained with the management action catalogue. The plans should undergo dry-run scenarios to understand the challenges around them, for example, concerning sign-off/governance changes that might be required.

5. Considerations for Continuum Analysis

Having provided a brief overview of a good practice risk management system included within continuum analysis, we now look at the additional steps that insurers may consider in preparation for particularly adverse scenarios as part of their risk management.

5.1. Capital Management

Insurers are bound by regulatory capital requirements which are designed such that in adversity, obligations to policyholders will continue to be met as they fall due and that adequate capital resources are maintained to meet ongoing capital requirements. Insurers also have commercial imperatives aligned with the setting of strategic goals and risk appetites which are invariably higher than regulatory imperatives. Capital management – determined in light of a full balance sheet economic approach - is fundamental to good insurance risk management. It is also important to review capital adequacy in anticipation of adverse conditions. The risk appetite – whose adequacy and appropriateness should be reviewed from time to time – should be geared such that issues related to capital adequacy are notified to management in a timely manner. Groups will develop their own processes whereby risk and capital are addressed in dialogue at management level.

In the context of preparing to react to the development of adverse scenarios, capital management considerations that inform what (if any) actions are needed - include the following:

- I. What factors affect the adequacy of capital levels at group and major subsidiary level?
Insurers will manage their capital levels to several targets such as internal, rating agency and regulatory. Consideration will be needed of how these, particularly internal and regulatory requirements, will be affected in stressed conditions and the consequential implications this will have, particularly for potential management actions.
- II. How might capital levels react in different scenarios, both at group and major subsidiary level?
Here one could consider the legal structure as well as intra-group arrangements. Under Business as Usual (BAU), regulatory requirements will be an important consideration concerning the levels and components of capital. It will be important to consider how the intra-group arrangements and consequentially capital levels are affected in a crisis situation.

- III. What de-risking actions (at group and major subsidiary level) are appropriate, given the respective scenario?

To assist in the assessment and analysis of capital positions in adversity, insurers should examine their ability to strengthen the balance sheet position, including options to de-risk.

- IV. What options regarding capital allocation and/or capital raising are available to address the situation and which are plausible?

To assist in the assessment and analysis of capital positions in adversity, insurers should examine their ability to strengthen the balance sheet position, including options to raise capital.

These considerations can form part of an on-going risk management and will be influenced by the specific developments an individual insurer may experience. This 'process' of understanding the risk framework (and appetite), testing for adversity, contemplating management actions and their plausibility is applicable at both Group and major subsidiary level.

5.2. Liquidity Management

A strong liquidity management programme is at the centre of an insurer's ALM policy. The nature, role and extent of ALM activities and their relationship with product development, pricing and reserving functions and investment management are all considerations that influence an insurer's liquidity management. The insurance sector's resilience during the financial crisis was due in part to the insurance model itself, being funded by upfront premiums and therefore not generally needing to rely on wholesale market funding for liquidity. Further, the long-term nature of many insurance products, where outflows are controlled and relatively stable, allows for investments to be generally matched to meet liabilities.

Despite the advantages an insurer has with respect to its liquidity profile (as a result of the insurance business model), an insurer/insurance group should also conduct assessments of their major liquidity sources and their availability in times of stress at the group level or at one or several major subsidiaries.

In this regard, the following considerations can be made:

- I. What is the magnitude and location of liquidity sources?
Insurers should also have an understanding of how these liquidity sources would perform under crisis. The group-level continuum analysis and assessment will provide them with an understanding of the main sources (such as dividend payment from subsidiaries, surplus liquidity above regulatory requirements) at major subsidiary-level.
- II. How does the liquidity profile change under stress?
Companies should make a pragmatic yet sufficient exercise to determine the consequences at group and possibly also at major subsidiary-level.
- III. What are the consequences of exercising liquidity sources (at group and subsidiary-level)?
Companies will likely consider rating triggers and potential unintended consequences of drawing, for example, a committed facility.
- IV. What considerations can be made regarding contingent liquidity at group-level and the likelihood of availability under extraordinary conditions?
When relying on contingent capital during stress, insurers should also consider the stress (and consequences) at the provider of contingent capital.

Liquidity risk has been a major contributor to insolvency in the wider financial services industry in the past and will remain a key risk to manage for the future. Comprehensive Liquidity risk management is of paramount importance as part of continuum analysis. Please also [click here](#) to see the CRO Forum paper on Best Liquidity Risk Management Practices.

5.3. Governance and Operations

In order to effectively deal with adversity, insurers consider, as part of their planning processes, whether their governance model is able to quickly acknowledge emerging issues and whether it supports the appropriate analysis and decision making in crisis times. To assess such an environment, we take a look at some of the considerations with respect to decision-making and execution, communication, and operational requirements during times of crisis.

5.3.1. Decision Making and Execution

It is clear that in order to effectively deal with a crisis, a streamlined governance model will be required to enable a quick impact assessment of emerging issues and for the group to respond appropriately.

Therefore, in preparation for these crisis events, companies could prepare by asking themselves the following questions:

- I. Does the crisis governance system enable responsive action by management in times of crisis?
In times of crisis, for example, a dynamic decision making structure may be required in order to respond to emerging issues quickly.

- II. Does the crisis management team have clearly defined members, frequency and roles and responsibilities?
The crisis team should comprise of key decision makers (for example, the CEO, CFO, CRO, in close coordination with the Chairman of the Board or a delegate). This team will take/prepare the key decisions and liaise with other relevant management such as: heads of Finance, Treasury, Capital and liquidity management, General Counsel, Head of Regulatory Affairs, Head of Investment Management, and representation from major local subsidiaries (such as local CEOs, CFOs or CROs). Representation from the subsidiaries is required 'where appropriate' (even if a sub is major it won't necessarily be included in the decision makers)

- III. Are the roles, responsibilities and delegation mechanism for the crisis team adequate under various scenarios?
From a group-perspective, insurers should also consider execution and ensure the decision making protocol (in coordination with subsidiaries) enables the right response in a timely fashion. This may require, after hypothesising a few scenarios, pre-defined rules of thumb for decision-making and execution (particularly where decisions are made at group, but executed at subsidiary-level). In doing so, insurers should ensure that there has been appropriate communication concerning how the parent Board discharges its responsibilities and how such actions will be evidenced.

- IV. Are there clearly defined criteria on when a decision must be made to activate or not the crisis management arrangements?
There should be a suite of indicators set out which individually or in combination trigger an evaluation and decision process on whether to escalate from BAU to a first level of crisis management. These indicators will be a mix of internal and external measures and may be both quantitative and qualitative.

- V. Is there a process to ensure procedures are revised and refreshed periodically including resetting of key indicators thresholds?

5.3.2. Communication

A key consideration for insurers, particularly Groups, is the need to maintain close coordination of communication at group-level and local-level to provide timely, relevant and non-conflicting messages to stakeholders. The crisis team would oversee communication with relevant internal and external (group-level) stakeholders. The local-level crisis teams could oversee communication with local regulators, distribution, customers and publicly within the local entity. Again, it is beneficial for important messages to be consistent and synchronized across the group.

In terms of communication, as part of continuum analysis insurers should consider whether there are appropriate and effective guidelines in place to enable communication plans to be developed quickly? This would include outlines of their high-level approach to coordination of internal and external communication.

5.3.3. Operational Considerations on Data and Infrastructure

As part of the ordinary course of risk assessment and analysis, insurers include a number of considerations regarding data and system infrastructure. Such analysis is particularly beneficial for assessing how the insurer may operate under adverse conditions, particularly with regards to maintaining key systems and infrastructure needed in times of crisis to ensure operational performance and effectiveness.

Management should monitor the likelihood of business interruption and business continuity and have the ability to appropriately respond.

These preparations should serve to ensure that information needed for crisis management and consequently by the supervisor should a firm or group move towards a resolution/winding up are identified and protected.

Accordingly, as part of continuum analysis, companies could prepare by asking themselves:

- I. Whether the systems in place are capable of providing the necessary information (timely and appropriate level of detail) during a crisis?
- II. Whether the systems can easily adapt to changes?

Additional coordination is required for groups to coordinate information requirements at subsidiary level.

6. Conclusions

- The attributes of the insurance business model require specific risk management techniques and regulatory approaches. Risk management reflects the nature of the insurance business and insurance regulation has also evolved based on this framework.
- Effective risk management as outlined in this paper provides an appropriate framework in preparing for stress conditions that may affect an insurer. These will include risk appetites, capital and liquidity management, governance arrangements and appropriate steps for forward-looking assessments with adequate testing and analysis.
- In light of the recent recovery and resolution plans for the banking sector, the focus for the insurance sector should be on the generic risk management of the insurer which includes effective processes and plans that enable an agile response to the specific stressed circumstances.
- Insurers should work to ensure robust recovery procedures and processes are in place. This may be achieved through a continuum analysis.

Annex 1

Development of recovery and resolution plans in the banking sector

Since the Global Financial Crisis (GFC), the main objective of the G20 is to ensure “the financial soundness of systemically important financial institutions” (SIFIs) and to establish a regulatory framework for all SIFIs, instruments and markets. The Financial Stability Board (FSB) is responsible for delivering against these goals. This will take the shape of major financial reform to ensure that the impact of potential future failure can be managed in such a way as to not need government intervention to support the financial system and to achieve an orderly and rapid wind-down to minimise the disruption to the remainder of the financial system and to the wider economy.

The FSB’s focus has primarily been concerned with the banking sector. As a result, the development of recovery and resolution plans (RRPs) has been formulated as a major policy initiative designed to address perceived weaknesses in bank supervision. To address the impact on the insurance sector within the financial services industry, the International Association of Insurance Supervisors (IAIS), which is the global standard setter for insurance, has been asked to provide input into FSB deliberations concerning “the differentiated nature of regulation” and to recommend improvements for the insurance sector.

The primary policy tool that has been proposed in banking to address G20 and FSB concerns is that SIFI’s should develop Recovery and Resolution Plans (RRPs). Designed primarily by banking authorities, RRP’s are envisaged to be a critical supervisory tool which requires banks to assess what actions they could take to recover from a range of stresses, and if necessary, to achieve an orderly wind down which preserves critical economic functions, such as payment systems and retail deposit taking.

The basic proposal for recovery is that SIFIs, and in some countries all banks, should put in place credible and realistic recovery plans to ensure, to the extent possible, that they are able to restore capital and liquidity rapidly in the event of unexpected losses or an increasing risk of deposit withdrawals. A recovery plan should go beyond ‘business as usual’ management actions by providing contingent responses to a range of forward-looking stresses, covering both firm-specific and market-wide stresses. In essence, this is the ‘when, how and could we sell core assets’ phase.

For resolution, SIFIs (and banking authorities) will be required to put in place resolution plans to ensure that, if necessary, the SIFI could be restructured rapidly and smoothly in ways that:

- (a) preserve critical economic functions;
- (b) minimise the contagion on other financial institutions and on the economy more generally;
- (c) allow some or all of the SIFI’s business to be sold or otherwise transferred in an orderly manner to new owners, with the rest of the business wound down; and
- (d) enable these three outcomes to be achieved with the lowest possible cost to taxpayers. In essence, this represents the ‘can we get the business transferred into a new structure over a weekend’ phase.

Whilst these actions are necessary for the banking sector, given the critical importance banking plays to the wider economy, a more targeted and effective policy framework is required for the insurance market given the key economic and operational differences which exist between the two sectors.

Annex 2

The sound regulatory environment pertaining to insurer risk management and governance

There are a range of regulatory change programmes developing globally, which are influencing risk management practices used by insurers. Two of the main areas of regulatory change are International standards being developed by the IAIS and in Europe via the implementation of the Solvency II requirements.

In October 2010, the IAIS endorsed a new suite of solvency, governance and group principles, standards and guidance covering capital adequacy and internal models, enterprise risk management (ERM), investments, systems and controls, and group supervision – the impact of which will have profound consequences for both insurance supervisors and the insurance industry.

In Europe, the Solvency II programme will fundamentally change the capital adequacy requirements. Insurer's will need to demonstrate that they have adequate financial resources, which includes key quantitative requirements, such as own funds (capital), technical provisions and the methods for calculating the Solvency Capital Requirement (SCR) and the Minimum Capital Requirement (MCR).

Of all the developing standards, ERM is perhaps the most significant. Standards now require supervisors to seek from insurers' high standards of risk management and governance within their organisations and critically, supervisors will be challenging their insurers on risk management issues. Importantly, the IAIS and Solvency II standards requires an Own Risk and Solvency Assessment (ORSA) under which an insurer undertakes its own forward looking self assessment of its risks, corresponding capital requirements and adequacy of capital resources. These requirements, if implemented effectively, should incentivise all firms to continue to focus on their risk management capabilities and best practices. Some of the significant changes include:

ORSA

- Perhaps the most significant feature of evolving regulatory standards is the ability of firms to regularly perform an Own Risk and Solvency Assessment (ORSA) to assess the adequacy of its risk management as well as the current (and likely future) solvency position.
- An ORSA is a bespoke strategic analysis process, which links together the outputs of risk, capital and strategic planning, to determine the current and future capital requirements of the firm, based on the business strategy and external environment.
- As part of its ORSA, firms are able to analyse their ability to continue in business, and the risk management and financial resources required to do so over a longer time horizon than typically used to determine regulatory capital requirements. In carrying out this analysis, in addition to the usual stress and scenario testing, the insurer would be expected to apply reverse stress testing to identify scenarios that would be the likely cause of business failure (e.g., where business would become unviable or the market would lose confidence in it) and the actions necessary to manage this risk.
- It is expected that the US ORSA will also require an examination of how risks are managed across the group and include insurance and non-insurance entities within the assessment. Solvency II requires an ORSA at group-level, and internationally, the IAIS standards include group-wide requirements and analysis of risks contained in various Insurance Core Principles (ICPs).

Governance

- Increased governance requirements have been implemented in Europe via Solvency II in regards to risk management (particularly ORSA), compliance, internal audit and actuarial functions.
- Firms need to have in place robust governance structures designed to instil the right behaviours in insurers and establish new skill sets across key functional business areas of risk, finance and strategy.
- The Board needs to play an active role in overseeing the Risk Management System (RMS) of the business and has an active role regarding to the firm's RMS, including setting strategy, risk appetite, tolerance limits and policy. The Board are kept fully informed of how reputational risk exposures could impact key risks.
- The Board also plays a key role in evaluating and reviewing the effectiveness of the RMS in addition to examining the quality and frequency of reporting and making recommendations for improvements.

Risk Management System (RMS)

- An insurer's RMS provides for the identification and quantification of risk under a sufficiently wide range of outcomes using techniques which are appropriate to the nature, scale and complexity of the risks the insurer bears, and adequate for risk and capital management for solvency purposes. The insurer's measurement of risk is supported by accurate documentation, providing appropriately detailed descriptions and explanations of the risks covered, the measurement approaches used, and the key assumptions made.
- Insurers have in place risk management policies, which outline how all relevant and material categories of risk are managed, both in the insurer's business strategy and its day-to-day operations. Policies describe the relationships between the insurer's tolerance limits, regulatory capital requirements, economic capital, and the processes and methods for monitoring risk. They also include an explicit Asset-Liability Management (ALM) policy, which clearly specifies the nature, role and extent of ALM activities and their relationship with product development, pricing functions and investment management.
- Insurers have an explicit investment policy, which specifies the nature, role and extent of the insurer's investment activities and outlines how the insurer complies with the regulatory investment requirements established in the particular solvency regime. The use of risk measurement techniques such as stress and reverse stress tests, and scenario analysis tools, requires insurers to invest properly in ensuring their short and long term liquidity positions are clearly understood and managed.

Risk Appetite

- Firms have established and well-maintained risk appetite statements, which set out the overall quantitative and qualitative risk tolerance levels, and defines tolerance limits, which take into account all relevant and material categories of risk and the relationship between them. These tolerance statements reflect the overall business strategy and are embedded into day-to-day operations via risk management policies and procedures.
- Insurers are responsive to changes in risk profile by incorporating a feedback loop, based on good quality information, management processes and objective assessment, which enables the insurer to take the necessary action in a timely manner in response to changes in its risk profile.

Solvency II reporting requirements (SFCR / RSR)

- Reporting requirements are becoming harmonised across Europe with aligned reporting and disclosure requirements. Under Solvency II, there are specific reporting requirements, such as a Solvency and Financial Condition Report (SFCR), and a private annual regular supervisory report (now known in Solvency II as the Regular Supervisory Report (RSR)). These reports increase the level of disclosure required by insurers and ensure a comparable playing field across Solvency 2 jurisdictions.

Annex 3 – Examples of existing Recovery and Resolution mechanisms available

Recovery mechanisms

Run-off:

What it is and how it operates:

Run-off is the most common recovery mechanism for insurers. A decision to discontinue underwriting a portfolio of business may be made voluntarily or imposed following the withdrawal of authorisation by the regulator. In a run-off, an insurer no longer receives premium income from new business and must rely on its existing assets to fund the management and administration of the run-off and to pay claims. Management of the run-off can typically be serviced in-house, or alternatively, may be outsourced to a specialist run-off service provider. Potential benefits of an external manager can include lower costs due to economies of scale, and access to industry specialists or expertise which may not have been retained in-house.

What it is designed to do and how it may be effective:

Run-off allows a company to continue to manage its discontinued business in an orderly manner – agreeing and settling claims as they are presented and billing and collecting reinsurance on those claims. It enables a company to remain largely business as usual, so minimising disruption to ongoing administration.

Novation:

What it is and how it operates:

Novation is a process that releases the contractual insurance policy rights, obligations and liabilities of an original party and transfers them to a new party. The new party essentially substitutes for the old party and performs all of the old parties' duties. The novated contract replaces the original contract policy or agreement. This process requires the formal agreement of all parties including the old and new (re)insurer as well as the policyholder. In the EU, if the novation of policies constitutes the transfer of a material proportion or all of the transferor's business, the novation must be undertaken in accordance with the rules applicable to Insurance Business Transfers.

What it is designed to do and how it may be effective:

The Novation process is designed to enable an original party, who does not want to or cannot perform the duties required in an insurance policy contract, the ability to release itself from its obligations. The new party in the agreement will not only assume all the duties, but also all of the benefits of the insurance policy contract. The old party is freed of any liability for non-performance of the contract. A Novation agreement also allows for the original contract agreement to continue without cancellation, avoids termination payments, and can be less costly to put in place than processes involving court or regulator involvement.

Whole account reinsurance

What it is and how it operates:

A whole account reinsurance is a reinsurance of the entirety of the business, where the economic interest is passed to the reinsurer. It may be restricted to particular lines of business. It is commonly used in insurance for a number of reasons, such as access to local markets for reinsurers who do not have a local authorisation or where the business is exposed to particular risks.

What it is designed to do and how it may be effective:

In the context of recovery, an insurer passes on economic risk to the reinsurer, which will take over the administration of the business (including claims handling). In return for the reinsurance protection, a premium is paid to the reinsurer made up of the existing assets of the firm. Although they can be relatively quick to put in place, whole account reinsurance arrangements, which are also known as a portfolio transfers, must be approved by the regulator.

Insurance Business Transfer:

What it is and how it operates:

An Insurance Business Transfer is a form of Statutory Novation in which liabilities are transferred between two legal entities. The effect of the transfer is that the risks and rewards under the policies are transferred to the new risk carrier and the policies continue as if they had always been underwritten by the new carrier. In certain jurisdictions, other parts of the business may also transfer from the transferor to the transferee, such as reinsurance and other assets, as well as non-insurance liabilities of the business. The transfer can range from a single contract to an entire portfolio. Depending on jurisdiction, formal consent to the transfer will be required from the court and/or regulator, however, the specific consent of the affected policyholders will not be required. In most EU member states, both the old carrier and the new risk carrier

involved must undergo disclosure requirements and may have to communicate details of the transaction to all affected policyholders, reinsurers, and other affected parties, unless the court and/or regulator agrees to waive certain of these requirements, or if every policyholder has consented to the transfer.

In USA and Canada, transfers of insurance business can be effected under the Transfer and Assumption process.

What it is designed to do and how it may be effective:

Because the liabilities are legally transferred, they no longer have to be recorded on the original company's balance sheet. The company can therefore release trapped capital.

Schemes of Arrangement and Commutation Plans:

What they are and how they operate:

In its most usual form, a Scheme of Arrangement (or its equivalent) provides for the wholesale commutation of a company's liabilities with its policyholders, either in total or in relation to certain specified portfolios. Policyholders with claims are invited to vote on the scheme proposal, and presuming the required voting majorities are obtained, the arrangement is subject to approval by the court and/or regulator. Policyholders must submit claims for known and contingent liabilities, which the company will then seek to agree and then pay a final claim value with each creditor that has made a claims submission,

Schemes of arrangement are available in the UK and many British Commonwealth countries such as Australia and Bermuda. In addition a process similar to a scheme of arrangement is available in the USA but is limited to one State, Rhode Island.

A number of US States permit the use of Commutation Plans, in which policyholders are invited to commute their policies. The process is similar in principle to a scheme of arrangement designed to bring closure to all or part of the business through mass commutation.

What it is designed to do and how it may be effective:

Schemes of arrangement and commutation plans are often promoted as an alternative to resolution through liquidation, and may allow for a recovery of the business. They can be very effective tools for an insurance company as it can bring finality to all of its business or to specific portfolios, without having to find an alternative purchaser for the business. Schemes of arrangement in particular offer inherent flexibility in their scope, including the ability to transfer portfolios where no other formal transfer processes exist.

Cross Border Mergers:

What it is and how it operates:

In a cross-border merger, the liabilities, assets and business processes of a firm are transferred to an acquiring company in a different jurisdiction to the transferring company. As part of the process, the firm is automatically dissolved into the acquiring company without liquidation, and the firm's business continues within the acquirer. The process is recognised by the European Economic Area (EEA). In most cases, the procedure will require court and regulatory approval.

What they are designed to do and how they may be effective:

A cross-border merger is a relatively fast and convenient procedure for combining the business of two parties based in different jurisdictions. The transferred liabilities and assets are recognised throughout the EEA and have a greater chance of being recognised in non-EEA nations. Its key advantage over an insurance business transfer is that there is much less potential for impairment of the reinsurance asset.

Resolution mechanisms

Upon an event of significant regulatory failure, an insurer is placed into run-off and is often required to file for formal insolvency under insolvency legislation. Formal insolvency (as opposed to regulatory failure) occurs when balance sheet assets are lower than liabilities. The actual formal procedure involved varies from country to country and includes such measures as liquidation, administration, rehabilitation and receivership. Each process will be determined in part by the regulations operating in the jurisdiction of the company, and in part by the status of company. In almost all cases, resolution will ultimately result in the complete winding up of the business.

Depending on the jurisdiction, the liquidator or other appointed official may wish to utilise some of the recovery mechanisms listed above. For instance, it is generally considered that a scheme of arrangement may bring benefits to stakeholders not available in a formal liquidation, such as speedier and higher distributions to creditors, less restrictive investment policies, and less court involvement.

Table: Use of Existing Insurance Recovery and Resolution Options across jurisdictions

Existing Insurance Recovery and Resolution Options							
	Insurance Business Transfer	Cross Border Mergers	Reinsurance	Novation	Schemes of Arrangement	Run-off	Liquidation
United Kingdom	✓	✓	✓	✓ *	✓	✓	✓
United States of America	✓	✓	✓	✓	✓*	✓	✓
Germany	✓	✓	✓	✓ *	n/a	✓	✓
France	✓	✓	✓	✓ *	X	✓	✓
Netherlands	✓	✓	✓	✓	n/a	✓	✓
Switzerland	✓	✓	✓	✓	X	✓	✓
Japan	✓	✓	✓	✓	X	✓	✓
Australia	✓	✓	✓	✓	✓	✓	✓
Bermuda	✓ *	✓	✓	✓ *	✓	✓	✓

* Subject to limitations set out in local legislation or in territorial application

- X **Option DOES NOT exist in nation or is almost never used**
- ✓ **Option DOES exist in the nation.**