REGIONAL WORKSHOP FOR ASIAN INSURANCE SUPERVISORS (CRISIS MANAGEMENT, COUNTERING FRAUD AND ANTI MONEY LAUNDERING)

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UNDERSTANDING THE NEED FOR CRISIS MANAGEMENT AND SYSTEMIC RISK IN INSURANCE

- Financial stability
- FSB mandate
- Systemic risk in insurance
- The new IAIS principles
- Tools
- Relevance

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- **The supervisor cooperates and coordinates with other relevant supervisors and authorities such that a cross-border crisis involving a specific insurer can be managed effectively.**
- Protecting policyholders and preventing serious domestic or international financial instability.
- Supervisory actions seek to ensure, as far as possible, that insurers behave prudently;
- to promote private sector solutions such as portfolio transfers and run-offs and to avoid the need for using public support to protect policyholders and to safeguard financial stability;
- and to minimize distortions to the efficient operation of the insurance sector as well as across jurisdictions.
- Effective cross-border crisis management ensures that preparations for and management of a cross-border crisis including policy measures, crisis response decisions and matters of external communication are coordinated, timely and consistent.

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- **The supervisor cooperates and coordinates with other relevant supervisors and authorities such that a cross-border crisis involving a specific insurer can be managed effectively.**
- Protecting policyholders and preventing serious domestic or international financial instability.
- **Who are the relevant supervisors??**
- **Do I have access to the relevant authorities??**
- **Cross border issues , is that mine area of responsibility???**
- **Specific insurer only??**
- **But what is financial instability??**

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CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- Supervisory actions seek to ensure, as far as possible, that insurers behave prudently;
- **What is a prudential behavior of insurers??**
- **Public support when does it make sense??**
- **Distortions vs companies going under!!**
- **What are the right policy measures, crisis response decisions and matters of external communication that matter to me??**

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FINANCIAL STABILITY

- Does financial stability require the soundness of institutions, the stability of markets, the absence of turbulence, low volatility, or something more fundamental?
- Can it be achieved and maintained through individual private actions and unfettered market forces alone?
- If not, what is the role of the public sector in fostering financial stability, as opposed to private collective action ?
- Is there a consensus on how to achieve and maintain financial stability ?

PRINCIPLES GUIDING THE DEFINITION OF FINANCIAL STABILITY

- Financial stability is a broad concept, encompassing the different aspects of finance (and the financial system)—infrastructure, institutions, markets, legal framework, supervision, regulation, monetary policy.

- Financial stability should be understood in terms of the potential **consequences for the real economy**.

PRINCIPLES GUIDING THE DEFINITION OF FINANCIAL STABILITY

- Financial stability entails both **preventive and remedial** dimensions. It relates not only to the absence of actual financial crises but also to the ability of the financial system to limit, contain, and deal with the emergence of imbalances before they constitute a threat to itself or economic processes.

- Financial stability is not a single state but a range where equilibrium is possible

WORKING DEFINITION OF FINANCIAL STABILITY

- *A financial system is in a range of stability whenever it is capable of* ***facilitating*** *(rather than impeding) the performance of an economy, and of* ***dissipating financial imbalances*** *that arise endogenously or as a result of significant adverse and unanticipated events*.

WORKING DEFINITION OF FINANCIAL STABILITY

- **Can the insurance sector provide effective risk management to the real economy participants?**
  - solvency, sufficient reserving, fast claims settlement
- **Can the insurance sector heal itself?**
  - market discipline, winding up mechanisms, mergers acquisitions, portfolio transfers
- **Is risk shifting and risk accumulation into the insurance sector taking place?**
  - Regulatory arbitration, cost of risk underestimation, observance of the new ICPs on macroprudential, group supervision, cooperation and coordination and a crisis management are necessary

THE MANDATE OF THE FSB IS TO:

- assess vulnerabilities affecting the financial system and identify and oversee action needed to address them;
- promote co-ordination and information exchange among authorities responsible for financial stability;
- monitor and advise on market developments and their implications for regulatory policy;
- advise on and monitor best practice in meeting regulatory standards;

THE MANDATE OF THE FSB IS TO:

- undertake joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities, and addressing gaps;
- set guidelines for and support the establishment of supervisory colleges;
- manage contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and
- collaborate with the IMF to conduct Early Warning Exercises.

VULNERABILITY TO INSTABILITY OR SYSTEMIC RISK

- Gaps in the macroprudential framework,
- failure of a SIFI,
- rapid liberalization of the financial sector,
- inadequate economic policy,
- non-credible exchange rate mechanism,
- inefficient resource allocation,
- weak supervision,
- insufficient accounting and audit regulation,
- poor market discipline.

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THE BANKING SECTOR HAS BEEN THE FOCUS OF MUCH OF THE STABILITY WORK.

- The BCBS developed three criteria to identify the systemic importance of financial institutions and markets: size, substitutability, and interconnectedness.
- While size and substitutability are more relevant for the banking sector, **interconnectedness** is a key element of systemic risk in insurance.

DEFINITION OF SYSTEMIC IMPORTANT FIRMS (SIFIS)

- *SIFIs are financial institutions whose **distress** or **disorderly failure**, because of their size, complexity and systemic interconnectedness, would **cause significant disruption** to the **wider financial system** and **economic activity**.*
- *To avoid this outcome, authorities have all too frequently had no choice but to forestall the failure of such institutions through public solvency support.*
- *As underscored by the 2008 crisis, this has deleterious consequences for private incentives and for public finances.*

SOME SEGMENTS OF THE INSURANCE SECTOR CAN CREATE SYSTEMIC RISK.

- Non-traditional non-insurance (NTNI) activity,
- direct investments of insurers in financial institutions,
- reinsurance and alternative risk transfer (ART),
- credit insurance, mortgage insurance and sophisticated insurance guarantees can result in correlated exposures to the financial and business cycle.
- The FSB has been working through the IAIS to address the systemic risk that the failure of a globally systemic insurer (G-SII) could pose to the financial sector.

SYSTEMIC RELEVANCE OF THE VARIOUS SEGMENTS OF THE INSURANCE INDUSTRY

"Non-traditional and non-insurance" businesses are more prone to be sources of systemic risk.

- Insurers have, additionally, entered a broader scope of activities that extend beyond "insurance".
- For instance in the life segment annuities for which the insurer bears the investment risk and guarantees a certain pay-out over longer periods of time. These type of products significantly increase the issuing insurer's vulnerability to economic downturns.
- In the non-life segment, non-traditional insurance covers credit insurance, financial guarantees, and financial derivatives (especially credit default swaps (CDS)).

SYSTEMIC RELEVANCE OF THE VARIOUS SEGMENTS OF THE INSURANCE INDUSTRY

Other financial risks

- Interconnectedness with the financial system is strong due to the counterparty risk exposure with banks.
  - With interest rate risk being a dominant risk exposure (for instance in the context of low interest rates), insurers are natural participants in interest rate derivatives markets as well as in the foreign exchange swaps. As a result, banks are the natural swap counterparties, increasing counterparty risk of the insurance sector toward the banking sector.

SYSTEMIC RELEVANCE OF THE VARIOUS SEGMENTS OF THE INSURANCE INDUSTRY

Other financial risks

- The significant exposure to financial risks requires important hedging activity, thus insurers actively participate in derivatives markets.
  - Derivatives react very quickly to market downturns. Losses or margin calls can spread quickly through the financial services industry.

SYSTEMIC RELEVANCE OF THE VARIOUS SEGMENTS OF THE INSURANCE INDUSTRY

The last financial crisis pointed out at areas of weak supervision:

- The globalization of the financial sector
- The size of financial conglomerates
- Unregulated activities
- Regulatory arbitrage
- Non existing cross border supervisory agreements for crisis management

RESPONSES OF THE FSB / IAIS TO ADDRESS SUPERVISORY GAPS

- New IAIS ICPs 23-24-25-26
- The IOPS principles have not been updated in this respect
- Development of ComFrame
- Introduction of a global capital standard
- Nomination of G-SIIs
- Resolution framework for G-SIIs

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- The supervisor cooperates and coordinates with other relevant supervisors and authorities such that a cross-border crisis involving a specific insurer can be managed effectively.

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- **The group-wide supervisor coordinates crisis management preparations with involvement from other relevant supervisors and ensures that all supervisors in the relevant jurisdictions (at a minimum those where the insurer is of systemic importance) are kept informed of the crisis management preparations.**

- **GROUP SUPERVISION IS KEY (ICP 23)**

ICP 23 GROUP-WIDE SUPERVISION

- The supervisor supervises insurers on a legal entity and group-wide basis.
- The supervisor, in cooperation with other involved supervisors as necessary, identifies the scope of the group to be subject to group-wide supervision.
- The supervisor establishes an effective and **efficient group-wide supervision framework**

ICP 23 GROUP-WIDE SUPERVISION

In deciding which entities are relevant for group supervision, consideration should be given to, at least:

- operating and non-operating **holding companies** (including intermediate holding companies);
- insurers (including sister or subsidiary insurers);
- other regulated entities such as banks and/or securities companies;
- **non-regulated entities** (including parent companies, their subsidiary companies and companies substantially controlled or managed by entities within the group); and
- **special purpose entities**;

ICP 23 GROUP-WIDE SUPERVISION

taking into account, at a minimum, the following elements related to the insurance activities:

- (direct or indirect) participation, influence and/or other contractual obligations;
- interconnectedness;
- risk exposure;
- risk concentration;
- risk transfer; and/or
- intra-group transactions and exposures.

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- **The supervisor develops and maintains plans and tools for dealing with insurers in crisis and seeks to remove practical barriers to efficient and internationally coordinated resolutions.**
- Stress testing
- Living wills
- Resolution plans
- Recovery plans

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- Anticipating the ability of reinsurance to back primary insurance under stress;
- Implications of a single-point-of-entry or a multiple-point-of-entry resolution;
- Implications of the extent to which an insurance company's ability to exercise early-termination rights creates broader systemic risk;
- Assessing conflicting policy objectives.

MACROPRUDENTIAL TOOLS ARE KEY

ICP 24 MACROPRUDENTIAL SURVEILLANCE AND INSURANCE SUPERVISION

- The supervisor identifies, monitors and analyses market and financial developments and other environmental factors that **may impact insurers** and insurance markets **and uses** this information in the supervision of individual insurers.
- The supervisor identifies **underlying trends within the insurance sector** by collecting data and
- Runs market wide stress tests to better understand **potential risks and plausible unfavourable future scenarios** with the objective and **capacity to take action at an early stage**, if required

ICP 24 MACROPRUDENTIAL SURVEILLANCE AND INSURANCE SUPERVISION

- The supervisor assesses the extent to which **macro-economic vulnerabilities** and financial market risks impinge on prudential safeguards or the financial stability of the insurance sector.
- The supervisor has an established process **to assess the potential systemic importance of insurers**, including policies they underwrite and instruments they issue in traditional and non-traditional lines of business.

SYSTEMIC RISK VULNERABILITIES

- Yield-Chasing
- Intra-Group Risk
- Operational risk.
- Non-traditional business
- Political risk

ICP 24 MACROPRUDENTIAL SURVEILLANCE AND INSURANCE SUPERVISION

- If the supervisor identifies an insurer as systemically important, it develops an appropriate supervisory response, which is commensurate with the nature and degree of the risk.

ICP 24 WHAT IS MISSING IN A MACROPRUDENTIAL PRINCIPLE

Main task of a macroprudential supervision is to:

- Have a clear mandate to look at the financial system as a whole and the authority to act to mitigate the risks developing;
- Identify and take steps to protect against the dangerous elements of procyclicality in the buildup of leverage, maturity transformation and complex interdependencies and interconnections in good times

ICP 24 WHAT IS MISSING IN A MACROPRUDENTIAL PRINCIPLE

Identification of legitimate risks to financial stability.

This requires analytical capability and access to information.

- One challenge is identifying tail risks - very rare outcomes that are possible, but not fully priced.
- Another is identifying externalities - in which potential costs and benefits to society exceed those to individual market participants.
- How to differentiate innovations that have genuine value-added from products that result primarily from regulatory arbitrage or speculative excess.

ICP 24 WHAT IS MISSING IN A MACROPRUDENTIAL PRINCIPLE

- Financial stability of the whole system should be an accepted objective of the insurance supervisor
- Insurance supervisors will need to be able to understand the objectives of macroprudential tools and buy into the overarching financial stability mandate.
- A clear responsibility between macroprudential and microprudential supervisors should be established.

COORDINATING ACTIONS TO MANAGE A CRISIS (ICP 26)

- **The supervisor cooperates to find internationally coordinated, timely and effective solutions.**
- Such cooperation takes account of the impact of the crisis on policyholders, financial systems and real economies of all relevant jurisdictions, drawing on information, arrangements and crisis management plans developed beforehand.

ICP 25 SUPERVISORY COOPERATION AND COORDINATION

- The supervisor cooperates and coordinates with other relevant supervisors and authorities subject to confidentiality requirements
- The supervisor takes steps to put in place adequate coordination arrangements with involved supervisors on **cross-border issues** on a legal entity and a group-wide basis in order to facilitate the comprehensive oversight of these legal entities and groups. Insurance supervisors cooperate and coordinate with relevant supervisors from other sectors, as well as with central banks and government ministries.

ICP 25 SUPERVISORY COOPERATION AND COORDINATION

- Coordination agreements include establishing effective procedures for:
  - information flows between involved supervisors;
  - communication with the head of the group;
  - convening periodic meetings of involved supervisors; and
  - conduct of a comprehensive assessment of the group.

ICP 25 SUPERVISORY COOPERATION AND COORDINATION

- Involved supervisors determine the need for a group-wide supervisor and agree on which supervisor will take on that role (including a situation where a supervisory college is established).
- The designated group-wide supervisor takes responsibility for initiating discussions on suitable coordination arrangements, including establishing a supervisory college, and acts as the key coordinator or chairman of the supervisory college, where it is established.

ICP 25 SUPERVISORY COOPERATION AND COORDINATION

- There is appropriate flexibility in the establishment of a supervisory college – both when to establish and the form of its establishment – and other coordination mechanisms to reflect their particular role and functions.
- The designated group-wide supervisor establishes the key functions of the supervisory college and other coordination mechanisms.

ICP 25 SUPERVISORY COOPERATION AND COORDINATION

- The designated group-wide supervisor understands the structure and operations of the group.
- Other involved supervisors understand the structure and operations of parts of the group at least to the extent of how operations in their jurisdictions could be affected and how operations in their jurisdictions may affect the group.

The designated group-wide supervisor is key

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- **The supervisor meets regularly with other relevant supervisors and authorities to share and evaluate information relating to specific cross- border insurers and to analyze and assess specific issues (including whether there are systemic implications) in non-crisis periods.**
- Supervisors remain aware of:
- potential contagion channels,
- conflicts of interest
- possible barriers to coordinated action in a crisis situation at specific cross-border insurers
- (such as legally required transparency rules in case of publicly listed companies or particular legislative requirements across jurisdictions)

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- As far as legal frameworks and confidentiality regimes allow, the supervisor shares with other relevant supervisors, at a minimum, information on the following:
  - group structure (including legal, financial and operational intragroup dependencies),
  - interlinkages between the insurer and the financial system in each jurisdiction where it operates,
  - potential impediments to a coordinated solution.

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- The supervisory regime requires that insurers be capable of supplying, in a timely fashion, the information required to manage a financial crisis.

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- **The supervisory regime requires insurers to maintain contingency plans and procedures based on their specific risk for use in a going- and gone- concern situation.**

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- The supervisor informs the group-wide supervisor as soon as it becomes aware of an evolving crisis.
- The group-wide supervisor coordinates such that this information and any other relevant information that it has become aware of on its own is shared among other relevant supervisors and other relevant authorities promptly.

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- Subject to legislative requirements and confidentiality regimes, the supervisor shares information with relevant supervisors and authorities and in a way that does not compromise the prospects of a successful resolution.
- The supervisor shares information with other relevant authorities or networks as well, whenever necessary, and subject to the same legislative and confidentiality requirements.

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- **The group-wide supervisor analyses and assesses the crisis situation and its implications as soon as practicable and supervisors try to reach a common understanding of the situation.**
  - This includes the identification of possible sources of systemic risk and jurisdictional assessment of such implications.
  - The group-wide supervisor is responsible for coordinating the gathering and the analysis of information as well as for coordinating supervisory activities.

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- **If a fully coordinated supervisory solution is not possible, the supervisor discusses jurisdictional measures with other relevant supervisors as soon as possible.**
- The supervisor takes into account that other authorities (e.g. Ministries of Finance) may take part in and be responsible for crisis management, especially if the crisis is of a very severe nature and may require the use of public funds.

CROSS-BORDER COOPERATION AND COORDINATION ON CRISIS MANAGEMENT ICP 26

- **In a crisis situation, the group-wide supervisor coordinates public communication at each stage of the crisis.**
- The supervisor, where practicable, shares its plan for public communication with other relevant supervisors from other affected jurisdictions to ensure that communication is handled in a coordinated and timely way.
- Where appropriate, the supervisor considers when and to what extent to communicate with the insurers.

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CRISIS MANAGEMENT AND SYSTEMIC RISK IN INSURANCE: IMPORTANT CHALLENGES REMAIN

MANY THANKS

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