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CLIENT UPDATE

FSB APPLIES *KEY ATTRIBUTES* TO INSURERS

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On August 12, 2013, the Financial Stability Board (the "FSB") issued proposed guidance (the "Proposed Guidance") on the application of the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the "*Key Attributes*") to non-bank financial institutions.[1] Comments on the Proposed Guidance are due to the FSB by October 15, 2013.

The Proposed Guidance contains three new appendices that supplement the *Key Attributes* for the resolution of financial market infrastructures (Appendix I), insurers (Appendix II), and financial firms that hold client assets (Appendix III). This client update focuses on Appendix II, the application of the *Key Attributes* to insurers. The *Key Attributes* are part of the response of the G-20 and the FSB to identify global systemically important financial institutions and to mitigate the risks these institutions pose to the global economy. One aspect of this effort is to facilitate the coordinated resolution, under a common set of goals and principles, of firms active in multiple jurisdictions. [2]

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1 FSB, *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions* (Aug. 12, 2013), available at http://www.financialstabilityboard.org/publications/r_130812a.pdf

2 At the Cannes Summit in November 2011, the G-20 leaders endorsed the *Key Attributes*, which set out the core elements of an effective resolution regime. While the *Key Attributes* are intentionally broad in scope, so as to accommodate corporate groups engaged in a variety of financial activities, not all the recommendations are relevant for all sectors of the financial industry.

Consistent with the analytical approach of the FSB and the International Association of Insurance Supervisors (the "IAIS") for the designation and regulation of global systemically important insurers ("G-SIIs"), this Proposed Guidance focuses on perceived risks arising from the resolution of insurance groups engaged in "non-traditional" ("NT") and non-insurance ("NI") activities. [3]

Notably, several provisions of the Proposed Guidance significantly depart from the generally-existing state insurance resolution regimes in the United States, including inserting a bridge bank concept into the insurance resolution process, allowing a receiver unilaterally to change policy liabilities, and granting authority to separate policyholders into different sub-classes and treating these subclasses differently in resolution. The Proposed Guidance also provides details about how systemically significant insurers, in particular insurers who have been designated as G-SIIs by the FSB, will need to prepare their recovery and resolution plans ("RRPs"), mandated in the *Policy Measures* document released by the FSB on July 18, 2013.[4]

OBJECTIVES & SCOPE

The FSB intends for the Proposed Guidance to meet the general objectives of the *Key Attributes*, making it feasible to resolve an insurer without systemic economic disruption or taxpayer loss, while respecting the hierarchy of claims in liquidation. Importantly, the Proposed Guidance states that resolution regimes for insurers should protect insurance policyholders, especially retail policyholders who are dependent on insurance benefit payments, and that resolution regimes should protect essential economic functions of insurance, including risk transfer, risk pooling, and pooling of savings. The FSB suggests that any insurer that could be systemically significant or critical if it fails, as well as any insurer designated as a G-SII, should be subject to this *Key Attributes* regime.

RESOLUTION AUTHORITY & POWERS

The Proposed Guidance calls on the relevant resolution authorities to exercise their responsibilities in a manner consistent with the *Key Attributes*. To this end, the FSB calls for clear, *ex-ante* markers of financial distress which call for the intervention of resolution

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[3] FSB, *Global Systemically Important Insurers (G-SIIs) and the Policy Measures that Will Apply to Them* (July 18, 2013), available at http://www.financialstabilityboard.org/publications/r_130718.pdf

[4] *Id.*

authorities, as exist already in the United States, both at the federal level for insured depositary institutions, and at the state level for insurers.[5]

The Proposed Guidance states that these resolution tools should encompass different sectoral entities within the same group, and should be done on a legal entity basis, but does not appear to address how a single authority could or would resolve an insurer with legal entities in multiple jurisdictions, apart from noting the need for cooperation with an insurance group's supervisor, and with all relevant resolution authorities.

Additionally, this Proposed Guidance suggests that resolving authorities should have a range of resolution powers at their disposal, including creation of a bridge institution to hold the viable assets of the insurer. The cost of the bridge institution would be met from the existing estate, the collection of premiums due, or from the collection of recurring premiums. Currently, U.S. insurers are resolved under the insurance insolvency laws of its state of domicile. The use of a bridge institution is generally not found in state insurance insolvency law. Instead, it is a concept borrowed from banking law; for example, in the United States, the Federal Deposit Insurance Corporation (the "FDIC"), in its role as receiver of failed banks under the Federal Deposit Insurance Act ("FDIA"), has long used "bridge bank" structures to resolve failed depository institutions.[6]

The inclusion of the bridge financial company concept in the Proposed Guidance is part of a general trend at the FSB and other international standard-setting organizations, such as the IAIS, to import bank regulatory approaches to the regulation of non-bank institutions. For example, the G-SII policy measures published by the FSB and IAIS in July borrowed concepts from regulatory capital requirements for banking organizations, including the concepts like a global quantitative capital standard for certain insurers.

The Proposed Guidance also recommends that resolution authorities should have the power to restructure or limit liabilities and allocate losses to creditors and policyholders in a manner that respects creditor hierarchy. These restructuring powers should seek to preserve, to the greatest extent possible, the payments falling due to policyholders and the continuity of insurance coverage generally. This recommendation, too, is a break with general U.S. insurance law practice. Generally, under U.S. insurance law, although policy liabilities may be restructured during the resolution process when policies are transferred to a solvent insurer (with the policyholder having the right to opt out of the transfer), the

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[5] *See, e.g.*, Federal Deposit Insurance Act, 12 U.S.C. § 1831o; National Association of Insurance Commissioners Risk-Based Capital for Insurers Model Act § 4 (Regulatory Action Level Event).

[6] 12 U.S.C. § 1821n.

typical insurance insolvency law does not empower the receiver with the authority to unilaterally restructure or limit policy liabilities of a failed or failing insurer.

SAFEGUARDS

The Proposed Guidance notes that in applying powers, resolution authorities should be bound by a respect for a creditor hierarchy in which policyholders have priority over shareholders and unsecured creditors. The Proposed Guidance also notes that resolution authorities should also operate under a "no creditor worse off" standard, which requires that no creditor receive treatment less favorable than would result under ordinary liquidation procedures, and if a creditor is so treated, it should have a right of compensation for the difference.

With respect to the treatment of policyholders in resolution, the Proposed Guidance recommends that resolution authorities should also have the flexibility to divide policyholders into separate classes for the purposes of applying *pari passu* treatment, subject to a necessity requirement and the "no creditor worse off" standard. This would allow a resolution authority to divide policyholders into sub-classes and apply differential treatment to each sub-class if it believed such treatment was necessary to contain the effects of the insurer's failure, to maximize the value for creditors as a whole or to meet other objectives of resolution.

This recommendation is at odds with New York insurance law, which specifically prohibits such actions in the resolution of insurers, and appears to be at odds with the trend of U.S. insurance laws generally. New York insurance insolvency law specifically prohibits such actions in the resolution of New York domestic insurers,[7] and recent model insurance insolvency laws either provide that no subclasses may be established within any class[8] or that all claims within a class be paid substantially the same percentage.[9]

FUNDING, CROSS-BORDER EFFECTIVENESS & CRISIS MANAGEMENT GROUPS (CMGS)

The Proposed Guidance recommends that jurisdictions have in place privately-financed policyholder protection schemes to assist in securing the continuity of insurance coverage and the timely continuation of payment obligations transferred to a bridge institution or a third party, and to compensate policyholders or beneficiaries in the event of liquidation.

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7 *See*, N.Y. Ins. Law §§ 7435(a) (life insurers); 7434(a)(1) (non-life insurers).

8 National Association of Insurance Commissioners, Insurers Rehabilitation and Liquidation Model Act (retired) §47.

9 National Association of Insurance Commissioners, Insurers Receivership Model Act §801 (Alternative A).

In situations where the law governing the insurer's resolution is not the law of the jurisdiction where the insurer is located, the authorities should be "satisfied" that the terms of transfer and liability restructuring by the resolution authority will be effective. As previously stated in the G-SII policy measures, the FSB recommends that CMGs and institution-specific cooperation agreements (COAGs) be maintained and developed, at least for G-SIIs.

RESOLVABILITY ASSESSMENTS

The Proposed Guidance recommends that insurers that could be systemically important, and, at a minimum, G-SIIs, be subject to regular resolvability assessments. These assessments should be conducted by the resolution authorities, in coordination with other relevant authorities.

The FSB gives a number of measures to be considered during the assessment, including such familiar items as availability of a purchaser, time needed to complete any evaluations and transfers and capacity of the guaranty scheme. Some measures, although familiar to certain banking organizations, may be less familiar to insurers. For example, an insurer would be required to assess the extent to which its resolution plans align with legal entities rather than business units or corporate structures, and whether "surplus" assets in other jurisdictions may be ring-fenced in resolution.

Although the Proposed Guidance mentions the issue of jurisdictional ring-fencing, it makes no effort to solve the problem. Instead, it calls on solvency and resolution regulators to cooperate. Indeed, although the Proposed Guidance states that these resolution tools should apply equally to different sectoral entities within a single insurance group, the Proposed Guidance does not address how, or even if, a single resolution authority could or would resolve an insurer with legal entities in multiple jurisdictions.

RECOVERY AND RESOLUTION PLANNING & ACCESS TO INFORMATION

The Proposed Guidance recommends that all insurers that could be systemically significant, or, at a minimum, all G-SIIs, be required to create RRPs, tailored to the specific risk faced by each company. The discussion of the RRPs in the Proposed Guidance elaborates upon the RRP description provided by the FSB and IAIS in the July policy measures release. The Proposed Guidance notes that "a key component" of the RRP is a strategic analysis of the insurer's systemically important functions, and a plan for maintaining those functions either in recovery or in resolution. The RRP should map the function to the legal entity in which the function is conducted.

The Proposed Guidance suggests that the RRP emphasize provision of critical insurance policies, services necessary for those policies, essential hedging activities, liquidity and measures to avoid spreading financial distress to the rest of the economy.

Recovery plans should be developed based on adverse systemic and idiosyncratic conditions, in cooperation with the insurer's direct supervisory authority, the relevant policyholder protection scheme, and the relevant resolution authorities (and, for G-SIIs, the CMG). The RRP should identify recovery measures, steps, and time needed, including actions to strengthen capital, sales of businesses, changes to reinsurance, investment, or hedging programs, changes to underwriting or claims handling, and modification of contract terms and conditions, changes to charges fees and payments. Finally, the Proposed Guidance advises that a solvent firm in run-off should have a plan to meet all liabilities to policyholders.

Resolution plans should include identification of those policyholders protected and not protected by the policyholder protection scheme, actuarial assumptions used to calculate liabilities, review of asset quality and concentration, preparation of portfolio transfers, sources of funding, including those from a policyholder protection scheme, provision for winding down any derivatives portfolio, details of allocation of ceded reinsurance among legal entities, an estimate of the outcome for each class of policy holder upon wind-up, and practical arrangements for ensuring continuity of coverage and payment under certain types of insurance policies. For G-SIIs, resolution plans should be developed in coordination with their CMGs.

Finally, the Proposed Guidance calls for all systemically significant insurers, including all G-SIIs, to be required to maintain information systems and controls that can promptly produce, both in normal and stress scenarios, relevant data and information for timely resolution planning, in particular of insurance activities where continuity of coverage and payment needs to be maintained in resolution, like details of eligibility for protection under policyholder protection schemes and deposit-like products that could be prone to runs.

CONCLUSION

It remains to be seen whether, to what extent, and even how the Proposed Guidance will be implemented in the United States. While the Federal Reserve Board and the FDIC can adopt certain provisions for insurers under their supervision using their Dodd-Frank or other supervisory authorities, the resolution of insurance companies remains the province of state insurance law. It is too early to tell how and whether individual states will adopt

the Proposed Guidance, and whether the federal government will try to use the preemption authorities given to it in the Dodd-Frank Act to impose this Proposed Guidance on the state insurance regimes.[10] For G-SIIs, this Proposed Guidance provides the details necessary to begin drafting their RRPs, which are due to, and with the approval of, their CMGs by the end of 2014.

For now, it is important for insurers to recognize that the Proposed Guidance differs in significant respects from state insurance law governing the resolution of insurance companies. If implemented in the United States, the Proposed Guidance would introduce the concept of a bridge institution into insurance resolution, would permit the resolution authority to restructure policy liabilities, and would divide policyholders into separate classes for determining their *pari passu* treatment.

Finally, although the Proposed Guidance advocates for cooperation among regulatory authorities, it does not address any of the details of how regulatory authorities would unwind an institution with assets in multiple jurisdictions, especially in cases where those jurisdictions might be acting to ring-fence any assets within the jurisdiction.

Comments on the Proposed Guidance are due to the FSB by October 15, 2013.

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Please do not hesitate to contact us with any questions.

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[10] *See*, 31 U.S.C. 313(f).