

Identification of critical functions in insurance and reinsurance companies



CRITICAL FUNCTION AS A TARGET FOR RESOLUTION

RESOLUTION OBJECTIVES:

- a. Protecting the collective interest of policyholders, beneficiaries and claimants
- b. Maintaining financial stability, in particular by preventing contagion and by maintaining market discipline
- c. **Ensuring the continuity of critical functions**
- d. Protecting public funds by minimising reliance on extraordinary public financial support

DEFINITIONS OF CRITICAL FUNCTIONS

IRRD

Activities, services or operations performed:

- ✓ for **third parties**
- ✓ that **cannot be substituted** within a reasonable time or at a reasonable cost
- ✓ where the inability of the insurance and reinsurance undertaking to perform the activities, services or operations would be likely to have a **significant impact** on the financial system and the real economy in one or more Member States, including by:
 - ✓ affecting the social welfare of a large number of policy holders, beneficiaries or injured parties, or
 - ✓ by giving rise to systemic disruption or by undermining general confidence in the provision of insurance services.

2013 FSB *Recovery and Resolution Planning for...*

The critical function is an economic function that must be maintained. It is characterized by two elements

- ✓ it is provided by a firm **to third parties** not affiliated to the firm
- ✓ the sudden failure to provide that function would be likely to have a material impact on the third parties, give rise to contagion or undermine the general confidence of market participants

Product delivery includes 3 key functions:

- ✓ new product sales
- ✓ providing insurance coverage with existing contracts
- ✓ insurance contract payouts

For each insurance product, it is analyzed whether the indicated 3 functions are critical, which means that the identification of critical functions **should take into account both the maintenance of sales of the offer, insurance coverage and benefit payments** in the context of insurance sales.

2019 IAIS *Holistic Framework for Systemic Risk...*

Two features of critical functions:

- ✓ the insurer provides services that are important for the functioning of the financial sector and real economy
 - ✓ there are few, if any, readily available substitutes
- 2021 IAIS *Application Paper on Resolution Powers and Planning*. These functions should be identified by considering the following:
- ✓ The nature and scope of the activity and the material impact on third parties (considering volume and number of transactions, the number of customers etc).
 - ✓ The significance of the insurer's operations, which may be assessed on the basis of its size, market share, external and internal **interconnectedness, complexity and crossborder activities**
 - ✓ **The nature of the customers and other stakeholders affected by the function**
 - ✓ The potential impact of disruption of the function on markets, infrastructures, customers and public services; or
 - ✓ The potential losses to taxpayers, as well as possible pressures for government interventions if the insurer fails.

DIFFERENT BUT CONSISTENT APPROACHES TO DEFINING THE SAME CONCEPT

CRITICAL FUNCTIONS - POSSIBLE APPROACHES

In November 2023 The Financial Stability Board (FSB) published the "Identification of Critical Functions of Insurers - Practices paper" showing examples of approaches to identifying critical functions. Within the European Union, in addition to the requirements of the IRR Directive, EIOPA will develop guidelines to clarify the criteria for identifying critical functions.

Prior to the IRR Directive, EIOPA had already outlined elements that can be considered in the assessment of critical functions as part of its advice on resolution. These can serve as a starting point for further work. Regardless of the legal requirements, it is clear that:

- ✓ the criteria must be adapted to the realities of the insurance sector,
- ✓ the criteria must apply to individual insurance companies and groups.

In principle, it seems that there should be no differences in the evaluation of activities that constitute a critical function between insurance groups and individual group companies.

However it should be determined which functions are not critical at the insurance group level, but can still be considered sufficiently important to the national or local economy.

HOW CAN CRITICAL FUNCTIONS BE IDENTIFIED?

STAGE 1

INDICATION OF A LIST OF ECONOMIC FUNCTIONS*

***ECONOMIC FUNCTION** – the function that the insurance company may perform (directly related to the provision of insurance coverage or another, e.g., related to activities in the financial instruments market).

Examples:

- ✓ Offering motor vehicle liability insurance
- ✓ Investing in government bonds

STAGE 2

IDENTIFICATION OF CRITICAL FUNCTIONS AMONG ECONOMIC FUNCTIONS

STAGE 2A

IDENTIFICATION OF CRITICAL FUNCTIONS BY NATURE
Identification of economic functions, considered critical due to their characteristics and role in the economy, in principle, in any insurance or reinsurance company that conducts business in a particular function (opt-out mechanism, material function)

STAGE 2B

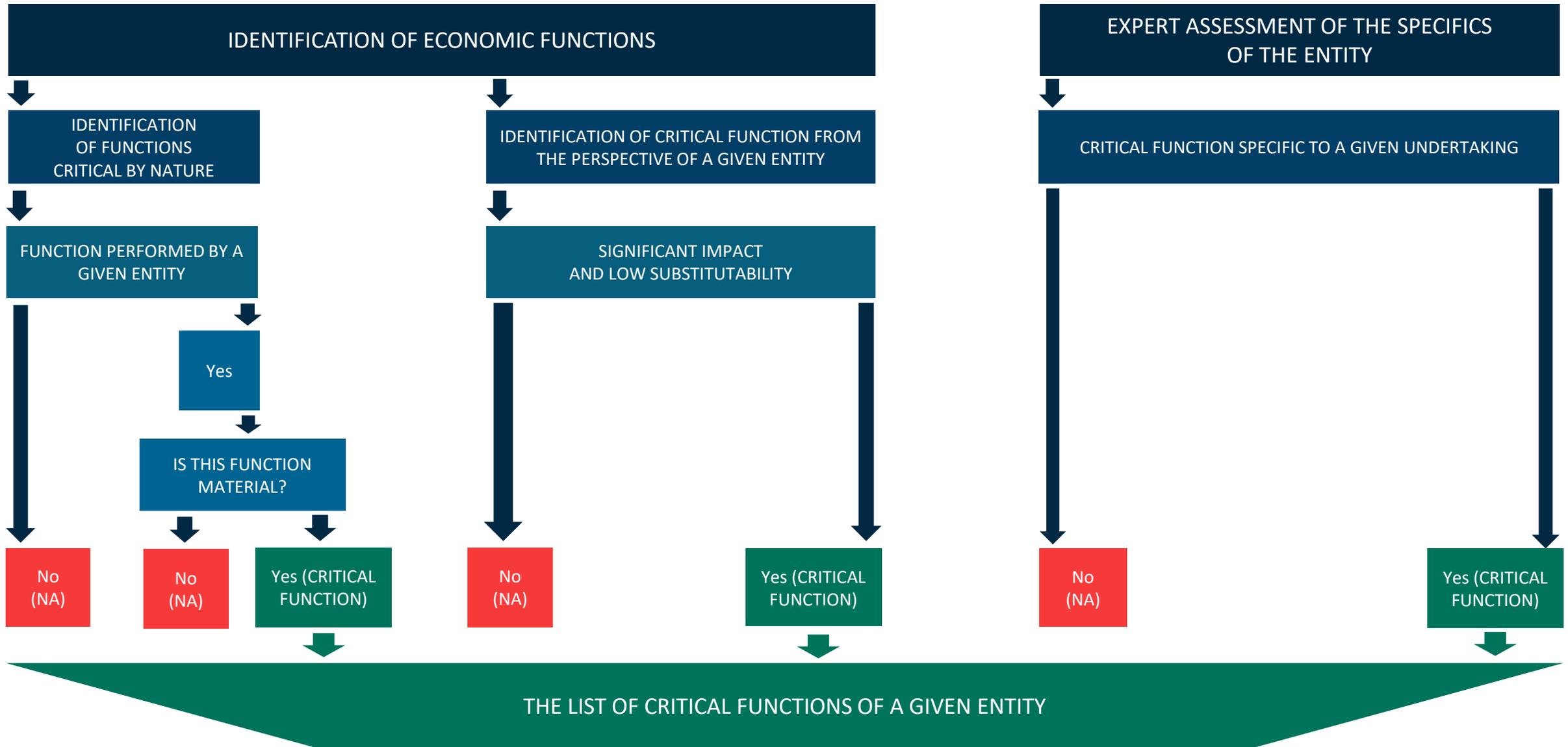
IDENTIFICATION OF CRITICAL FUNCTIONS FROM THE PERSPECTIVE OF A GIVEN ENTITY
Identification of economic functions that are critical at a given undertaking because of its role (e.g., significant market share) in performing that function on a market-wide, segment or sub-segment basis.

STAGE 3

IDENTIFICATION OF CRITICAL FUNCTIONS SPECIFIC TO A GIVEN ENTITY

Identification of other critical functions in a given insurance or reinsurance company based on an expert assessment of the specifics of the company's operations

GRAPH - THE PROCESS OF IDENTIFYING CRITICAL FUNCTIONS



FUNCTION CRITICAL BY NATURE

What can be critical functions by nature?

It seems that these should be functions that, by their characteristics (primarily, significant impact on society and the economy, including the financial market), are critical to the undisturbed functioning of the economy and the financial system (e.g., products related to long-term savings, particularly related to the retirement). Such functions could be considered critical in any insurance or reinsurance company, as long as the company has such a function.

It may be that within a given critical function by nature, the insurance company plays a marginal role. In such a case, the analysis made using the model would have to be adjusted and take into account the specifics of the insurance company under study (opt-out).

Possible criteria for testing critical functions:

1. Is it possible for economic entities to continue doing business if a particular insurer ceases to perform a critical function by nature?
2. What would be the social consequences of discontinuing a particular function?
3. What is the substitutability of the function in question?

CRITICAL FUNCTIONS FROM THE PERSPECTIVE OF THE ROLE OF A GIVEN ENTITY

It refers to functions other than critical by nature, i.e., the economic functions other than critical by nature, that can be analyzed in terms of the importance of the entity in providing them in the economy.

TWO-STAGE TEST:

1. Significance (impact analysis) of an undertaking for the provision of a given economic function based on an assessment of the impact of the discontinuation of this function on the real economy or financial system
2. Substitutability of a given economic function

SCHEME:

Could the discontinuation of the economic function of the entity have a significant negative impact on the economy or the financial system?



No
(Function is not critical)



Yes



Is the function difficult to replace?



No
(Function is not critical)



Yes
(Function is critical)

SIGNIFICANCE (IMPACT) ANALYSIS

Each economic function should be analyzed in terms of the impact that a sudden disruption of its provision by a given insurance company may have on third parties.

Exemplary assessment areas:

1. What is the nature and scope of the activities conducted by the insurance company (including reinsurance), e.g. does it concern compulsory insurance, what is the type of products or services offered?
2. What types of consumers are they intended for (corporations, small and medium-sized enterprises (SMEs), large domestic companies, large multinational companies, financial institutions, individuals)?
3. What is the scope of the undertakings' operations (global, regional, national)?
4. What is the number of external entities that rely on the undertaking's operations?

Quantitative criteria (examples):

1. Market share
2. Market position in the market for a given function or segment
3. Amount of gross technical provisions
4. Gross written premium
5. Number of contracts, clients, intermediaries
6. Value of deposits (including the State Treasury and financial institutions)

ANALYSIS OF SUBSTITUTABILITY

The aim of the substitutability analysis should be to assess whether the function can be replaced by other market participants in an acceptable manner, within a reasonable time frame, i.e. without affecting the actual provision of services, i.e. whether there would be entities on the market capable of providing services or products if the analyzed insurer ceased to offer them.

Exemplary evaluation areas:

1. Can the function be replaced in a reasonable time?
2. Can the function be replaced at a reasonable cost?
3. Can the function be replaced while avoiding systemic problems for the real economy and financial system?
4. Does the market have the capacity and flexibility to freely meet the additional demand that will be generated if a function in an entity or group were to be discontinued or withdrawn?

Quantitative criteria:

1. The structure (concentration) of the market for this function, i.e., the number of other undertakings providing the function and their ability to take over the handling of the portfolio
2. Number of other suppliers of this or analogous function

IDENTIFICATION OF CRITICAL FUNCTIONS SPECIFIC FOR A GIVEN ENTITY

Basic assumption for potential identification of critical functions specific for a given entity:

The analyzed insurance company may perform a specific function (other than those indicated in the list of economic functions), the discontinuation of which would, after detailed analysis, have a probable negative impact on the real economy or financial system and be difficult to replace.

Reasons:

- ✓ Negative impact of the cessation of a function on overall confidence in the financial system
- ✓ Significant participation of the establishment in a reasonably separable "sub-sector." The function in question is then assumed to be critical to the proper functioning of the "sub-sector" in question
- ✓ Some specific services performed in the local market, for a certain category of customers, or market infrastructure

DISCONTINUATION OF A CRITICAL FUNCTION AT A GIVEN ENTITY

Determining the critical function at a given facility is an element of the resolution plan. The regulations provide for cyclical review and updating of the plan. However, the risk of changing the identified critical functions too frequently (e.g., due to potential reporting obligations) should be eliminated.

A possible approach to identifying critical functions:

If, in at least two consecutive periods of evaluation of economic functions at undertakings for the purpose of the identification of their critical functions, a critical function previously identified at a given undertaking does not meet the criteria specified above (in accordance with the method of evaluation of economic functions specified above), the resolution authority shall cease to recognize the economic function in question as a critical function at a given undertaking.

If the resolution authority no longer considers a particular economic function to be a critical function at a particular facility, it shall inform the entity of this in correspondence addressed to the undertaking. Upon receipt of correspondence from the Fund, the facility may consider that the indicated functions are no longer its critical functions.

Materials on resolution in the insurance sector can be found on the Bank Guarantee Fund website:

<https://www.bfg.pl/en/resolution-a-tool-to-manage-the-risk-of-uncontrolled-failures-of-insurance-companies/>