The rationale for the prudential regulation and supervision of insurers

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- The financial crisis has necessitated a re-examination of the level, nature and distribution of risk across the financial system, including insurance companies. But the degree to which a common understanding has been reached on how insurers might affect financial stability is lower than, for example, the analogous discussion for banks.
- In a Workshop hosted by the Bank in July 2013, the risks posed by insurers for both insurance policyholders and financial stability were discussed, together with what this might mean for how insurers should be regulated and supervised.

Overview

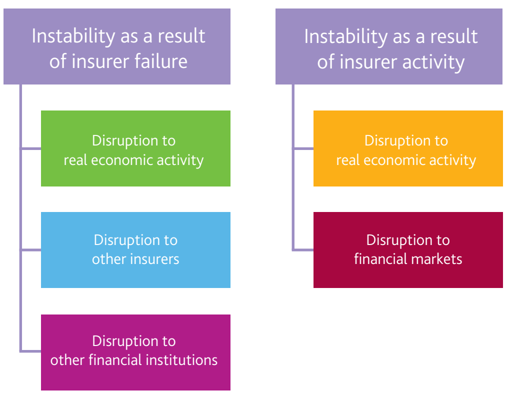
The financial crisis led to wide-ranging reforms across the financial system, including the insurance sector. In April 2013, the Prudential Regulation Authority, as part of the Bank of England, became responsible for the prudential regulation and supervision of insurers. In part as a result of these changes, the Bank has undertaken work to re-examine the economics of insurance and its regulation and supervision.

Insurers play a critical role within the financial system and support economic activity. However, there can be examples where insurance markets — if left unchecked — can result in poor outcomes for policyholders, for example if insurer failure resulted in disruption to insurance payments.

Insurance might also affect financial stability (see **summary figure**). Insurer failure can directly disrupt the provision of critical financial services. There might also be indirect effects if the failure of an insurer propagates stress to other financial firms, for example through financial market interconnections. Insurers might also affect financial stability through their ongoing activities, including relating to their large asset holdings.

These issues were discussed with representatives from the industry, academia and the wider policymaking community at a Workshop hosted by the Bank in July 2013. Most agreed that it was not obvious that insurers cannot generate risks to financial stability. Nevertheless it is clear that insurers are not systemic in the same way as banks. There was also general agreement that the relevance of different types of insurance markets and firms to protecting policyholders and maintaining financial stability will vary across insurance products and with the activities of the insurer. This might suggest that the intensity of prudential regulation and supervision should vary according to the nature of the risk. More work is needed to examine the channels by which insurance affects financial stability, and whether a greater degree of differentiation in regulatory and supervisory intensity is warranted.

Summary figure How insurers could affect financial stability



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In April 2013, the Bank of England became responsible for regulating and supervising insurance companies for the first time. This is carried out through the operations of the Prudential Regulation Authority (PRA), which was created as a part of the Bank in response to the recent financial crisis.(1) The PRA has two complementary statutory objectives relating to insurers.(2) The first follows from the PRA's general objective to promote the safety and soundness of the firms it regulates, focusing on the adverse effects that they can have on the stability of the UK financial system. The second is a specific insurance objective to help ensure that policyholders are appropriately protected. These objectives support the Bank's objective of protecting and enhancing the stability of the financial system.

On 18 July, the Bank hosted a Workshop on the rationale for the prudential regulation and supervision of insurance companies. The aim of the Workshop was to examine the risks posed by insurers for policyholder protection and financial stability and discuss what this might mean for how insurers should be regulated and supervised. Participants at the Workshop included senior representatives from leading insurers, academics operating in the insurance field and policymakers from the United Kingdom and overseas.

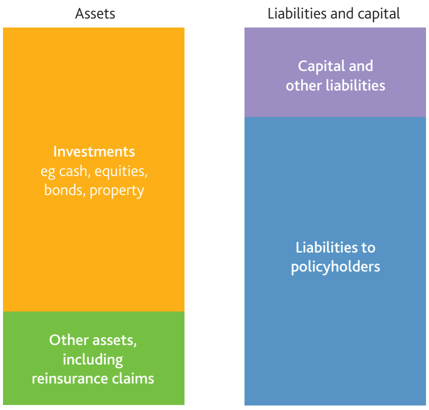
The first two sections of this article set out some of the channels through which the actions of insurers may generate poor outcomes for their policyholders or pose risks to financial stability. The final section then summarises the main themes that emerged during the Workshop on how the potential impact on policyholders and financial stability should influence the regulation and supervision of insurance firms. The Workshop was conducted under 'Chatham House Rule', so opinions are not attributed to individuals. This article does not represent the views of the Bank, the PRA Board or the Financial Policy Committee.

The impact on policyholders of insurer failure

Insurance is a critical financial service. It enables firms and households to transfer some of the risks they face to others better placed to bear them. General insurance — for example, property, motor or liability insurance — reduces policyholders' uncertainty over future outcomes. This can support economic activity since, for example, firms may find it easier or cheaper to obtain financing if they are insured against events which may otherwise disrupt their business activities, such as fire or theft. Life insurance provides benefits in the event of death, retirement or changes in health, and also represents an important savings mechanism for households.

The importance of the insurance sector is underlined by the scale of payments made to households and firms by insurers. In 2011, for instance, UK insurers paid out £9.3 billion in motor claims and £4.7 billion in property claims to firms and households.(3) These payments arise from the obligations of insurers to their policyholders according to the terms of their insurance policies, and will typically be funded by the assets held to back the insurer's liabilities, as shown in **Figure 1**.

Figure 1 A stylised balance sheet for an insurance firm



The scale and nature of insurance provision suggests that the disorderly failure of insurers could result in considerable costs for firms and households if, for example, this resulted in insurance payments not being made as expected. Such costs will vary considerably with the type of insurance. For instance, the impact for an individual of an insurer not meeting medical bills is likely to be much greater than if, say, mobile phone insurance claims were not honoured.

There could also be other costs besides non-receipt of expected payments. If an insurer fails and its policyholders need to find another insurance provider, then they will lose out if they are unable to secure cover on similar terms elsewhere. This may be particularly important for life insurance where the policyholder's life expectancy may have reduced considerably since the original policy was taken out, meaning that life insurance premiums on a new contract would be much higher. There may be examples, however, when policyholders should not necessarily expect to secure cover on similar terms, for instance if underpricing had led to the insurer's failure. In addition, policyholders may be prevented from undertaking certain activities — such as driving a car — until cover is replaced, with potentially large economic impacts. Alternatively, policyholders could, in effect, be forced to self-insure and accept additional risk until they obtain a new policy.

But the existence of potential costs for policyholders following insurer failure does not itself establish a case for prudential regulation and supervision. Public intervention will only be

(1) For an overview of the new regulatory framework for the financial system in the United Kingdom, see Murphy and Senior (2013).
(2) See Bailey, Breeden and Stevens (2012) for a description of the PRA's role and its approach to supervision for deposit-takers, insurers and major investment firms.
(3) Association of British Insurers (2012).

justified if it can successfully address the underlying market failures which give rise to insurance firm failure in the first place. And even if that is the case, it would need to be determined whether intervention takes the form of *prudential* regulation and supervision — that is, promoting the safety and soundness of individual firms. For some types of market failure, compensation schemes (such as the Financial Services Compensation Scheme(1) in the United Kingdom), resolution arrangements or conduct regulation may be sufficient. There are examples from other sectors — for example, certain parts of the tourism industry — where there are arrangements to protect consumers in the event of firm failure, but where a framework of prudential regulation and supervision has not been judged necessary.

An example of a market failure relevant in insurance markets is the potential for 'moral hazard'. This arises because insurers receive premium income from policyholders upfront but do not have to make payments to the policyholder for some time, if at all. This can incentivise or allow behaviour which — if left unchecked by regulation and supervision — can lead to a firm making poor underwriting or reserving decisions, or holding excessively risky assets, not consistent with safeguarding the interests of policyholders or society as a whole. **Table A** lists some of the main market failures relevant for insurance regulation and supervision.

Table A Market failures in insurance

Market failure	Example
Moral hazard: insurers receive premiums upfront, but it can be a long time (if ever) before any payments are due. This gives scope for insurers to take action in the meantime at odds with policyholders' interests and financial stability.	Firms may be able to take risks greater than their policyholders would prefer, for example by underpricing policies or holding very risky assets. But policyholders may be constrained from switching insurers if, for example, contracts are very long (such as for many life insurance contracts).
Adverse selection: some policyholders are less able or less incentivised to assess their insurers. Intermediaries may also lack information or face conflicts of interest in their assessment of insurers.	Retail policyholders may be less able to assess the riskiness of insurers (because of asymmetric information) than corporate policyholders. In many cases, retail policyholders may simply select the cheapest cover available.
Degree of competition: if the level of competition is weak, firms which make poor risk decisions may nevertheless not exit the industry.	Barriers to entry and exit tend to be highest in life insurance markets, as are impediments to switching between firms and market concentrations.
Externalities: there may be costs related to insurance provision not taken into account by the insurer.	There may be important costs for other financial firms and the wider economy from insurer failure or the firm's asset allocation choices.

The relevance of these market failures will vary with the type of insurance. Economic theory would suggest that in well-functioning markets consumers are able to exert sufficient influence over firms such that the way they operate is broadly consistent with consumer preferences. This influence will often be exerted through the threat of switching to alternative providers. However, the extent to which this holds in insurance markets varies across products. For example, retail policyholders are less likely to be able to influence their insurance provider than a large corporate policyholder. And within retail insurance, the fact that much life insurance involves very long contract periods and early redemption penalties reduces the ability to switch providers. By contrast, within general insurance, personal property insurance is typically renewed more frequently.

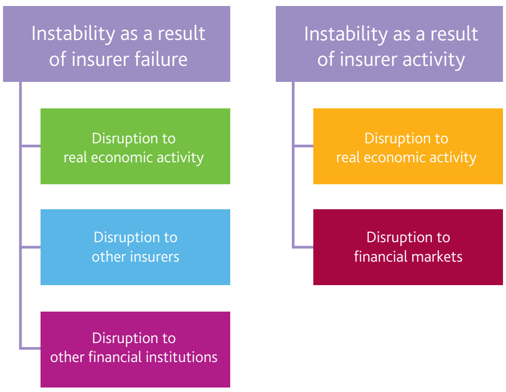
Insurance and financial stability

As noted in **Table A**, insurance markets can be subject to externalities. An important example of insurance externalities stems from the impact of insurers on other financial institutions, and the firms and households which use their services. If these potential financial stability effects are material, this could justify the regulation and supervision of insurers.

A stable financial system can be defined as one which is able to provide a smooth supply of critical financial services to firms and households. Such services will include efficient risk transfer and channelling savings into investment. While the insurance sector is critical to both these services, this does not necessarily mean that an insurer will generate financial instability.

To evaluate whether and how insurers are most likely to generate risks to financial stability, one can set out the potential channels and then examine case-study evidence to assess their relative likely importance. These are summarised in **Figure 2** which groups the possible channels by which insurers could generate financial instability into two categories: those stemming from insurer failure (or extreme distress) and those related to insurers' activity during the normal course of their operations.

Figure 2 How insurers could affect financial stability



Financial stability risks resulting from insurer failure

Insurer failure can directly disrupt the provision of critical financial services, in particular where the firm is dominant in a market and cannot easily be substituted by other insurers in

(1) For more information see www.fscs.org.uk.

the short term. For example, the failure of the Australian general insurer HIH Insurance in 2001 resulted in significant short-term disruption to Australia's construction industry. This was because HIH dominated the market for mandatory builders' warranty insurance — largely because it underpriced its policies. But this underpricing, and subsequent underreserving, resulted in HIH's failure. Given the lack of competing providers to step in when HIH failed, this led to a disruption in the supply of a critical type of insurance.(1)

Financial instability might also be the result of insurer failure propagating stress to other financial firms. For example, interconnections within the insurance sector can be generated through reinsurance, whereby insurers pass on some of the risks they have taken on to other insurers. While reinsurance helps individual insurers manage their insurance risk, it also results in additional counterparty exposures. Hence if a major reinsurer failed and was not able to meet its reinsurance obligations, this could affect the solvency of the insurers from which it faced claims, and so threaten the supply of services they provide. While we have seen no failures of very large reinsurers, huge losses were generated in the London reinsurance market in the 1990s as a result of complex and opaque interconnections between reinsurers, subsequently addressed through a number of reforms in the market, including tougher prudential requirements and improved disclosure.

Insurers are also interconnected with other parts of the financial system. These interconnections can result from insurance firms forming part of wider financial groups, including banks. They can also follow from insurers' participation in financial markets (for example related to the investments that insurers hold as assets, as shown in **Figure 1**). The collapse of AIG — a major global insurance group — was triggered by its activities in derivative and securities lending markets, and it was rescued by the US government partly because of the likely impact that a disorderly failure would have had on other participants in these markets. An important point here is that it was not AIG's insurance underwriting activity which caused its failure and threatened financial stability, but the auxiliary financial market activities it undertook on the back of its core insurance business.(2)

Financial stability risk arising from insurer activity

Aside from failure, insurers might also affect financial stability through the activities they undertake as part of their normal operations. In particular, the insurance sector is a natural provider of long-term financing to the real economy given that many insurance liabilities — such as annuity payments — are similarly long-lived. Indeed insurers are large, long-term providers of corporate finance, with UK insurers holding over £370 billion of UK companies' debt and equity. Changes in the size or type of this investment could therefore affect the provision of funding to the real economy.

These large asset holdings also mean that insurers' investment decisions could have broader impacts within the system. For example, insurers may be incentivised to act in ways that generate or amplify price movements in asset markets, potentially contributing to 'fire sales' or asset price bubbles. Insurers in the United Kingdom have been granted 'regulatory forbearance' — that is, the waiving or relaxing of prudential requirements where permitted by the legal framework — during past periods of financial market disruption so as to ensure that regulatory requirements did not encourage fire-selling behaviour. Insurers may also affect financial markets through providing insurance products that can amplify credit booms. For example, the underpricing of financial guarantee insurance — providing insurance to holders of particular securities to protect against the non-payment of interest and principal — in the run-up to the recent financial crisis may have helped amplify aggregate credit expansion.

Key topics from the Workshop discussion

This section sets out three key themes which emerged during discussion at the Workshop held at the Bank on 18 July 2013. The themes relate to the channels through which insurers may affect policyholder protection and financial stability, and what this might imply for the approach to regulation and supervision of insurers in practice. The Workshop was conducted under 'Chatham House Rule' so individual comments are not attributed to particular speakers.

Policyholder protection and insurance regulation and supervision

Most Workshop participants agreed that market failures, and the potential impacts on policyholder protection, can differ considerably across insurance types. While there was a mix of views as to what this means in terms of a supervisor's priorities, there was relatively broad agreement that — given supervisory resource is inevitably limited — attention should be focused on firms providing insurance products that are subject to the most significant market failures and which could pose the greatest economic costs following insurer failure.

It was noted that it was often unreasonable to expect policyholders to be able to exert any disciplining effect on insurers, or take any action to diversify insurance exposures across firms. Many policyholders selected insurance based on price alone. This suggested a strong case for public intervention, at least for some insurance products.

One participant queried whether there may be risks to reducing supervisory attention on particular types of insurance. Even where insurance covers relatively 'low-value' risks for policyholders, the failure of a large provider of such

(1) See HIH Royal Commission (2003).
(2) See US Government Accountability Office (2011).

cover would still affect a large number of consumers and could erode trust in the industry and in the regulatory and supervisory framework. This could lead, for example, to firms and households underinsuring or life insurance policyholders seeking to liquidate their policies where they are able to.

Another participant noted, however, that regulatory and supervisory interventions impose costs on the industry, and that these can be passed on to policyholders. If these costs become excessive, they could affect the amount and type of insurance that can be provided by the industry at a reasonable cost to consumers.

What is the case for insurance supervision and regulation based on financial stability considerations?

Turning to the possible financial stability relevance of insurers, one participant suggested that many large firms, including non-financial firms, could be considered systemic because of the complexity of their supply chains and the importance of the continuity of supply of their products. It was not clear to this speaker that insurers would feature at the top of a list of non-bank systemic firms. As such, there was a risk that additional regulation and supervision for insurers relative to other financial sector firms on financial stability grounds was unwarranted and risked stifling innovation.

For others, however, it was not clear that the failure of an insurance firm would not generate financial instability. A number of participants stressed the potential effect of the failure of a large insurer that provides critical cover on the economic activity of firms and households. One participant suggested that the number of government interventions in a sector could be a key indicator of potential relevance for financial stability, and that there had been a number of significant interventions in the insurance sector, both in the United Kingdom and elsewhere. This argument rests on the assumption that the interventions in question were undertaken, at least in part, with financial stability objectives in mind.

The relevance of different types of insurance for financial stability was highlighted by a number of participants. Some types of life insurance, for example, can be considered to be savings vehicles allowing policyholders ready access to funds as well as providing guarantees on the level of returns. To the extent that such products are backed by long-term and illiquid investments, this generates a risk for the insurer that policyholders seek to liquidate their holdings faster than the insurer can convert its assets into cash. As such, policyholders could be incentivised to liquidate at the first sign of any apparent distress, although the use of policy surrender penalties can limit such behaviour. This type of 'run risk' is usually associated with banks, and is one of the key reasons why banks are subject to prudential regulation and supervision.

Aside from 'runs', participants also discussed other scenarios where insurers might be incentivised or forced to sell assets in a disorderly way, which could propagate stress to other market participants. For example, insurers might participate in fire sales in falling markets because they find it difficult to deviate from the behaviour of other market participants. In addition, regulatory requirements or shareholder pressure might encourage insurers to sell assets even when values are decreasing because to do otherwise could further weaken their balance sheet. The role of accounting rules, including valuation approaches, in driving such behaviour was also highlighted.

Insurers are generally acknowledged to be long-term investors. But they can respond during periods of economic stress by rapidly changing their asset allocations. There was broad agreement that if insurers are incentivised to act in a short-termist way this would undermine insurers' ability to hold assets to maturity. There was discussion over whether insurers' regulatory requirements contributed to this, and whether requirements should be altered in order to reduce or remove the incentive to sell assets in response to short-term market falls and thereby support insurers' role in providing long-term finance to the real economy. There was agreement that more work was needed in this area.

One participant suggested that in the run-up to the recent financial crisis, the extent to which banks lent to each other became excessive relative to the credit banks provided to firms and households, and that the scale of such intra-sector activity was a key vulnerability revealed during the crisis. This might suggest that the relative size of insurers' intra-financial sector claims — including reinsurance — could similarly be an early indicator of financial stability risks arising in the insurance sector. While work has been undertaken to improve transparency in reinsurance markets,(1) the relative lack of data to understand reinsurance interconnectedness was also highlighted. Another participant argued, however, that there were no instances where reinsurer failure had significantly affected other insurers, and that the market was characterised by a high degree of substitutability between firms.

Which factors should shape how insurers should be regulated and supervised in practice?

Most participants highlighted weak governance and poor risk management decisions as the key underlying causes of insurer failure.(2) As a result, most were keen that a greater focus should be given in insurance regulation and supervision to governance issues. It was noted, however, that it was easy to identify examples of bad decisions after the event; it was

(1) See, for example, International Association of Insurance Supervisors (2012), which draws on work undertaken by the IAIS Reinsurance Transparency Group.
(2) A number of participants referenced the findings of the 2002 report on the 'Prudential supervision of insurance undertakings' by the Conference of Insurance Supervisory Services of the Member States of the European Union (the 'Sharma Report').

much harder for supervisors to design frameworks to identify and challenge poor or irrational choices before decisions are made.

The role of the board of directors in decision-making was highlighted, and in particular the need for the board to exhibit expert and professional judgement. Diversity of board members was also said to be important. One participant suggested that more should be done to make board members more accountable. Another noted that the board can play a key role in approving a sound business plan and setting appropriate checks and balances. One participant highlighted the complexities in managing cross-border groups, which can complicate the supervisory process.

A wide range of views was expressed on how much weight to place on model outputs versus judgement in insurer risk assessment. At one end of the spectrum, one participant believed that models were frequently a waste of time and money, in particular where they were built on an overly theoretical or simplified approach. Another participant argued that while models were useful, there was a danger of overreliance on models in supervisory frameworks. Most speakers, however, agreed that models were a useful input into decision-making, so long as they did not replace expert judgement. Several emphasised early warning indicators or alternative quantitative measures of risk as a valuable tool in the supervisors' toolkit. Finally, one participant suggested that a focus on supervisory judgement could generate additional uncertainty for firms.

The importance of effective resolution arrangements for insurers was stressed by a number of participants. One participant said that they doubted whether the tools and powers to facilitate a reasonably orderly resolution of a large insurer were in place. Another participant stressed the need for effective resolution arrangements given the interconnectedness of some insurer activities — including both those supporting mainstream insurance business such as the use of derivatives and securities lending markets, as well as non-insurance activities.

The possible trade-offs between the policyholder protection and financial stability objectives were also highlighted. For example, the two objectives may suggest different priorities for supervisory intensity across insurance markets.

Conclusion

The Workshop yielded much useful discussion and highlighted a number of important avenues to explore. Most participants agreed that market failures, and the potential impacts on policyholder protection and financial stability, will vary considerably depending on the type of insurance. This might suggest that the intensity of prudential regulation and supervision should also vary across insurance markets. This is already a feature of many supervisory frameworks — for instance, life and general insurance are typically separated. But there may be value in considering whether there is a case for extending this approach further, and if so, how this could be effected in practice. The role that other interventions, for example resolution arrangements, compensation schemes and disclosure requirements, can play in addressing insurance market failures as an alternative or complement to prudential regulation and supervision should also be further explored.

The balance of views expressed at the Workshop suggested that it is not clear that insurer failure could not generate financial instability. Nevertheless, it was equally unclear precisely how insurers generate risks that could threaten the rest of the financial system and the real economy. What was clear was that insurers are not systemic in the same way as, for example, banks. More work is needed to evaluate the importance of the channels through which insurance can be relevant for financial stability. In particular, it would be useful to consider the counterfactuals of episodes where regulatory forbearance or other public interventions may have reduced the financial stability impact of insurer failure or activity.

Such work would be important in considering whether there could be a case for further adapting insurers' regulatory requirements in accordance with macroprudential objectives. Exploring whether financial stability objectives would always be consistent with those of policyholder protection also warrants further analysis. For example, insurers' asset allocation choices will be relevant to supporting the provision of credit to the wider economy, but such benefits may not be taken into account with solely policyholder protection objectives in mind.

The Bank will continue to examine these issues and participate in the international debate, including through existing relevant fora such as the Financial Stability Board, the International Association of Insurance Supervisors, the European Insurance and Occupational Pensions Authority and the European Systemic Risk Board.

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