BANK OF ENGLAND

Speech

Insurance, stability and the UK's new regulatory architecture

Speech given by

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With thanks for comments to Hector Sants, Julian Adams and Andrew Bailey at the FSA, and to Governor King and Vicky Saporta at the Bank.

Many thanks for inviting me this morning. I trust it will provide a useful opportunity for an exchange of views on how the reform of the UK, EU and global regulatory architecture affects the insurance industry. In particular, the UK's regulatory reform Bill, currently going through Parliament, makes special provision for insurers; the EU's Solvency 2 directive is being prepared for implementation; and the G20 Financial Stability Board, helped by the International Association of Insurance Supervisors, is asking itself whether any non-banks could prove systemically significant. I am going to start and end with how insurance fits into our efforts to make the financial system more resilient.

The significance of insurance to stability

The insurance industry is important to our economy. It enables households, businesses and the rest of the financial services industry to insure against all kinds of risks. That hugely enhances efficiency and welfare. It is something to be proud of.

Is insurance also integral to stability? The reflex of many in the industry is that it is not; that AIG was a complete aberration.

There is something to be said for this point of view. Unlike banking, insurers don't all run a maturity mismatch as the very essence of their business.

But, as everyone in this room knows, there are no absolutes in this business. Most of us will recall the run on a medium-sized US insurer around a decade ago. Indeed, there can in principle be runs on any financial business that, while a going-concern, redeems investments on a first-come/first-served basis. Which should remind us of the importance of so-called Market-Value Adjustment mechanisms in controlling spikes in insurance-policy redemptions. Although you might not all appreciate the analogy, they are akin to the 'gates' employed by many hedge funds. They are a prudential tool in the hands of management.

In a similar spirit, we need to be attentive to insurance firms building shadow banks within their groups. AIG did, of course. Not only in its derivatives business. Also in its securities lending business, which was conducted from one of the group's core insurance companies.

Securities lending and shadow banking

Securities lending is essential for any capital market to work efficiently. Liquidity requires market makers or traders who willingly incur short positions to meet buyers' orders. They will do so only if they can cover their short positions – meaning that they need to be able to borrow securities to deliver into their sold positions. That in turn requires investors in those securities to be willing to lend them. Insurers are integral to that. I go over that familiar ground in order to underline that, notwithstanding what I am about to say, nothing must be done to jeopardise the essential functions of securities lending.

The 'but' comes because securities lending also allows anyone holding a portfolio of stocks and bonds to build themselves an in-house shadow bank. All it takes is to lend out securities for cash, and for the cash to be lent or invested in higher-yielding assets. Since most securities loans are at call, this is rather like funding a portfolio of loans with overnight deposits. AIG blew up when its stock-lending shadow bank – an insurance company – suffered a run. Although in Europe securities lending is typically against <u>stock</u> collateral rather than cash, we mustn't pretend to ourselves that that is a foolproof mitigant. Collateral swaps can involve maturity transformation and leverage. And the market is invisible – including, I suspect, to many of the asset managers who outsource stock lending to their custodians.

Various steps are underway to catch up with this. Domestically, the FSA has recently issued guidance to insurers on 'liquidity swaps' in order to get senior management focused on the risks associated with lending out high-quality securities against lower quality collateral.

Internationally, the authorities are going to have to go further, putting some structure around these markets. The Financial Stability Board has work underway to that end, led by the FSA's David Rule. And in the UK, the Securities Lending and Repo Committee, chaired by Andrew Hauser at the Bank, is engaging the industry in dialogue. The Bank wants, in line with our traditions, to find market-led solutions where we can. One issue is transparency. Maybe we should at least contemplate introducing a Trade Repository. If we are moving towards greater transparency in derivative markets, why not do so in a core financing market.

<u>Insurance and capital markets</u>

Of course AIG's problems were much broader. Nevertheless, the 'AIG was unique' refrain risks amnesia. Going back quite a few years, insurers around the world got into the business of lending via complex insurance products – 'time and distance' policies at Lloyd's of London, and 'finite risk reinsurance' more widely. Much of that has gone. But only a few years before the current crisis, 'insurance/capital market fusion' was all the rage,[1] especially in continental Europe and the US. It was not all a bad thing, and efforts continue to build capital markets in catastrophe bonds and longevity bonds. But it is not vanilla. Remember all the so-called Transformers in Bermuda, for converting derivatives into insurance contracts and vice versa? Well, they're still there, although perhaps a little less active.

It is worth remembering, moreover, that complexity does not stem solely from flirtations with capital markets. Around the world, the insurance industry offers some 'savings' products with embedded optionality that is either complex or demanding or both. An example would be US-style 'variable annuities', many of which offer – despite their name – guaranteed <u>nominal</u> returns. Writing long-term options of that kind isn't low risk.

[1] D Rule "Risk transfer between banks, insurance companies and capital markets: an overview". Bank of England Financial Stability Review, December 2001.

Moves, globally and in the EU, to enhance the consolidated supervision of insurance groups can help detect these kinds of issues. The FSA's policy of generating 'realistic balance sheets' for insurers, combined with stress testing, have the same objective. Both will, I trust, feed into the Financial Policy Committee's surveillance of risks to stability. But no one can pretend that detecting such risks is easy.

The regulatory regime

That poses a challenge for the regulatory regime: how to cater for complexity in business models without becoming overly complex itself.

At the Bank, as we get up to speed with the regime for insurance, we (and the FSA) have been dismayed by how much it is costing the industry and the regulator to adapt to Solvency 2. We are also concerned that that, like the initial attempts at Basel 2 for banks, it risks being too complicated in its desire to introduce a 'risk sensitive' regime.

And we cannot understand why the legislative regime place such stress on microregulators 'approving' specific models. This is pretty well bound eventually to bump into circumstances where the models have been found seriously wanting. Now, we are certainly aware that the modelling of risk is long established in insurance. But we need to be wary of regulators drowning in masses of data going beyond anything they can get their hands round. Unless we are careful, it risks distracting supervisors from the big risks.

The supervisory regime

Indeed, however good a regulatory regime, no society can rely on it 100%. We need effective prudential supervision too. Not supervision that is mesmerised by checking compliance with a rule book or approving the details of individual models. But supervision that attends to the big risks that would undermine the safety and soundness of a firm. That test – safety and soundness – is the language of the objective for the Prudential Regulation Authority (PRA) in the new Bill, and we think it is a big improvement on what has gone before.

For insurance, safety and soundness is combined with the future PRA having a duty to ensure appropriate protection for policyholders. In most cases, these two objectives will be entirely complementary. But a challenge is posed by With-Profits Policies, because the terms of these savings products are not only complex but also discretionary and, therefore, incompletely pinned down. A legacy stock of policies exists, so there is no ducking the issue. The PRA will in effect need to judge whether a with-profits provider is adequately capitalised after taking into account a range of returns policyholders might expect. Judgments on the latter call for expertise that will be housed in the Financial Conduct Authority (FCA), and the Bill accordingly makes provision for PRA to take a view from FCA on 'fairness' issues in the light of a firm's marketing material etc. Hector (Sants), Martin (Wheatley) and I have discussed this, and the arrangements for co-operation will be set out in a Memorandum of Understanding later in the year.

In placing weight on a MoU, I realise that some of you worry about having to engage with two microregulators – one for prudential, one for conduct. But I hope you will accept that the previous architecture, based on 'one-stop regulatory shopping', didn't serve society or the City itself at all well. In our line of work, just as in yours, some specialisation helps to build expertise. In the PRA, we will have a dedicated insurance directorate, which Hector has already put in place at FSA, under Julian Adams, as part of the preparations for the new regime.

Safety and soundness; distress and resolution

As with banking, Julian and his team will be more focussed than in the past on what happens in the event of an insurer failing, consistent with the Bill defining safety and soundness as including "seeking to minimise the adverse effect that the failure of a firm could be expected to have on the system".

It means that insurers must be able to fail quietly, in a controlled, orderly way.

The received wisdom is that this is pretty straightforward. But we need to be careful. First, there is little current experience of the failure of a large traditional insurer. Second, most countries' special resolution regimes are confined to deposit-takers. With the IAIS, FSB will therefore be thinking about how the new International Standard for resolution should be applied to insurance.

The importance of this will be underlined as we – and I mean the global community – move towards a world without a safety net for banks, leaving holders of bank bonds exposed to risk. Insurers are significant investors in bank paper. In the future, whether in the UK or elsewhere, you will not be protected by an implicit guarantee from the state for those investments. Over time, that will be good for stability because it will increase market discipline. But it will be a new world for the insurance industry to adjust to.

Conclusion

The issues I have briefly reviewed this morning underline, I believe, the usefulness of your prudential regulator being housed in the same institution – the Bank's PRA – as the banking supervisor.   That represents continuity. What will be new is the alliance with the Bank's market intelligence and analytical surveillance teams Your industry will be central to the work not only of the PRA, but also the Financial Policy Committee, and therefore to the work of the Bank as a whole. We look forward to that.