BANK OF ENGLAND

Speech

Changes in insurance regulation globally and how we should ensure the changes are appropriate and proportionate

Speech given by

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Thank you. Can I start by saying what a pleasure it is to be in Bermuda for the first time. Twenty four hours is by no means long enough to see anywhere properly, so I will need to return.

I want to use my time today to reflect on the broader issues of why and how the insurance industry is regulated for prudential purposes. I am well aware that this is well-trodden ground, but it is a very important subject in view of the developments in insurance regulation. By way of introduction, let me also add that I wear two hats: as CEO of the Prudential Regulation Authority, responsible for the supervision of banks, insurers and major investment firms; and as a member of the Financial Policy Committee, the Bank of England's macro-prudential body charged with maintaining the overall stability of the financial system.

I am quite often asked in the UK why the PRA regulates banks, major investment firms and insurers? (I should note that the Financial Policy Committee has the power to designate other firms for PRA supervision, but to date it has not done so.) There is sometimes an implication that we do not distinguish banks from insurers, and that since the former were the cause of the crisis, this is a bad deal for insurance. You won't be surprised – I hope – to know that my retort is that we can spot the difference between a bank and an insurer. What we also know is that banks provide a set of critical financial services without which economies could not function – the intermediation of savings, provision of payments services etc. But, likewise, insurers also provide a set of critical services to economies which are all about the management and transfer of risk. So, there is one thing banks and insurers have in common, namely the provision of financial services upon which we are all critically dependent. And for both, this activity involves bringing customer money directly onto their balance sheets to provide these critical services, and thus creating direct exposures for policy holders, savers and depositors to these balance sheets. This common element of critical service provision marks banks and insurers out from most other financial firms. The PRA regulates banks and insurers because of their critical role in the financial system, but that is not to say they have the same role – they do not – or that they are monolithic – there are different types of bank and insurer.

But let me here reflect on one other consequence of the financial crisis, namely that it has prompted a much more rigorous drive to understand the risks to the financial system that can result from the firms and markets that play such critical roles. I would draw three conclusions from this drive. First, that it is important that such work is done so that we understand the financial system and its fault lines better than we did in the years before the crisis. But second, we should do the work recognising that different sectors of the financial industry perform different roles and take different risks. Understanding the risks of the financial system most certainly does not involve a one size fits all view of life. Third, we should ensure the same capacity to differentiate exists for the different benefits sectors bring in terms of helping to stabilise the financial system, and thus continuing to provide critical financial services. For instance, where they write long-term contracts, insurers can be a welcome source of long-term stable financing for corporates and infrastructures, and we should encourage this contribution.

Insurance is a critical financial service without which economies and societies would struggle badly. There should therefore be a focus on ensuring continuity of cover for those risks transferred by agents in the economy irrespective of the well-being of the specific insurer. This concern over ensuring continuity can arise with individual contracts, especially where the contracts are very long-lived, and from the need to have a market that can provide assurance on the continuous provision of insurance cover (i.e. new contracts) over time. This helps in my view to explain why the PRA has two objectives for its role in insurance: the safety and soundness of the firms it regulates, with safety and soundness expressed in terms of the risks to the financial system; and the protection of policyholders. For banks, we only have the objective of safety and soundness. The long life of some insurance contracts helps to explain the need for the second objective.

The financial crisis did not prompt, nor did it result from, failures in the mainstream insurance industry. But AIG (in its non-traditional insurance activities), and other financial guarantee insurers such as monolines and some re-insurers demonstrated what could go wrong with rapid expansion outside traditional insurance. The mainstream of insurance was not caught up in the storm of the financial crisis. But, clearly insurers can get into trouble – that's a matter of historical fact. But let me be clear, this role of critical importance, and the history of periodic problems in particular firms, does not therefore prescribe the outcome in terms of regulation. It does not mean that an enhanced framework of financial regulation is required without thinking about the particular risks.

History tells us therefore that insurers are not immune to failure. Some of the common causes of insurance failure are: rapid but unprofitable growth; under-pricing and under-reserving; concentrated exposure to catastrophes or major loss events; excessive appetite for investment risk; and management and governance risks (including fraud). With the probable exception of catastrophes, these risks are not unique to insurance; rather, risks like under-pricing, unprofitable growth, poor management and governance are a generic feature of business. They do not add up to a case for regulation when viewed in isolation of the business model of insurance. The case for regulation comes from the critical nature of the service provided and the need for continuity in the provision of contracts.

While this assessment of the risks of failure in insurers is not unique to the industry, some of the risks arise in ways that are specific to the business model of insurance, but some are more generic. Underwriting risks, for instance, tend to be uncorrelated and can therefore be pooled – thus there is a role for re-insurance in a way that does not exist in quite the same way with banks.

But asset risks – such as the risk of adverse changes in market prices – tend to correlate, especially in times of financial crisis.

With this in mind, it is worth looking briefly at why larger insurance companies have failed. Here is a selection of ten failures.

1. Fire, Auto and Marine (1966) – Rapid expansion , under-pricing and fraud;
2. Mutual Benefit Life (1991) – Losses on property assets led to a run by policyholders;
3. Homestead (1994) – Poor management, high dividend payments and rapid growth;
4. Equitable Life (2000) – Under-pricing, inadequate reserving and misunderstanding legal risks;
5. Drake Insurance (2000) – Under-pricing and lack of reinsurance;
6. Taisei Marine and Fire (2001) – Outsourced underwriting and inadequate reinsurance;
7. Independent Insurance Company (2001) – Under-pricing, rapid growth and false reporting, including fraud;
8. HIH (2001) – Rapid expansion, under-pricing, inadequate reinsurance and fraud;
9. AIG (2008) – Expansion outside its area of competence, mispricing of financial contracts, excessive balance sheet leverage, maturity transformation (i.e. shadow banking) and concentrated exposures;
10. Quinn Insurance Ltd (2010) – excessive exposure to a failed bank, breaches of solvency requirements.

I could have added that most if not all of these cases had failings of management and governance, which again is a generic attribute of failed firms.

It would, of course, be straightforward to name a few more than ten failed banks! In doing so, it would be possible to list the proximate causes of failure in terms somewhat similar to the insurers – bad lending rather than underwriting decisions, fraud, inadequate capital rather than reserving, under-pricing risk, rapid expansion etc. But, we were reminded in the financial crisis that the position of weaker banks can be severely jeopardised by their inter-connectedness, exposures to common shocks and broad systemic weaknesses such as excessive leverage. While a few of the failed insurers were exposed to the common shock of 9/11, this was the exception, and none of the insurance failures set off system-wide effects, with the exception that AIG played a role in assisting the growth of the most explosive phase of the financial crisis, by virtue of its failure to control its non-insurance activities.

The reason I laboured the description of the ten failures is that while they illustrate the risks that arise from the loss of critical services, on their own they do not make a convincing case for macro-prudential intervention, where that intervention is intended to maintain the stability of the financial system.

But they do make the case for the importance of good quality prudential and conduct supervision in order to protect policyholders and their dependence on the critical service of insurance. This supervision is micro prudential (or firm specific conduct supervision) aimed at the safety and soundness of insurers and the protection of policyholders.

The case for robust firm-level supervision of insurers has recently been re-made by my former colleague Paul Wright in a publication for the Centre for the Study of Financial Innovation. In it, Paul sets out a number of practical measures on which good supervision is founded: rigorous, clear-sighted global consolidated

supervision of groups; effective co-ordination among national supervisory authorities; harmonising national approaches to valuation and solvency requirements wherever possible; the ability for supervisors to apply additional measures where there is a threat to financial stability; regulatory tools – especially capital requirements but also liquidity risk assessment for those products like Variable Annuities, where insurers provide guarantees and thus provide greater access to liquidity to savers than the investments made by the insurer offer or where they undertake Securities Lending; and effective recovery and resolution planning. The message is that there is no substitute for effective on the ground supervision at the firm level. Macro-prudential measures are a welcome complement, not a substitute, and should be used when the risks demand them.

By its nature, in terms of the limited threat to the broader financial system, effective supervision is more likely to be the normal approach to insurance. Let me spend a few minutes illustrating this with a current example, namely the PRA's approach to reserving in general insurance. Recently, we have written to firms noting that competitive pressure within many sectors of the general insurance market remains high, and many parts of the industry show signs of being in the soft part of the insurance cycle. In the face of increased pressure, some firms have chosen to lower their premium rates, extend the terms and scope of cover offered, or weaken their underwriting selection criteria to protect their market position.

The claims environment has also been challenging: claims inflation, claims frequency and severity, have seen an increase in some lines of business, and there has been continued growth in some particular areas which give rise to reserving uncertainty such as periodic payment orders and asbestos claims. All of these aspects have the potential to increase the risk of mispricing business and/or weakening the reserving basis beyond what is adequate.

At the same time that firms have experienced pressures with current underwriting conditions, many parts of the industry have reported high levels of prior year reserve releases in recent years. Where firms are using prior year reserve releases to support current financial results, such releases should not deplete overall technical provisions beyond a level which is prudent.

The PRA requires firms to set adequate technical provisions. In so doing, it expects general insurers to have a robust approach to the setting of reserves and to put in place appropriate and adequate oversight of reserving processes.

More specifically, the PRA expects general insurers to pay particular attention to the need to:

- understand the key issues and sources of material uncertainty in the reserve-setting process, and how these may impact the reserving basis, in order to make informed decisions on reserve levels;

- be able to demonstrate strong governance around the reserve-setting process. For example, firms are expected to be able to explain how they have sought to ensure an adequate degree of independent challenge or peer review of the key assumptions in the reserving basis, and to be able to articulate a clear rationale for the management booked reserve;

- ensure that the level of reserving strength is monitored and reported to the board over time, such that the board can take appropriate and timely action, if required;

- assess whether an unexpired risk provision needs to be established. This is particularly relevant under current market conditions;

- have regard to the underwriting, reserving and economic cycles when setting reserves;

- ensure clear feedback loops exist between underwriting, claims and reserving; and

- have regard to data quality and consider how any data limitations might impact firms' reserves.

Reserves from prior years have in some cases been used by firms to offset poor underwriting year/accident year results. However, the PRA will question the robustness of the underwriting practices at firms that rely unduly on prior year reserve releases to support ongoing underwriting activity for any sustained period of time.

Given the pressures on firms' performance caused by current market conditions, firms should be aware that the PRA is placing increased emphasis at present on gaining assurance over firms' reserving. As part of regular supervisory interactions, firms should stand ready to demonstrate the robustness of their reserving governance frameworks, and the adequacy of reserve levels. Firms should expect supervisors to make use of some or all of the tools outlined above to provide the PRA with assurance in this area.

This example of reserving is a good illustration of the importance of judgemental supervision of insurers. It does not presume a system-wide risk or reaction even though the root causes are often common.

That said, we have learned the importance of establishing and maintaining the overall stability of the financial system the hard way during the crisis. So, it is important to ask whether there are aspects of the activity of insurers which fall into that broader macro-prudential category?

At the end of last year, UK insurers held just under £1.8 trillion of assets (equivalent to 110% of 2013 UK GDP). Life insurers represented the largest share, with around 85% of those assets. Consistent with the long life of contracts and the predictable payment streams, long-dated and illiquid assets form a substantial part of the holdings of life firms. An important macro-prudential question is therefore whether there is excessive procyclicality, defined as investing in a way that could exacerbate market movements and contribute to asset price volatility. Thus, if insurers were in aggregate to react in a procyclical manner in response to a negative shock to asset prices, forced selling of risky assets in downturns could put additional pressure on financial markets.

A number of factors influence the asset allocation behaviour of insurers, including liability characteristics, regulation, accounting and valuation methodologies. The evidence of whether insurers have behaved procyclically in the past is mixed. There was evidence of shifts in asset allocation in the dotcom crash of the early 2000's, but in the more recent financial crisis procyclical behaviour was less evident. One response to such events is regulatory flexibility to alleviate the "forced" element of selling. But this is not a policy that is best applied on a case-by-case, either for firms or asset classes, basis. It requires careful thought to understand the impact on the incentives for risk-taking in choosing the assets in the first place. Solvency II is important in this context because the Volatility Adjustment mechanism that it enables should be used with care. Hence there is a good argument for a macro-prudential response in such a situation. Such a framework would provide insurers with more clarity on the conditions under which regulatory action would be taken. Macro-prudential tools can have the important benefit of reducing the uncertainty of policy intervention, and the costs associated with that uncertainty.

I have used this case as an illustration of a potential macro-prudential tool of relevance to insurance – but in doing so, let me be clear that it is no more than an illustration; while it should be on the menu it is not something under consideration for active use at the moment.

The final area of policy in which the role in relationship to insurance needs to be defined carefully is resolution. Special resolution regimes, which exist increasingly for banks, are powerful tools in that they enable the resolution authority to change property rights outside the framework of normal insolvency law. They should therefore be used only when absolutely necessary.

The normal approach for dealing with an insurer that ceases to write new business is to put it into a so-called solvent run-off, whereby the authority to write new business or take new premiums is withdrawn, and liabilities are paid out as they fall due – which can be over a very lengthy period. As with some banks, insolvency can also be an appropriate means of winding down and liquidating some insurers, alongside an Insurance Guarantee Scheme (IGS) to compensate covered policyholders. In the UK, these arrangements have been successfully used in past cases of small and medium sized insurers, and run-off has been used to manage the failure even of large life insurers such as Equitable Life. In fact one third of insurers authorised by the PRA are in some form of run-off.

But the prospective insolvency of a larger insurer could in some circumstances carry the potential to create risks to financial stability that make it an unsuitable means of dealing with failure. This has been recognised in the FSB's designation of Globally Significant Insurers (G-SIIs) and in the revision of the FSB Key Attributes of Effective Resolution Regimes to explain how the key attributes should be applied to insurer resolution regimes.

The insolvency of an insurer could have indirect consequences for financial stability through the risks policyholders are exposed to. These could arise principally from disruption to the continuity of insurance cover for critical financial services functions and to payments to policyholders caused by a creditor moratorium in insolvency. As in any insolvency, there will be disruption and potentially lengthy delays whilst the court-appointed insolvency administrator conducts a valuation and the courts hear applications and deliver directions.

Payments from insurance products may be critical when individuals rely on them as a primary source of current or future income, whether to meet general living expenses (as in the case of the annuities market in the UK) or to mitigate individual costs, such as healthcare costs.

Certain types of insurance can be required in order to conduct specific economic activities. When an insurer enters insolvency these economic activities may come to a standstill until replacement insurance can be arranged and there may be a lack of substitutability in certain specialised insurance markets (e.g. medical, legal, construction, aviation etc).The adverse consequences could lead to pressure to bail-out an insurer rather than letting it enter insolvency. Such pressure can of course also arise where there are concerns about policyholder protection.

In addition, there are financial stability risks that could arise due to shortcomings in an insolvency regime. Illiquid assets may be sold at fire sale prices in response to a policyholder run or liquidity risks can arise associated with derivatives and short term funding.

The insolvency of an insurer with a large derivatives book or repo/securities lending program will represent an event of default under the terms of most financial contracts. This could trigger close-out by counterparties of their positions, destroying value and imposing greater losses on policy holders and/or the Insurance Guarantee Scheme.

The revision to the FSB Key Attributes indicates that special resolution powers should be available to respond to these risks. Such powers could, for instance, enable the rapid transfer of insurance business to enable the preservation of continuous cover. But, to repeat my earlier point, the case for these powers must be made on the basis of the position and risks at insurers, not of banks, or any other entities for that matter.

In conclusion, insurance is a critical financial service supporting economies and societies more broadly. The critical nature of the service supports the case for firm level regulation to promote the safety and soundness of insurers and the protection of policyholders. Micro-prudential regulation of this sort should be complemented, but not substituted, by the use of macro prudential tools where appropriate. The risk of procyclical asset liquidation by insurers in response to sharp asset price corrections could be one such case where macro-prudential tools are warranted, but I use that as an illustration rather than a statement of need today. And, there is a case for enabling special resolution powers in respect of insurers. But, all of these interventions must be justified by the risks run by insurers.