BANK OF ENGLAND

Speech

Global systemically important insurers: issues, policies and challenges after designation

Speech given by

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Good afternoon – and thank you for inviting me to speak here today.

The panel is focusing on issues and policies affecting global systemically important insurers (G-SIIs) after designation - and I've been asked to focus specifically on challenges. But before I do, I'd like to take a step back and first set the scene - in my capacity as Chair of the Financial Stability Committee (FSC) - for the work that the International Association of Insurance Supervisors (IAIS) is delivering, and why it is so important.

The financial crisis underscored the disruption that individual financial institutions can cause to the wider financial system and real economy and has amplified our appreciation of the risks that firms in the financial sector pose to each other.

The insurance business model enabled the insurance sector to weather the effects of the crisis better than some other financial institutions. This is largely because the underwriting cycle is, in general, not correlated with the business cycle; in particular, the inverted production cycle – the upfront accumulation of premiums and the deferred nature of payment of liabilities - means that insurers are unlikely to fail in the same way as banks.

However, where insurance groups engage in activities that expose them to active developments or movements in financial markets, they become more susceptible – and can indeed contribute – to systemic risk. For insurers, these types of activity have been termed NTNI, or non-traditional non-insurance, by the IAIS as part of its work on systemic insurers and reinsurers.

The "non-traditional" element captures business where the promises made by an insurer can only be met through extensive use of market instruments. Non-traditional business includes those products with credit related exposures, e.g. credit-default swaps (CDS), or other activities which involve maturity transformation.

Many large insurers are also part of groups offering other financial services so it is appropriate that the IAIS methodology captures the risks arising from "non-insurance" business too.

Against the backdrop of work being undertaken by the Financial Stability Board (FSB) on the threats that financial institutions can pose to the financial system, the IAIS has developed an initial methodology for the designation of G-SIIs. This methodology is transparent in its differentiation of risks posed by traditional insurance vs. non-traditional and non-insurance business. This makes clear that whilst traditional insurance is not considered to introduce a significant degree of risk to financial stability, potential does exist for NTNI risks to build up and threaten the global system. So whilst size and global presence are important considerations for G-SII designation, the methodology is clearly driven by two factors – namely interconnectedness and NTNI – which are, as a consequence, heavily weighted in the scores.

Of course some will argue that insurers are different from other global systemically important financial institutions (G-SIFIs) and that they don't pose risks to the financial system in the same way – in fact, I'm sure some of you here today will hold this view. But the failure of an insurance group can have significant effects on the real economy – and this is true of both life and general insurance business. In an increasingly globalised financial sector, there is a genuine interconnectedness between insurers and the rest of the financial system. But regardless of the many and varied opinions on this matter, what I think is important is that the FSB has clearly determined that specific measures are necessary for those firms that have been identified as systemic.

As part of the FSB's announcement on G-SIIs last July, the IAIS was asked to develop additional policy measures for G-SIIs that will identify and mitigate the risks to financial stability. This will be achieved through effective supervision, enhanced resolution and higher loss absorbency requirements. On enhanced supervision, there is already a great deal of increased co-operation between supervisors in colleges and other fora. Meanwhile the establishment of crisis management groups marks a first step towards more effective management of insurance resolution, and this work will continue throughout the coming year.

Higher loss absorbency (HLA) requirements will aim to capture the risks associated with NTNI business. Since there is no universal foundation for HLA requirements, the IAIS will first develop a Basic Capital Requirement (BCR) which will serve as a global basis to which HLA can be consistently applied.

Significantly, the FSB also considers a sound capital and supervisory framework for the insurance sector more broadly to be essential for supporting financial stability. The Insurance Capital Standard (ICS) will achieve this objective and is intended to be a more sophisticated, risk-sensitive measure. It is simply too early to comment on the likely interaction of the ICS with other measures under development – at this stage, the ICS could include some, all or none of the elements eventually agreed for the BCR.

As a consequence, a large programme of work now lies ahead for the IAIS – which will likely include further refinement to the approach in what is a continually evolving policy landscape. The timetable set by the FSB is certainly challenging – not least for the BCR - but I believe it is achievable. So before I turn to the challenges we face in the immediate future, I want to first outline the areas of common ground – for it is often easy to overlook the areas on which we already agree.

The concept of consolidated group supervision is one which is already familiar in many jurisdictions and there appears to be a growing appreciation of the merits of holistic group supervision. Indeed, the Financial Stability Oversight Council (FSOC) process in the US now tasks the Federal Reserve with the consolidated supervision of domestic systemic insurers. This point is especially relevant in the context of G-SIIs where oversight of the entire group is essential if we are to fully understand the risks both within, and emanating from, the group to the wider system.

If you agree that consolidated group supervision is the best way in which to supervise large internationally active groups, a natural consequence of that view is a belief in a comparable solvency regime. Of course, I recognise the challenges associated in the development of such a regime given the multitude of different accounting and regulatory practices that exist. But in lieu of full convergence across jurisdictions, the IAIS must consider what progress can be made in those areas where treatment is most different.

I think the key issue preventing comparability and a common valuation approach is the determination of a liability valuation. There are two key considerations here – margins and discount rates.

What is clear is that the approach to liability valuation is similar, in essence, across many jurisdictions and, invariably, includes a technical calculation of the provisions needed to meet (future) claims – on top of which further margins are added to reflect prudence, accounting rules and other considerations. The second area of difference among insurers is the different approaches taken to discounting liabilities, using valuation interest rates.

The IAIS has therefore proposed an approach for the BCR which takes an insurer's best or current estimate of their liabilities. Importantly, this strips out any additional margins to create as close to an objective and technical assessment of the liabilities as is possible.

In addition, the IAIS will test four different approaches to the discounting of liabilities. The testing of different approaches, including the use of market-adjusted techniques, is essential if we are to truly understand the range of risks arising from an insurer's balance sheet at a particular point in time.

In adopting this consistent approach across different jurisdictions, we stand the best chance of collecting data that is comparable amongst insurers and which can be used to develop a BCR that is meaningful and credible on a cross-border basis.

The field testing that the IAIS launched last Friday (21 March) therefore requests an insurer's best estimate of liabilities on four different bases in order to test the impact of various valuation approaches. The request covers statutory and accounting balance sheets – but also captures economic and market-adjusted valuations. In many cases, I know that that these balance sheets are already produced and utilised by insurers.

Part of what I've been asked to talk about today is the challenges associated with the IAIS' work on G-SIIs so I'd like to now touch on where we are in the policymaking process. The IAIS issued the first of two public consultations on the BCR last December and has been actively engaging with and receiving feedback from industry participants over the past few months – be it through consultation comments or direct participation by firms in IAIS observer sessions.

In addition, and since assuming my role as Chair of the FSC, I have now met personally with senior management in the vast majority of G-SIIs directly affected by this work. So I think it's fair to say that, despite the tight timeframe in which these policy measures are being developed, the IAIS has committed itself to being transparent and proactive in listening to the views and, indeed, concerns of industry.

Since the data captured during field testing will be used to inform the overall BCR calculation, it is equally important that firms are given an opportunity for their voice to be heard. I should also reiterate that we are still in the policy development phase so I fully acknowledge that the IAIS field testing exercise will be completed on a "best efforts" basis.

But there is one point on which I must be very clear. The use of a best or current estimate by all firms in determining the value of an insurer's liabilities is essential if we are to develop a capital measure which is globally consistent.

And I want to be absolutely candid with you that this exercise is not about Europe imposing Solvency II on the rest of the world. Of course I think that Solvency II is rooted in many valuable and relevant principles. But I have said it before, and I will repeat it once more because it is important – I genuinely believe that we must shape, but also be prepared to be shaped by others, in developing global insurance measures.

Before I conclude, I should add that I think the IAIS – as the international standard setter for insurance supervisors – is uniquely placed to deliver on this body of work. Indeed, the thinking on the BCR has already progressed a great deal in the past few months and we now enter the field testing phase with a clearer idea of how the BCR calculation will be framed.

Of course several elements contained within the BCR can only be decided upon once the data collected has been analysed. And I am aware that there are aspects of the evolving framework which remain unclear. But I am confident that the IAIS will be able to provide views on many of the outstanding issues once the BCR has been fully developed.

I think it's fair to say that a considerable amount of work has been undertaken since last July and we have achieved a great deal in that period. I recognise the efforts of both the industry and regulatory communities in getting us to this point.

But what has got us here will not take us to the end destination. It is clear that we have much to achieve in the next few months and that our work in developing global standards for insurers will not stop with the BCR. I look forward to continuing this work with all of you in the future.

Thank you.