BANK OF ENGLAND

# Speech

## Looking out for the policyholder


Speech given by

Sam Woods, Deputy Governor, Prudential Regulation and Chief Executive Officer, Prudential Regulation Authority


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I will begin this speech with a bold claim: insurance regulation is fun!

This is just as well, because it is half of what we do at the PRA. Parliament very wisely decided to put prudential regulation of banks and insurers together in one institution following the financial crisis. I think this works very well, because there are many synergies. Both sectors provide critical services to the real economy, bringing customers' money directly onto their balance sheets. And I would argue, for instance, that the basic qualities which make a good chairperson aren't materially different between banking and insurance.

But there are also very big differences. An annuity writer is nothing like a building society. London Market underwriters I have sat next to do a very, very different thing to what goes on in banks. The eighty actuaries we employ as part of our insurance division speak a different language from our risk specialists sat on the floor above them at 20 Moorgate.

Much of the time, this insurance activity goes on underneath the radar, relative to banking. But in recent months, the spotlight of the Treasury Select Committee (TSC) has swung onto this area, and we have all been enjoying the debate! Many hours have been spent highlighting the biblical scale of the reporting requirements, the wickedness of the risk margin calculations, the mystical nature of the Ultimate Forward Rate…I could extend this list tenfold. Then we have had a rather more pointed exchange about whether we at the PRA have been over-zealous in our implementation of Solvency II, perhaps damaging competition, or making life too difficult for insurance companies, or denying the nation of vital new infrastructure by being too cautious about insurers' investment strategies, or all three!

All of these are important topics, and in the course of the debate I am as guilty of focusing on them as anyone else. Indeed, I will double-down by talking about some of them again today. So for those of us inside the insurance beltway, this is a very useful and timely debate and I think it is a great thing that the TSC has taken an interest. Can we make our implementation of Solvency II work better? In my opinion, despite some inevitable differences of view, there is in fact a strong degree of agreement between us, the TSC and the industry about the answer to that question.

**Where is the policyholder?**

However, in all the blizzard of insurance and regulatory jargon, I think something has been missing from our discussions. Where is the policyholder? Through our statutory objectives, Parliament has asked us to look out for the policyholder – but in an environment where insurance is provided by private sector firms. This means that other actors – particularly firms' management, employees, shareholders and creditors – have an important role and a valid claim on our deliberations. As the regulator we need somehow to balance these various interests as best we can, but we do have a particular duty to represent the interests of the policyholder.

How should we go about delivering this responsibility? The best way into that question is to ask another one: why do we bother to regulate insurance companies at all?

We all in this room probably take for granted that we need prudential regulation of insurers; but every now and then I think it is worth reminding ourselves why this is so.

Insurance comes in many different forms and many people rely on insurance for their livelihoods. Some rely on insurance proceeds to ensure they have a comfortable retirement. Some rely on insurance pay-outs following a serious accident, for example from a workplace injury or a car crash. Insurance allows us to go about our daily lives secure in the knowledge that there is a financial safety net should we get into trouble. And this is a huge business – for instance, in the UK there are around 6 million pension annuities in force and around 27 million motor insurance policies.[1]

We give money to insurance companies trusting that they will make good on their promise to us, in the event that an insured risk crystallises. 'Trust' is the key word here, as many people cannot reliably assess whether an insurer will be able to fulfil its financial promise if the need ever arises. It can be very expensive to switch insurers and so people can find themselves 'locked in' with the same insurer. And depending on the nature of the contract and claim, it may be months or years before a claim either arises or is fully settled.

Even if they do have the right information, it would be unreasonable to expect individuals to be able to exert a strong disciplining effect on insurers. Even the best-informed retail policyholder would not be able to make sure that an insurer holds adequate reserves to pay claims, that it does not grow excessively by taking on too much risk, or that it does not under-price in an unsustainable manner to attract new business.

We have seen the significant human cost that can be associated with insurance failures. A prominent example is the fate of over a million policyholders when Equitable Life came to the brink of collapse in 2000. Equitable was forced to close to new business, after it found it could no longer honour its promises on offering guaranteed annuity rates on its products. Many of its customers, aged 75 and over, had invested their life savings into these products but were left with significantly reduced retirement income. Ten years later, the Government agreed to pay compensation amounting to £1.5 billion. But many policyholders and their families suffered over the decade when their fate remained uncertain, and some of those affected were no longer alive to benefit personally from the compensation.

Another way to think about this is to consider the importance, at a human level, of what insurance companies do – and therefore, how we would feel about it if an insurer couldn't make good on its promises. Much of this is about the everyday business of work, family and home, and I have spent some time this year with policyholders to remind myself of this. The most striking thing about talking to a group of policyholders is simply the vast range of insurance needs people have, from burst pipes to with-profits funds. One is also

[1] Based on ABI data, as at end 2016.

struck by how complex people find insurance, and some of the different experiences that can arise. One person I spoke to had a really excellent experience with a UK home insurer. Another's family had been injured in a motorway pile-up, and was having terrible difficulty trying to find out if the non-UK insurer of the driver who had hit them is or is not solvent. I also spoke to a group of small business owners, and was struck by how reliant many of them are on insurance for running their businesses. One of them was held liable for another company's goods damaged in transit, and would have gone bust if it wasn't for the insurance pay-out.

I also remember another case. A middle-aged woman suffered a brain tumour, and became unable to work as a result. Her chief concern was not her own well-being, but a crushing fear that – given her lost income – her son would no longer feel able to go to university, without a bit of financial support from her. It all hung on whether the insurance company would pay out on her term assurance policy. It was a very, very intense moment when this insurance company called her to explain that they would indeed pay out. When you hear the huge relief of people when an insurance company comes through in their hour of greatest need, you realise two things: how important this industry is, and how important it is that insurance companies are safe and sound.

But this is not only a life insurance issue. General insurance also serves a very important role, and similarly when things go wrong the consequences can be severe. A string of high-profile failures in the 1960s and 1970s included the failure of Fire, Auto and Marine, which left 400,000 (mostly motor) policyholders uninsured, and an even bigger failure in 1971 when Vehicle & General, with 1.2 million policyholders, collapsed. You can imagine the chaos this caused, even on the scale of the 1970s. And a couple of decades later, many companies and individuals suffered when things went wrong in the Lloyd's Market. Events like these, resulting in part from poor regulation, of course do great harm to the UK's reputation as a good place to do insurance business.

A more extreme event still was the failure of HIH Insurance in 2001 in Australia. About 200 permanently disabled people claiming on salary continuance policies with HIH stopped receiving their regular payments, which they often relied on for day-to-day living expenses. Thousands of holders of professional indemnity, public liability, home warranty and travel insurance policies found themselves uninsured for claims made by or against them. And almost AUD$ 2 billion of construction activity was put on hold whilst replacement builders' warranty insurance cover was sought.

This illustrates the fact that we particularly need to be mindful of innocent third parties who don't actually buy insurance policies, such as the victims of motor accidents and employees who suffer workplace injuries or illnesses. Such covers are compulsory and the motorists and companies who buy them are even more likely to select the lowest price. Without regulation, that would present an obvious opportunity for unscrupulous insurers.

You will notice that I have not mentioned the most spectacular insurance failure of all – that of AIG in 2008, which played a significant role in the financial crisis. Of course we need to keep an eye on the financial stability of insurance activity, but this omission is deliberate. Our chief day-to-day concern with insurers at the PRA is safety and soundness and policyholder protection.

**Competition and competitiveness**

In this context, let me turn to the one element of the current debate about Solvency II – whether we've been over-zealous in implementation and not taken enough heed of competition and/or competitiveness. So what does our secondary competition objective require of us? And what have we actually done?

In 2014, the PRA was given a secondary objective to facilitate effective competition. This helps inform decisions about new regulation and supervision policies. It influences how we choose between alternative ways of achieving our primary objectives, provides a useful check on whether prudential interventions are being applied proportionately, and guards against the risks of unintended consequences. This is a useful, and very British, innovation.

In support of our competition objective on the insurance side, we have taken a number of steps to achieve a better fit between regulation and firms' particular business models, fostering a UK market which comprises a very wide range of businesses, by size and line of business. For example:

- We have approved many more internal models than any other EEA jurisdiction. Small as well as large firms are able to use internal models: of the 23 internal models approved to date, 8 were for smaller firms.
- More generally, we have issued over 700 approvals and waivers under Solvency II; many of these allow for alternative approaches to calculating technical provisions and capital requirements. We have made full use of the flexibility within Solvency II to tailor regulatory requirements to the wide range of different insurance business models present in the UK.
- We have set out our proposals to reduce the reporting burden on firms. Of the part of the reporting package that is within the PRA's gift to change, our proposals would reduce the required reporting by up to half.
- We have implemented a streamlined and tailored regime for the smallest firms, representing 35% of the firms we regulate, that fall outside the scope of Solvency II.
- We continue to support new firm authorisations, having authorised 26 new insurance firms since 2013. Furthermore, we are exploring how we might improve our current authorisations approach to facilitate the entry of new insurers.

Some have expressed concern that the PRA's focus on prudential matters may inhibit competition. I would argue that the opposite is true. Prudential regulation is integral to competition. Without minimum standards, policyholders would be much more exposed to the risks presented by imprudently run firms. An absence of prudent standards would enable less scrupulous firms to drive out better-managed firms by engaging in unsustainable pricing practices in order to gain a greater market share. This perversion of competition could lead to the failure of insurers to pay out claims and reputational damage to the wider UK insurance market.

The collapse of a large insurer would also lead to higher prices for new consumers. This is because the Financial Services Compensation Scheme would need to be replenished by the surviving firms, who would in turn pass on these costs to their customers. Robust prudential standards underpin the sustainability of the fund and reduce the potential need for taxpayer funds to compensate policyholders following a failure, as we have seen in the past.

I am not therefore persuaded of the case for giving a primary competition objective to the PRA. This would likely require the PRA to pursue competition as an objective in its own right and enable it to use its powers for that purpose alone. It's difficult to say what specific activities this would entail for the PRA. Potentially, the PRA would be given the same competition powers that sit with the FCA, allowing the PRA to undertake market studies with a view to introducing new rules with the specific aim of promoting competition. Given the potential for overlap with the FCA and the CMA, which both have specific objectives to promote competition, I would be wary of taking this route.

Our secondary competition objective refers to competition, not competitiveness. This is an important distinction. Competitiveness is usually taken to mean a firm's ability to compete on cost or quality grounds. Competition includes wider factors, for example: the range of firms competing in the market; barriers to entry, expansion or exit; and incentives to innovate and compete. But the two concepts are linked; competition is what drives innovation and ultimately drives productivity and long-term competitiveness. On the other hand, measures designed primarily to make one part of the market more competitive than another, through measures that favour one group of firms over another, will reduce innovation and productivity and be damaging in the long run. So facilitating competition brings the right type of competitiveness.

Fresh in the memory is an example of how we have had regard to competitiveness, as required in the Chancellor's letter to the PRC[2]. We worked closely with HMT, the FCA and industry to design a new, commercially viable framework for Insurance Special Purpose Vehicles (ISPVs).[3] Given growth in the insurance linked securities (ILS) market, this is a good opportunity for the UK as we are one of the first Solvency II jurisdictions to have done this. The framework went live in December 2017 and very shortly thereafter the PRA authorised its first ILS vehicle.

[2] In March 2017, the Chancellor of the Exchequer sent a letter to the Governor of the Bank of England recommending that the PRA should have regard to considerations including: competition; growth; competitiveness; innovation; trade; and better outcomes for consumers.

[3] ISPVs are the vehicles central to the structure of insurance linked securities which provide (re)insurers an alternative, capital markets-focussed form of risk transfer to traditional reinsurance products. It is a growing and particularly innovative market, often able to offer (re)insurers more attractive terms.

**Solvency II reform**

Even though insurance regulation is fun, I would love to finish this speech without a long technical section on Solvency II. The good news for you here in the room is: we will set it all out in our report to the TSC, so I will spare you the detail.

When it comes to Solvency II, it pays to see the woods for the trees. Let me briefly address a couple of myths.

First, there is simply no evidence to suggest that the introduction of Solvency II has crushed the profitability or growth of UK insurance companies. Over the two years following the introduction of SII, assets in the UK insurance sector grew by more than 10%. Returns on equity for larger UK insurers have remained steady at above 9%, close to the levels seen on average since 2010. And UK life insurers' average credit default swap premium fell from 70 basis points on 1 January 2016 to 47 basis points on 6 February 2018.

Second, there is no convincing evidence that Solvency II has driven up prices for UK insurance policyholders. On the general insurance side, average motor and household premiums and changes in premiums were not in our assessment affected by the introduction of Solvency II. In both motor and household, rates hardened in 2015 due to greater loss experience, and UK motor insurers were particularly affected by the reduction in the 'Ogden rate'[4]. Risk-free market interest rates and corporate bond spreads continue to be the dominant driver of annuity prices – this relationship does not appear to have changed since Solvency II came into effect. The limited impact of Solvency II on pricing should not surprise us, given that the running costs of the new regime represent 0.07% of insurance premiums[5] in the UK, which you could think of (for instance) as 35p on an average motor policy premium last year of £493.

As we get more experience of operating Solvency II, however, it is right that we make our implementation of the directive work better. That means, for example, reducing unnecessary costs and complications which have no prudential benefit.

We are therefore consulting on an extensive package of reforms for the part of the Solvency II framework over which we have discretion. We are making a series of proposals to give firms greater confidence in using the MA. We propose to reduce the amount of time firms (and we) have to spend on discussing and agreeing minor changes to internal models. And we will cut reporting requirements, particularly for smaller firms. On two further points – dynamic volatility adjustment and the risk margin – we are still working and will respond to the TSC in due course. On the risk margin we will act to tackle the problems we, the industry and the TSC have agreed exist.

[4] From 2.5% to -0.75%. The Ogden rate is used to discount future liabilities for personal injury and fatality claims.
[5] Based on 2016 data.

But let me be clear: we are not going to go soft. We can tell the difference between feedback about a genuine technical flaw and generalised lobbying for lighter-touch regulation. And we will continue with our forward-looking, judgement-based approach to supervision – which will inevitably mean that conflicts with firms sometimes arise. This is inherent in a system in which a regulator is charged with pursuing the public interest through the activities of privately-owned firms.

In that spirit, let me say a few words about the Matching Adjustment (MA). Allowing insurers to capitalise an illiquidity premium has long been a feature of the UK regime. It makes sense and we fought hard to get it included in Solvency II. It delivers a massive benefit to those insurers that use it – £66 billion in capital which is the difference between those firms being at 155% of their capital requirement and 65% of it.[6]

Given the size of the benefit, we should all want to handle this part of the regime very carefully. We are applying particular scrutiny to two areas: first, the internal ratings and spreads on direct investments in illiquid assets, particularly the senior tranches of internal securitisations; and second, the use of financial restructuring to bring new assets within the MA. We have accepted internal securitisations as a means to achieve fixed cash flows. But that does not alter the requirement that the underlying assets must match the maturities of the annuity liabilities. We will of course take a careful and prudent approach to all such activity. We have made a series of proposals to give firms greater confidence about which assets can attract MA, and how we will deal with any breaches. But my message to the firms is: if we ended up in a position where the MA's fundamental credibility was undermined for the sake of a few marginal items, we would all regret it immensely. Collectively, we need to remain on a sensible path.

**Conclusion**

I began by making the claim, which might sound somewhat outlandish to the uninitiated, that insurance regulation is fun. It is! But it is also a deeply serious business, precisely because the insurance industry plays such a vital role in society.

I hope you will see from our response to the TSC that we at the PRA – right up to and including the Prudential Regulation Committee – have been putting a lot of effort into this package of reforms, which are needed in order to make Solvency II work better in the UK. But we haven't done this in a regulatory ivory tower. We have always engaged closely with industry – through our membership on various ABI working groups, our frequent meetings with firms and our close analysis of comments we receive through public consultations. However, we acknowledge that the challenge of Solvency II implementation may have crowded out space to engage with the industry and stakeholders on other strategic issues. We have therefore decided to go further, and with Martin Gilbert's agreement we are launching an insurance sub-committee of our Practitioner Panel in order to free up more space for discussion focussed on insurance issues.

[6] Based on Solvency II data, as at end 2016.

It's important that we get insurance regulation right.  At this juncture, that means two things in particular.

First, the TSC has rightly highlighted aspects of Solvency II which are not working well.  We are taking forward reforms to address those issues at a good pace.

Second, we need to maintain high standards of safety and soundness for UK insurers – not primarily for financial stability reasons, but in order to ensure an appropriate degree of protection for policyholders.