Mark Carney: Putting the right ideas into practice

Speech by Mr Mark Carney, Governor of the Bank of England and Chairman of the Financial Stability Board, at the Institute and Faculty of Actuaries General Insurance Conference, Wales, 25 September 2014.

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Introduction

It is an honour to be invited to address you today. Insurance is at the core of the new Bank of England.

As regulator, we are tasked with ensuring the safety and soundness of the UK's insurance companies and the protection of their policyholders. To discharge these responsibilities, we draw on the entire resources of the Bank.

Fully one third of our regulatory staff – over 200 supervisors and 50 actuaries – are engaged in supervising insurance companies. But that is just the start.

Our supervisors are supported by hundreds of credit risk analysts, scores of monetary policy experts and macro-financial analysts.

As a central bank with responsibilities for both monetary and financial stability, we have a view of both the asset and liability sides of your balance sheets.

And as a highly active participant in global financial reform, we influence the measures that are reshaping the global system.

In all of our actions, we recognise the importance of insurance to the economy. The UK insurance industry makes a major, direct contribution: £25bn to annual GDP and 300,000 high-paying jobs including many of the 14,000 members of the Institute & Faculty of Actuaries. It is a major exporter with about 30% of premiums earned overseas. And the Lloyd's market underlines London's status as a world centre for insurance excellence and innovation.

But the economic contribution of insurance goes much deeper. By spreading and managing risks, it increases the resilience of corporations, investors and financial institutions. It makes entrepreneurship and trade more viable. And it safeguards companies and individuals from perils they could not otherwise shoulder.

From a financial system perspective, insurance companies play a vital role in the efficient allocation of capital. By matching long-term savings and investment, it finances the infrastructure essential to build our economy. The long-term perspective of insurance companies diversifies the financial system and reinforces its resilience.

The contribution of the UK insurance industry can't be taken for granted – especially in a macro-financial environment that challenges traditional business models.

Challenges from the macro-financial environment

Of course, relative to the recent past, the economic outlook is much improved. The UK has experienced the strongest growth in the G7 over the past year. Job creation has been the quickest on record. Inflation has fallen below target having been above for most of the past five years.

With many of the conditions for the economy to normalise now met, the point at which interest rates also begin to normalise is getting closer. In recent months the judgement about precisely when to raise Bank Rate has become more balanced.

While there is always uncertainty about the future, you can expect interest rates to begin to increase.

We have no pre-set course, however; the timing will depend on the data.

Moreover, the precise timing of the first rate rise is less important than our expectation that, when rates do begin to rise, those increases are likely to be gradual and limited.

Why does the Bank expect this to be the case? In part, because the headwinds facing the economy are likely to take some time to die down. Demand in our major export markets remains muted. Public balance sheet repair is ongoing. And a highly indebted private sector is likely to be particularly sensitive to changes in interest rates.

Over the medium term, several dynamics are likely to keep rates lower than in the past. UK rates could be restrained by continued imbalances between global saving and investment, together with potentially lower rates of global productivity growth. Central banks can also be expected to accommodate with lower risk-free rates the higher spreads that are likely to result from new regulatory requirements.

All of these factors likely mean that, even when spare capacity is used up, Bank Rate will need to be materially lower than in the past in order to keep the economy operating at its potential and inflation at its target.

The Bank is well aware that a prolonged period of historically low interest rates could encourage other risks to develop. In the UK, the biggest risks are associated with the housing market, which is why last spring the Bank took graduated and proportionate actions.

We are also alert to the possibility that financial markets may be mispricing risk. As the FSB concluded last week, "there are increased signs of complacency in financial markets, in part reflecting search for yield amidst exceptionally accommodative monetary policies. Volatility has become compressed and asset valuations stretched across a growing number of markets, increasing the risk of a sharp reversal."

In such circumstances, insurers' proven ability to look through such short term volatility is invaluable.

Nevertheless, an abrupt correction in term and risk premia could have a sharp impact on the valuation of securities that are marked to market and reduce the effectiveness and availability of proximate hedging strategies.

More fundamentally, by squeezing margins, persistently low interest rates challenge business models. Insurers feel this pressure on both sides of the balance sheet: through muted investment returns; and as long-term obligations to policyholders – most common for life firms but increasingly relevant to general insurers that have Periodic Payment Orders on their books – become more expensive in today's terms.

An understandable response would be to move towards less traditional types of investments – such as infrastructure; into new or more complex types of business – like telematics pricing; or into new geographies like emerging markets.

All these strategies bring new risks that must be well understood and prudently managed.

Low rates are encouraging inflows of external capital into sectors like reinsurance. In effect, a "soft cycle" in financial markets is reinforcing a "soft cycle" in insurance – a particularly problematic combination.

More capital boosts market capacity, but can also test underwriting discipline.

Putting the right ideas to work

As supervisor, the Bank of England is monitoring closely how these new risks are being managed and how your business models are evolving.

At the same time we'll be implementing reforms.

Reforms to promote a more resilient insurance sector without standing in the way of an effective insurance sector, and without imposing unnecessary impediments on your ability to evolve your business models in response to the challenges I described.

To borrow the theme of this conference we will be "putting the right ideas to work".

Today I want to highlight three of them:

- Tailored, consistent and robust capital standards;
- Holding the right people to account; and
- Global standards for globally systemic insurers.

With those right ideas, we are promoting a resilient, innovative insurance industry that supports the real economy.

Right idea 1: tailored, consistent and robust capital standards

The first right idea is to implement tailored and consistent capital standards to ensure the safety and soundness of insurers.

Resilience against unexpected losses requires risk-based capital standards and robust valuation practices.

The UK's Individual Capital Adequacy Standards deliver this and were one reason why the UK's insurance sector weathered the crisis so well.

The Bank of England wants the principles behind ICAS to be applied as widely as possible; to establish as level a playing field as possible.

That is why we support Solvency II. It embeds across Europe the core principles necessary for sound regulation, namely:

- appropriate market-based valuation methodologies;
- a comprehensive measure of risk and solvency covering all group activities; and
- capital resources of an appropriate quality to absorb loss.

Solvency II is the biggest change to insurance regulation in a generation, and it will be live in just over a year. While our shared history with ICAS means the UK insurance industry is relatively well placed, we must not underestimate the scale of the challenge.

Even the standard formula, which nine out of ten UK insurers will use to determine their solvency requirements, is significantly more advanced than the Solvency I approach it replaces.

Although more demanding, we have worked to ensure the standard formula does not impede your provision of long-term finance to the real economy. Steps have been taken to make Solvency II more accommodative of securitisation. And in parallel, the Bank of England has been working with the European Central Bank to remove other impediments to the revitalisation of securitisation markets, including pushing for revisions to regulatory requirements for banks and for the development of simple, transparent and consistent products.

Where the standard formula is not a good fit for a firm's risk profile, firms will be asked to consider developing a partial internal model; making an application for an undertaking-specific parameter; or adjusting their underlying business model.

Many of you in this room are acutely aware of the demands of the Solvency II model approval process.

This rigour has a purpose. The dangers of using poorly designed models were made all too clear in the banking sector. So the Bank won't hesitate to withhold approval of inadequate or opaque models.

Models must be based on appropriate data and account for all quantifiable risks. Boards have the responsibility to ensure models remain appropriate and to show they are used in practice.

Of course, risk-based capital standards are about more than models. Models can never be relied upon in all circumstances or in isolation, nor can they be substitutes for sound judgment.

Solvency II recognises this in its three-pillar approach – supplementing a modernisation of the quantitative regime with new supervisory review, governance, risk management and transparency requirements. These requirements, under pillars 2 and 3, build a coherent framework for the future.

Tools like scenario testing and the Own Risk Solvency Assessment are therefore fundamentally important. By thinking about the risks that could harm future solvency – and the possible responses to a stress – ORSAs promote the protection of safety and soundness of insurance firms, while providing insights into overall financial stability.

Right idea 2: a regime that holds the right people to account

The step-change in regulatory standards under Solvency II has several implications for the industry.

Risk professionals like yourselves have a central role to play in building models; in using expert judgment to marry quantitative and qualitative assessments of risk; and in making technical subject matter accessible to Boards.

Your work will be vital to making these new standards a reality and thereby to establishing a stronger, more consistent standard of resilience across the EU.

But amidst our work to embed new regulatory standards, it must not be forgotten that the responsibility for running insurers rests with their Boards and senior managers.

This leads to the second right idea we are putting into practice: the people running insurance companies should be more clearly held accountable for their actions.

It is now clear that in some parts of the financial sector, the link between seniority and accountability had become blurred or even severed. The Parliamentary Commission on Banking Standards recognised this when they recommended a new regime for the senior-most managers in banks, ensuring their accountability.

The principles underlying that regime are more widely relevant. Those individuals that run financial institutions should act with integrity, honesty and skill regardless of whether they work for global investment banks, regional building societies or in the general insurance sector.

Solvency II recognises this imperative. It requires both firms and regulators to monitor the fitness and propriety of staff with key responsibilities in the insurance sector.

As a consequence, the Bank of England is now working with other regulators to develop a regime for the key people in your industry.

That doesn't mean we are about to extend the banking regime indiscriminately. For one thing, unlike in banking, there will be no statutory provision for applying a "reverse burden of proof" in the insurance sector.

In developing a regime tailored to insurance we will also have to consider the particular skills and roles that matter. This includes the central role of actuaries, which is one of the important functions specifically recognised by Solvency II. In 18th century London, the title “actuary” was often interchangeable with that of Chief Executive.

It’s your role in backing entrepreneurship with science; in ensuring premiums, reserves and capital are prudent; and in scanning the horizon for new risks and opportunities, that means we are minded to include both life and general insurance actuaries within the scope of our updated fit and proper regime for individuals in insurance.

By including your profession in the new regime, we recognise the importance of your skills, the range of your contributions, and your personal propriety.

Later this year we will consult on a regime that includes the most senior actuaries – alongside CEOs, Chairmen and Chief Financial and Risk Officers – in our senior managers regime, making them directly accountable for how a firm is run, for their decisions, and for their actions.

These senior persons will be expected to prove their fitness to regulators before they take up a role, and the onus will be on them to ensure risks are understood, measured and properly considered.

Right idea 3: global standards for globally systemic insurers

While much progress has been made on the home front, the focus of the global reform agenda since the crisis has been on putting a third idea into practice: common *global* standards for systemically important insurers.

The goal of this work is to increase systemic resilience; preventing spillovers from the failure of an insurer to the wider financial sector and the real economy.

Policymakers agree that traditional insurance activities need not of themselves be a source of systemic risk. Indeed, recent events demonstrated three reasons why insurers are better able to withstand crises than other financial institutions.

First, the underwriting cycle is generally not correlated with the business cycle;

Second, the inherent resilience of business models that take a long-term view, and

Third, an insurer’s production cycle is inverted as they collect premiums today with a view to paying claims tomorrow. This model reduces liquidity risks and immunises insurers against risks of a run.

Insolvency takes time to manifest, and wind-down when it happens has historically been more orderly.

Given all that, you might ask: why the concern about systemic risk in insurance?

The answer is simple: The financial crisis laid bare that the actions of some individual insurers – like AIG – can have broad spillovers; that some insurance markets – like the monolines – are systemic, and that the insurance sector plays a systemic role in diversifying the financial sector thereby reinforcing its resilience.

AIG was the extreme case of a systemic insurer.

That sorry experience highlights the need to understand all the activities in which insurers are engaged, including on occasion substantial business beyond the boundaries of traditional insurance.

Regulators have grouped those activities as “non-traditional” and “non-insurance” – including business involving extensive use of market instruments, like derivatives, and instruments that engage in substantial maturity transformation. Where this type of business is carried out in scale or across borders, risks to the system can be substantial.

The crisis also showed how particular insurance markets can affect systemic stability.

The Monolines demonstrated how sub-sectors that are excessively concentrated or undercapitalised can amplify shocks.

The failure of multiple insurance companies in response to economic stress can disrupt the provision of critical economic functions. It can also suddenly transfer risks to other parts of the financial system that may be ill-equipped to manage them; or shift assets around in a way that can amplify and spread distress.

As I said previously, the insurance sector is systemic in a positive way. Insurance companies have different risk bearing capacities than many other financial institutions. They play a stabilising role by deploying funds over a longer time horizons, in a manner less vulnerable to sudden outflows.

The resilience of large insurers is therefore important to safeguard that positive contribution to the global economy.

The starting point for the application of global standards has been the identification of systemically-important insurers.

More than four-fifths of that assessment rests on the extent of non-traditional non-insurance activities in a firm's business model and on its interconnectedness to the wider financial system. Nine firms have been designated.

It is vital that these systemic insurers, like systemic banks or financial market infrastructure, can be resolved in the event of failure without the need for taxpayer support and without disruption of the wider financial system. That's why the development of resolution plans is a top priority.

Nonetheless, given the externalities from the failure of a systemic insurer, it is of course preferable that their ***probability*** of failure is lower.

That's why systemic insurers will be subject to higher global standards.

The Higher Loss Absorbency requirements, being developed now by the IAIS, will ensure that all of the activities of a systemic insurance group – but especially non-traditional, non-insurance activities – are backed with an appropriate minimum level of capital resources.

Given the patchwork of capital standards across major jurisdictions, the first step towards applying these heightened resilience requirements is the development of the Basic Capital Requirement – an internationally comparable capital measure that will act as the baseline for additional resilience.

Last week in Cairns, the FSB approved the final BCR proposal which will be presented to G20 Leaders at the Brisbane summit in November. It is simple and factor-based, contains a common valuation approach, and captures all activities of insurance groups.

This is an important milestone – one that takes us further towards embedding the right idea of increased resilience for those few insurers that have the capacity to impact the global financial system.

I look forward to your continued support as the IAIS builds on this progress to put into practice the overall package of requirements for systemic insurers by 2019.

And we will need your support as we further develop, over time, an International Capital Standard to apply to all internationally active insurance groups. Our aim is nothing less than a standard which embodies the principles which underpin ICAS and Solvency II.

Conclusion

The ideas I've described today are vital to preserving the positive role of insurance in the financial system and the real economy.

These ideas – tailored capital standards that promote a level playing field; a framework to hold the right people to account; and global standards for globally systemic insurers – are needed *now* in practice.

The Bank knows that as our reforms are implemented and as your business models evolve we need a regulatory approach that is regularly reviewed, adjusted if necessary; and that takes account of evolving financial conditions, product innovation and changing markets.

Robust interaction with the industry is essential to ensuring the right ideas can be put into action now, and for the future.

The Institute & Faculty of Actuaries has been at the heart of the insurance industry for over 150 years, and the changes to regulation, the industry and the world around us mean your contribution is more essential than ever.

Having the right people putting the right ideas to work has never been more important.