Lee Hsien Loong: Best practices in insurance regulation

Keynote address by Mr Lee Hsien Loong, Deputy Prime Minister of Singapore and Chairman of the Monetary Authority of Singapore, at the International Insurance Society's 38th Annual Seminar, Singapore, 15 July 2002.

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Introduction

Mr Douglas Leatherdale, Chairman of the International Insurance Society, distinguished guests, ladies and gentlemen,

I am pleased to address this seminar organised by the International Insurance Society. It is an honour for Singapore to be hosting this prestigious event again.

These are trying times for the insurance world. Insurers are coping with extraordinary losses arising from the Sep 11 tragedy. High profile corporate scandals involving household names such as Enron and Worldcom are depressing market sentiment. Sustained declines in asset values mean that insurers can no longer rely on investment returns to offset poor underwriting results.

New risks facing insurers

Over the past decade, insurers have forayed deeper into financial markets in pursuit of higher profitability - both as investors and as intermediaries.

As investors, they are exposed to the vagaries of volatile capital markets. As intermediaries, they are taking on new financial risks. Insurers investing in credit derivatives effectively take on bank credit risks. Insurers who underwrite professional indemnity policies for bank directors and officers, effectively assume banks' operational risks.

Insurance company managers must keep abreast of these developments. They must understand how their companies' risk profiles have changed, and how new activities can have opposing effects on both sides of the balance sheet. All insurance industry professionals need to become more astute at assessing risks, and competency needs to be upgraded at all levels in the company.

Regulators must also keep pace. In supervising individual insurers, regulators need to look beyond insurance risks and protecting policy-holders. From a broader systemic perspective, greater engagement of insurers in financial markets raises important questions concerning their impact on financial stability. How well are insurers managing this new portfolio of risks? What are the spillover effects of an insurance company failure in this environment of inter-linkages?

Traditionally, regulators associate systemic risk with the failure of large banks. The events of Sep 11 have turned the spotlight onto the importance of the insurance industry as a whole, and even of individual insurance players. A number of recent failures and near failures of insurance companies have revealed just how wide an economic impact insurers have. The high-profile collapse of a few major insurers such as HIH and Independent, left businesses without essential insurance cover, and critical services without professional indemnity coverage. Economic activity in these sectors might have ground to a halt, had the government not stepped in. But by stepping in, the governments created a new source of moral hazard.

These issues have been extensively debated. The IMF has concluded that the insurance industry, while not systemically critical, has taken up a definite systemic relevance. We need to understand better the nature of insurance companies' financial activities and their possible impact on global financial stability.

In Singapore, the supervisors of banks, insurance companies and securities houses are housed under one roof in MAS. This has given us a head-start in dealing with current industry trends, with financial product boundaries blurring and insurance companies crossing over into banking and capital market territory. The pressure is on to bring integrated supervision to an even deeper level.

Singapore's response

In today's new risk landscape, MAS aims to develop sound and efficient markets where risk can be effectively spread and mitigated. We need to make sure that best practices prevail in the management as well as regulation of insurance companies. Strong players will make for a resilient industry.

Two years ago, Singapore opened up completely the direct life and general insurance market. The earlier closed-door policy had insulated both local and foreign incumbents from competition and engendered complacency. Creating an open and competitive environment was the first step to raising standards and strengthening resilience.

Since we opened up the industry, insurers in Singapore have taken various measures to enhance their competitiveness. They have sharpened their business focus, moved into higher-value added and higher-growth areas and improved professional standards. This will stand our insurers in good stead to meet new challenges and opportunities.

Meeting new challenges and opportunities

Entering new growth areas

Globalisation of markets, advances in technology, changing demographics and socio-economic patterns are some trends that will result in new or changing needs for insurance protection and financial planning. Insurers should hone their skills in these new areas and take advantage of emerging opportunities.

One important opportunity is in health insurance, especially financing the health care needs of the aged. This is a challenge that is facing governments around the world. It is no different in Singapore where the population is aging rapidly. Health insurance can play a greater role in financing old age medical care than it now does. MAS plans to introduce in 2003, a regulatory framework for this specialized area of insurance. We will be seeking feedback from local industry on this.

The government recently announced the launch of Eldershield, a national long-term care insurance scheme to be underwritten by private insurance companies. Eldershield provides a basic level of benefits, which many Singaporeans will wish to supplement. This will create opportunities for insurers to structure and market appropriate Long-Term Care policies.

Credit insurance and political risk insurance are two other promising areas. Globalisation and lower barriers to cross-border trade will spur continued internationalization of trade and support strong demand for credit and political risk insurance.

Being located in Asia, a region that has traditionally witnessed strong trade flows, Singapore is well-placed to develop further as a hub for such activity. Several new specialist insurers and brokers have in recent months set up a presence in Singapore, including financial guarantee insurers and trade credit insurers and brokers.

Another growing area of business is bancassurance activity. Life insurance products sold through the bancassurance channel now account for 25% of new life insurance business. Two new specialist bancassurance players have established operations in Singapore, and contributed significantly to this trend.

Increasing resilience

Amidst these new opportunities, more than ever, we now need to strengthen the resilience of the insurance industry. The MAS has for some time, been working with the insurance and reinsurance industry to raise standards of corporate governance, internal controls and professionalism. Many of our companies are already at international best practice standards. However, as in all countries, practices vary, and we aim to have all our insurers to attain best practice standards by 2005 if not earlier.

Risk-based supervision

In 1998, MAS embarked on a strategic change in our regulatory philosophy. We moved from a bottom-up, audit-based inspection approach to a top-down, risk-based supervisory approach. This approach, being prospective in nature, is well suited to today's world of new and increased risks.

Risk-based supervision evaluates the major risks faced by an institution and assesses how well these risks are being mitigated. This will help both regulators and companies to identify and, importantly, to pre-empt problems. Well-managed institutions will be given greater flexibility, while less well-managed ones will be subject to closer scrutiny.

Singapore's risk-based supervisory framework for insurers

The basic framework for risk-based supervision of insurers in Singapore has been set up.

MAS is now developing risk profiles for each Singapore-based insurer. We have devised a five-step "supervisory ladder of intervention", and will use it to classify insurers according to their risk rating. The five steps range from "Normal" to "Viability at Risk" and terminally, "Winding Up or Closure".

Insurers assessed to be on the more critical steps will receive more stringent and intrusive supervisory actions. MAS draws the analogy between the risk classification of an insurance firm and the medical assessment of a patient's health. If an insurer is classified as being on the "Viability at Risk" step, it will probably be admitted to MAS' Intensive Care Unit.

However, MAS is not regulating for a no-failure regime. We encourage industry consolidation. In today's competitive environment, size brings financial strength and facilitates diversification on both sides of the balance sheet. But it is not possible, and also not desirable, to operate on the basis that we will never, under any circumstances, allow a financial institution to fail. That way lies moral hazard.

Improving corporate governance and internal controls

A risk-based supervisory approach relies heavily on the strength of company leadership and management. Corporate governance is thus critical. MAS expects the Board of Directors to provide clear strategic leadership and set consistent corporate values. Management teams must operationalise these strategies while upholding the spirit of the corporate values.

Given the nature of the insurance business, corporate values need to be guided by risk management concerns. What is the company's risk appetite? What should be its risk tolerance limits? What is the level of risk management skills in the company? How profitable is the underwriting of various classes of risks? Apart from answering to shareholder interests, the board of directors and management also have a fiduciary duty to their policy-holders. Sound internal risk management and controls are needed to protect policy-holders' interests.

Currently, our regulations oblige the Appointed Actuary to take responsibility for monitoring the financial soundness of life insurance companies. But the Board and management cannot just sit back and rely on the actuaries. Board and management themselves must acquire a better awareness and understanding of actuarial assessment.

We need to set clear expectations of the role that the Board and management play, in ensuring the financial soundness of their companies. MAS will work with industry and professional associations to set out guidelines for this important area.

In Singapore, we established the Corporate Governance Code for listed companies last year. MAS has tightened corporate governance standards for local banks. We recently required auditor rotation for local banks, a policy which we had been considering for some time, even before the latest wave of accounting scandals.

For insurance companies, we are currently working on a draft corporate governance framework. MAS is consulting the industry and will issue guidelines for internal governance for local boards of directors, as well as guidelines for the roles and responsibilities of Principal Officers of insurance companies.

The guidelines for internal governance will deal with the main responsibilities for the Board, stress the importance of transparent and performance-linked compensation; emphasise the need for the integrity of financial information; encourage fair dealings with the members of the public who are policy-holders and urge insurers to engage in regular communications with policy-holders.

Life insurance companies are entrusted with the management of long term funds. We are considering more rigorous corporate governance requirements for life insurers. We intend to formally introduce and enforce the corporate governance framework for the insurance industry later this year.

Imposing risk-based capital requirements

In a world of new and increased risks, appropriate levels of capitalization are necessary. Insurers face mounting complexities, given the increased volatility of asset risks and the diversity of liability risks.

In Singapore, as in many other countries, the existing statutory framework of solvency and capital adequacy for insurers is essentially a "one-size-fits-all" approach. This is clearly no longer appropriate, since different insurers have acquired different levels of exposures to financial risks and developed different underwriting specialties.

In banking, a risk-based capital approach is well-established. There are clear guidelines from the Bank for International Settlements, and a new standard is undergoing extensive worldwide consultation.

For the insurance industry, the same level of regulatory consensus does not as yet exist. MAS has formed two work groups comprising industry practitioners, representatives of professional associations and regulators to develop risk-based capital models for life and non-life insurance.

Besides refining the treatment of liability risk, we will also look at capital charges for asset risks. This will help to level the playing field between banks and insurance companies, and minimise opportunities for capital arbitrage. The new capital requirements should also provide an early indicator of financial weaknesses, and thus facilitate progressive intervention by regulators. These risk-based capital requirements will be introduced by end-2003.

Raising professional standards in insurance

To improve corporate governance and internal governance, it is critical to raise insurance professional standards. All insurance professionals should constantly upgrade both their technical and management skills.

In 2000, MAS appointed a private sector committee, the Committee for Efficient Distribution of Life Insurance Products (CEDLI) to recommend minimum standards of transparency, competition and efficiency in the distribution of life insurance products. MAS accepted CEDLI's recommendations to enhance the sales advisory process and professional training.

To date, industry practitioners have adopted these minimum standards enthusiastically. Many have gone further, and set their own requirements that exceed the prescribed standards, because they realised that this makes them more competitive in the market. This has improved the level of professionalism among life insurance agents and greatly enhanced the reputation of the industry, which in turn, is helping the industry to attract higher-calibre talent.

Training and competency requirements should apply across-the-board to all insurance professionals, and not just to life insurance intermediaries. MAS is currently reviewing the manpower capabilities of the insurance industry and will identify the main competency gaps and areas of weakness. Apart from upgrading professional competency, consideration will also be given to the technical competency of company directors and other staff involved in the insurance business. We will work with industry to formulate an insurance manpower development strategy. We envisage industry players, training providers and tertiary institutions co-operating to develop programmes that will enhance professionalism in the insurance industry.

Conclusion

MAS will continue to work together with the insurance industry to achieve international best practices and standards. Over the past two years, MAS has worked hard to build a closer partnership with the financial sector. We will continue to promote an open environment and consult actively with the private sector for its views. The relationship between the regulator and the regulated should be arms length but not adversarial. The regulator has to be firm, but also friendly. Market practitioners can help regulators generate ideas, keep abreast of market developments, anticipate global trends and review our financial sector strategies. Candid, thoughtful feedback, including dissenting views, go a long way to ensure that policies are pragmatic and remain relevant.

We hope that such a regulatory environment will help to develop well-managed insurers in Singapore, who will take up new challenges, and play a more active and productive role in upgrading our insurance industry, and thus our financial sector as a whole.

I wish you fruitful deliberations.