Andrew Bailey: The evolution of insurance regulation – a shifting scope and new frontiers

Speech by Mr Andrew Bailey, Executive Director and Member of the Financial Policy Committee, Bank of England; Managing Director of the Prudential Business Unit, Financial Services Authority, at the Nicholas Barbon Lecture, London, 6 February 2013.

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Thank you for inviting me to give this Nicholas Barbon Lecture. And, thank you for giving me the opportunity to remind myself of the career of Nicholas Barbon – I say "remind myself" because a long time ago I was an economic historian. Barbon is certainly one of the founders – if not the founder – of the insurance industry in London in the late seventeenth century. He was first a builder, indeed, he wrote a tract called "an apology for the builder" in which he defended new construction in London on the grounds that cities created employment and wealth. Barbon was probably the leading builder of the time and he offered an integrated service because he pioneered house insurance. Indeed there are observations that Barbon's business was to build, insure, and re-build your house when it fell down. These days you would be in FSA enforcement if you tried that one.

But Barbon was also one of the early economic theorists in a period at the end of the seventeenth century when economic theory flourished, before it went into abeyance until Adam Smith and David Hume came onto the scene. Barbon developed the argument that wealth creates demand and he extolled conspicuous consumption: he wrote that "a poor man wants a Pound; a rich man a Hundred". Clearly, Barbon never quite imagined that one day investment bankers would take his idea to a whole new level.

And, finally on Barbon, he was around at the time of the founding of the Bank of England. Indeed, the records suggest that he very much wanted the Bank of England not to be founded, and instead that his own idea of a national Land Bank should have received the favour of the Crown and Parliament. That did not happen, and so I guess that Barbon would not be happy on finding out that the Bank of England will, over three hundred years later, take on regulating his industry of insurance. But then his writings suggest that Barbon was no fan of regulation.

From my perspective this is a very exciting time because after nearly three years of work on a wide range of subjects covering the legislation, the new model of prudential supervision, our staff, property, IT and other things, we can see the new Prudential Regulation Authority starting to take shape for real. We are in the process of moving into our new home at 20 Moorgate. There were several reasons why we chose a City location. One consequence is that it will bring us closer to the insurance industry, which for the most part resisted the appeal of Canary Wharf and stayed close to the roots that date back to Barbon. He would have approved, providing he could have built, insured, and rebuilt your building. Time will tell whether you will welcome having your prudential regulator near to your doorsteps, and as far as we know located in the City for the first time.

I want to tackle a number of large issues today, which are closely connected. First, why do we think it makes sense to place prudential supervision of insurance in the PRA alongside banks and major investment firms? Second, what style of supervision will the PRA adopt and how will it affect insurers? And third, how do we think about the issue of systemic risk, and systemically important status for insurers?

There are over 700 insurers in this country which will be subject to prudential supervision by the PRA and conduct supervision by the FCA (in addition, insurance brokers will be entirely supervised by the FCA). Why place prudential supervision of insurers in the PRA alongside banks? I am tempted to make one point here and conclude, namely that we asked to have one industry that caused us less trouble than banks. Of course, that would be on the basis of "please keep it that way". It's tempting to stop there, but in all honesty it would not be the full story. Banks and insurers have one crucial thing in common which distinguishes them from other financial services providers, namely that they bring the funds customers deposit or invest directly onto their balance sheets and therefore expose customers directly to the risk inherent in those balance sheets. We did not, however, place insurers under the PRA because they are like banks, even though there are important similarities in the prudential approach we apply to both sectors. Why then? For me, the logic has to do with what we have learned about our role during the crisis.

The traditional model of supervision has been quite industry specific. The FSA regime introduced in 1997 created a single authority, but within the FSA the framework of rules applied to insurance supervision is unique to the industry. It is true that in the run-up to the start of the crisis, and for some time thereafter, the FSA mingled insurance and bank supervision in terms of its operating units, but I think that did not work effectively and we have moved to a clear distinction with an insurance supervision directorate headed by Julian Adams. Insurance supervision is a skill of its own, and while our supervisors do move roles between insurance and banking in both directions, we want to ensure that we have groups of truly expert insurance and banking supervisors.

The reason for locating insurance and banking in the PRA is in my view that we have learned during the crisis that our job as prudential supervisors is to ensure that the public and users of financial services, including the corporate sector, can be assured of continuous access to the critical services on which they depend.

Many financial services may be regarded as critical by their users, but some are distinctive because it is hard for consumers to replace their provider with a substitute without accepting unacceptable cost and loss. Insurers provide critical services to the public in terms of risk transfer and very long-lived savings contracts. This last point draws out that insurance is not a single homogenous industry – general and life insurance are very different activities – and we recognise that in our supervision. It would be unacceptable to the public to have access to risk transfer through, say home or car insurance, or professional indemnity insurance, to name but a few, withdrawn in a disruptive and unannounced way. In the same way, savings contracts that are long-lived and provided by life insurers, and are often an individual's primary pension provision, are critical financial services that are difficult to replace without unacceptable cost. For me, there is therefore a common feature of banking and insurance in terms of continuity of access to critical financial services.

This is not, however, the end of the story on the issue of why the PRA will regulate banks and insurers. What I have started to describe is the first objective that the new legislation gives to the PRA, namely the safety and soundness of the firms we will supervise. But there is another important leg to the definition of the objective, namely that the underlying objective of our pursuit of safety and soundness is the stability of the financial system. For banks, this had led us to emphasise that we will be a proportionate supervisor, putting more emphasis on the large firms that have more scope to damage the stability of the system. We think we can do this for banks because the depositor is protected by the deposit insurance arrangements on the first £85,000 of deposits provided by the FSCS for all banks except branches from other EU countries (where the insurance comes from the home country), and because as a consequence of the crisis the resolution regime is now set down in statute, though we clearly have work to do to make the larger banks resolvable using those resolution powers, supplemented we expect by future EU legislation.

For insurers, the legislation gives the PRA a second objective, namely the protection of policyholders. We do not have a comparable objective for depositors. Policyholder protection means in effect that our approach of proportionality in supervision cannot be the same for insurers. Why? This is a good question because the FSCS is set up to cover insurance. For me, the reason is that we have more work to do to develop the best tools to ensure continuity of access to critical insurance services.

Why do I think we are short of tools? To explain my view on this requires some background on the resolution of banks. Statutory special resolution regimes for banks like the one adopted in the UK in 2009 have at their heart the power to alter property rights, the power to separate the business of a company from its owners, albeit with safeguards against unfair expropriation. It is a very powerful tool, and one that should be used carefully for that reason. For banks a typical use of the resolution regime is because depositors can lose confidence in their ability to have access to their funds, and thus a run can start which brings down the bank. A resolution regime can bring order to that process. For insurers, policyholders are less likely run in the sense that they can withdraw their contract and take it somewhere else, though it is possible for some life contracts to be surrendered without penalty. Unlike money, insurance contracts are not fungible because the cover is specific to the contract. In the limit, a bank depositor can exchange their claim on the bank (commercial bank money) for a risk-free claim on the central bank (by requesting bank notes). An insurance policyholder cannot do this.

Work is under way to determine whether insurance would benefit from a special resolution regime that overrides normal insolvency rules in order to enhance the ability to ensure continuity of critical contacts through, say, the transfer to business to another firm. I will return to this subject later in this lecture because it is one that we should consider carefully. My general view is that the policyholder protection objective for insurance points to the need for a resolution regime for insurers, but the important issue is to be clear on what sort of regime.

There is one further area of insurance that for me clinches the case for the policyholder protection objective in the PRA. I almost mention “With Profits” with trepidation, but I am afraid I must do so at this stage. With about £350bn of policy values outstanding, and policy maturities that can run into decades hence, With Profits is clearly a legacy that will be very much with us for a good while yet. Consequently, I do think that the industry and the authorities need to be alert to its inherent risks and complexities.

In thinking about the implications of With Profits, let me step back for a moment. In broad terms, I can see two distinct types of financial contract involving deposits and savings. A deposit contract with a bank has at its core the promise that the bank will return the full value of the deposit at any time when it is contractually obliged to do so. Loss of confidence in a bank sets in when depositors fear that this may not happen. An asset management contract is quite different because the promise is at its simplest to return the proceeds of the investment strategy, which may be more or less than the amount invested. It is cruel to remember the Woody Allen jibe at this point that a stockbroker is someone who invests your money until it is all gone. Economists might call the deposit and asset management contract “corner solutions” in that they have a robust definition and lie at opposite ends of a range. If so, With Profits falls in between, and it is in this ground that issues can arise.

The proposition was essentially to offer investors a blended exposure to cash, bond, property and equity return with some degree of smoothing of overall returns, essentially at management’s discretion, to reduce market timing risk. The marketing tended to make much of these products’ potential to earn above cash returns without the volatility of pure equity exposure; and this in turn conditioned policy holders’ expectations, a fact first acknowledged explicitly in the UK’s prudential solvency regime for insurers in 1967 (bear in mind that this was not the original prudential regime, which was introduced in 1870).

The essence of the With Profits contact as I understand it is that the provider offers a guaranteed minimum return, variously structured , plus the prospect of additional returns derived from the return earned on a pooled fund that combines many contracts including over different generations of policyholders. There is of course a logic to pooling returns, but for the policyholder the return can be complicated, and sometimes made opaque, by the practice of pooling different generations of policyholders who may have different expectations on their returns (conditioned, for instance, on changes in the external environment); and by the practices of smoothing returns and of charging differentially for the economic value of the guarantees. Additionally, problems have arisen because the funds are made up of many different groups of policyholders with different guarantees, some of which, essentially on the annuity side, became increasingly valuable as nominal interest rates fell from the mid 1990's. The existence of these guarantees was often, at best, unclear or, at worst not disclosed to new joiners to the fund. Bear in mind also that these contracts are long-lived with maturities typically of 25 years of more; and that the With Profits insurers themselves have often built up over many years through the take-over or mergers of many smaller providers, each with their own distinct products, associated policyholder expectations, and administrative "legacy" systems.

Suffice to say that in the last two years in which I have been involved with insurance supervision, some of the most difficult issues that I have faced have been in the area of With Profits. For that reason, I think it is appropriate that the PRA should have a policyholder protection objective because I think we have to recognise explicitly the contractual complexity that we inherit and the solvency risks this can generate. I should also add finally that it is not a coincidence that we have found this area to be the most challenging in terms of creating the "twin peaks" model in which the FCA will have responsibility for reaching judgements, through a formal determination process on fairness to policyholders and the PRA will be responsible for ensuring that those judgements are compatible with the prudential soundness of firms. We have reached a satisfactory conclusion, with specific language in the legislation, and a special With Profits MoU between the FCA and PRA; but it has required very careful consideration to ensure that each regulator's role and responsibilities has been appropriately defined to avoid any "under-laps" and that the correct balance has been struck between them.

Let me now move on to the second subject – what style of supervision will the PRA adopt and how will it affect insurers? Let me start by drawing the distinction between regulation and supervision in our world. Regulation is about the framework of rules and policies against which we operate. Supervision is about how we apply that framework every day. They are not the same thing. Rules are for the most part in our world the product of international agreement, eventually. There are good reasons for this in terms of seeking to ensure comparable standards of protection where services can be provided across borders, and where encouraging free trade in services is consistent with open economies.

When it comes to supervision the PRA will be applying judgement around the framework of rules. This is important for a number of reasons, but above all against a background of inexorable increases in rule making we must have the determination to be focussed on the key risks that matter to our objectives. One of my commitments is that we must be focussed on the (I hope) small number of big risks that threaten our objectives of safety and soundness and policyholder protection. I don't have any difficulty with intensive and intrusive supervision where it is focussed and justified by the risks. We are not, however, substitute compliance officers – that is the job of firms, and one that we will expect to see in place and functioning along with risk and audit functions.

Another key aspect of judgemental supervision is that it must be forward-looking to the risks that may arise. This is crucial, and was not properly incorporated into the pre-crisis regime of supervision. Let me give a few current examples of this for insurers.

We are focussed on the impact of very low interest rates staying with us for a protracted time, and when I say this I am offering no view whatsoever on the likely course of monetary policy. Likewise, we want to know that the prudential position of firms also captures the possible impact of an unexpected upward shift in the slope of the yield curve, and again I am offering no view on monetary policy. My third example is different: we are watching the range of possible outcomes on flood insurance in this country for their prudential implications.

Judgment in supervision is not, however, without its challenges when it comes to the practice of supervision. There are two large challenges I see. First, we have to balance the use of sensible judgement against the risk of creating undue uncertainty in our behaviour which damages your ability to do business. This is not easy I accept. It requires us almost constantly to check and test our judgements against a framework of reasonable predictability.

Also, it requires a greater degree of transparency from us to you, and I think from both of us to the public and investors. This is important to ensure that we can both be held to account for applying judgement in a way that is consistent with the pursuit of our objectives. I am conscious that achieving accountability in insurance supervision in the current environment is challenging because all the focus is on the banks. No visits to the Treasury Select Committee may seem like a blessing, but we have to ensure that the accountability still holds water. On that point, frankly, I think there should have already been more accountability for how the processes of the European Union could have created such a vast cost for an industry for the implementation of a directive which has not even yet been finally agreed, and for which I cannot give you a date. Largely unseen in the banking crisis has been the shocking cost of Solvency II.

The second challenge with the use of judgement in supervision is that elsewhere we have seen a preference to have many rules, but often ones which can then be gamed. Paul Volcker put it nicely in his evidence to the Parliamentary Banking Commission. He said that people ask for clear and simple rules so that they can tell when they are in abeyance, but they typically fail to add that they want to know how to get round the rule too, but that is part of the deal. At the PRA we will apply judgement rigorously; sometimes you will agree with us, and sometimes you won't. We will be clear and transparent in our judgements, and we will be accountable.

Finally on the issue of the PRA's approach to supervision, I want to assure you that we will take supervision of insurers just as seriously as we do the other lot. It is not in our nature to do otherwise. And, we are putting more emphasis on senior level contact in the new approach. We want to deliver key messages very clearly to senior management and boards, and we want to know how your governance works in practice. I will give one example of this approach in recent months, returning to Solvency II. It was clear to me by the end of last summer that we were facing a long delay in the directive on top of a bill that, as I have said, was indefensible and ever rising. We have had extensive contact with chief executives and the Association of British Insurers in recent months, with the overarching objective that this cannot go on. I think we have reached a sensible conclusion which at least makes the best of where we find ourselves. Where possible and sensible we will use the work done on Solvency II to date to bolster our existing ICAS regime, though I should stress that we are quite comfortable with the core of ICAS and believe that we can use it as the framework to build the PRA approach until such time as Solvency II appears. I hope that this change of approach both alleviates the costs and helps to create a less pressured environment in which we can seek to obtain a better framework for prudential supervision of insurers in the future than would otherwise be the case. There is too much at stake for the industry and the economy to compromise on this objective.

Let me turn to the third and final issue, namely how do we think about the issue of systemic risk, and systemically important status, for insurers? This is obviously topical in the context of the IAIS proposed policy measures for globally systemically important insurers. First of all, in my view the case for systemic importance for insurers has to be proved. It does not follow that because major banks are systemically important, the same must be true for insurers. And, second, if a case can be made, it does not automatically determine what the response should be; in other words, it does not follow that the same capital treatment of systemic firms and/or a statutory resolution regime are needed as for banks. The calibration of these responses will have to be proven, and the response will need to be consistent with mitigating the cause of the systemic risk. So, let's put banks to one side, but only after making one important point, that whereas systemic risk in banking is dangerous in good part because that it is in the nature of banking that the confidence issue combined with a very high level of inter-connectivity of risk within the system creates systemic risk, this is not true to the same extent in insurance.

Over the years, re-insurance has come under the spotlight as a possible cause of intra-system connectivity and risk, but I have not yet seen a convincing demonstration of a major systemic issue for pure reinsurance of idiosyncratic, diversifiable, non-financial risks such as fire, weather, earthquake or liability.

It is of course likely that within the insurance industry there are firms which because of some combination of complexity of risk and size pose more risks to the financial system, and as such our supervision should be proportional. Let me develop this theme drawing on, I should say, valuable input from my colleagues Paul Sharma and Julian Adams.

The resolution challenge for non-life insurance involves ensuring short-term continuity of risk cover. But life insurers make long-term promises to their policyholders which can only be matched imperfectly with available financial instruments (securities and derivatives). This creates a vulnerability to shocks from financial markets such as the impact of the large fall in equity markets in 2002 to 2003.

Life insurers do not close down by going into so-called solvent run-off in the same way as non-life insurers, and bear in mind that the term solvent run-off is the expression of a probability of an outcome. A non-life insurer when it enters run-off typically ceases to collect new premiums. The risk in run-off here – and there is a risk that needs examination – is that near-term claims are paid out to the detriment of unidentified far-term claims, thereby creating an inequality through a form of time subordination. In contrast, a life insurer that enters run-off continues to collect regular premiums on its existing in-force life insurance policies. Moreover, it needs to continue to pay its obligations (e.g. annuities-in-payment) on the exact day contracted whereas a non-life insurer in run-off has some greater flexibility to pay claims to match its cash flow. Finally, a life insurer in run-off needs to honour contractual policy surrender rights.

These features of life insurers draw out the difference in economic interest between near-term and far-term policyholders, and one who has a right of surrender and one who does not. Moreover as life insurers are making long-term promises to policyholders, they often seek to match those commitments dynamically, using short-term derivatives, and therefore rely on continued access to those derivatives and the willingness of counterparties to take such exposures to a firm in run-off. These derivative positions will not be more idiosyncratic like traditional insurance, but will be determined by the overall direction of financial market prices, giving scope for more system-wide problems.

I described earlier the issues I see with more traditional With-Profit contracts. The issues I highlighted were not so much to do with definite features of the contract between the insurer and the policyholder but with the uncertainty around the contract itself arising from the substantial discretion afforded to the insurers' management to determine final policy charges and returns.

There is an argument that such uncertainty is helpful to the insurer because the promise to the policyholder is cautious in terms of accrued income and gains, and the insurer is in control of the investment strategy for the asset pool. The issue with uncertainty around contractual terms is therefore arguably more of a conduct issue to do with fairness in the operation of the contract, but to be clear it will have prudential consequences if the scale of the fairness problem is large enough, as Equitable demonstrated.

Compare this with the newer life insurance products in some jurisdictions which contain much more definitive promises, for example that at each valuation point the policyholder has a commitment such that if their asset-pool is valued higher than the previous guaranteed amount, this new amount will feature in the minimum guaranteed return.

This reduces uncertainty in one sense relative to With Profits but increases financial risk for the insurer – which is further increased where policyholders can switch instruments at each valuation point and thus select against the insurer on the basis of a more definitive promise they have made on future returns. The insurer thus risks adverse selection against them. The risks in this type of contract are therefore more clearly prudential.

Globally the scale of all of these promises is very large – the full extent is not clear, but it could be well over $1 trillion. In the UK these contracts are marked to market, which provides useful information, but that is not consistently the case globally. There is scope for problems in, for instance, the time-value of liabilities and the valuation of complex derivative positions.

All of this tends to my mind to demonstrate that there is at least one part of the insurance industry that is, globally, large and complex, and UK firms are an important part of this sector. That does not, to be clear, lead to a conclusion that therefore the approach and toolkit taken for globally important banks should apply to these insurers. It leads me to two initial conclusions. First, that in a world of proportionate supervision, we should take a more enhanced and intensive approach for these large and complex firms. This is what the PRA will do, and it does not contradict our policyholder protection objective which, as I indicated earlier, gives us in my view a somewhat different objective in respect of small insurers versus small banks.

Second, this degree of complexity inevitably raises important questions around our resolution tools where we face dealing with large-scale run-downs. In this context, I am aware that the PRA will need to be very clear how it interprets and puts into effect its policyholder protection objective in the context of insurers that enter run-off or require some other means to draw the business to a close.

In conclusion, I hope this description has given you a sense of the PRA's intended approach to supervising insurers, and some of the big issues that we see ahead. We have grown all too accustomed to focusing heavily on banks, reflecting their capacity for damaging spillovers and externalities. Whether, or how much, insurers share some of these characteristics is the subject of extensive debate. I am yet to be persuaded that the similarities of insurers and banks are more important that the differences. But I am persuaded that insurance is a critical financial service provided by firms that have considerable complexity in terms of financial risks. This alone demonstrates why we care about the prudential supervision of insurers. I should stress that we are looking forward to the challenge.

Thank you.