Paul Fisher: Confronting the challenges of tomorrow's world

Speech by Mr Paul Fisher, Executive Director for Insurance Supervision of the Bank of England and Deputy Head of the Prudential Regulation Authority (PRA), at the Economist's Insurance Summit 2015, London, 3 March 2015.

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Thank you for inviting me to speak to you today. As many of you will know I have been covering as Executive Director of Insurance, in addition to my responsibilities as Deputy Head of the PRA, since August last year whilst a search was made for a permanent appointment. At long last I will be passing the baton over to Sam Woods at Easter. So this is likely to be my final speech made as Insurance Director.

I would like to take the opportunity to offer up some personal observations about the current and prospective state of the insurance industry, as well as comment more generally on the role regulation will play in "confronting the challenges of tomorrow".

The insurance sector, by absorbing and laying off risk, plays a fundamental role in fostering a stable economy. A successful industry is therefore key to achieving the Bank of England's financial and monetary stability objectives. And as society and its economy evolve, it is vital that the insurance sector also responds to that changing environment.

Tomorrow's world inevitably brings change. Some changes can be forecast, or guessed by extrapolating from what we know today. But there are, inevitably, the unknown unknowns which will help shape the future. That means that a successful industry needs to be both dynamic and robust.

Uncertainty generates challenges but also represents opportunity. I want to discuss these risk/reward trade-offs and the importance of understanding the potential for new exposures that changing risk profiles can bring.

Insurance fulfils important social functions: the provision of income security in retirement; income protection whilst in work; funding for health care services and preserving the continuity of businesses subject to unexpected shocks. Indeed, in some areas, insurance is compulsory such as with motor insurance and employers' liability. Disruption to these functions is unlikely to be tolerated by wider society, not only because of the social benefits, but because risk transfer and pooling are crucial for sustainable economic growth and development. It is for this reason that the need to protect the interests of policy holders and to preserve long-term critical cover is so important.

Although one cannot be sure what the future may bring, we can learn from past mistakes to avoid their repetition. That is particularly apposite given that the residual effects of the great financial crisis are still being felt across the global economy. One of the things we appreciate very well at the PRA is that insurance business is very different to banking, and I have seen that at first hand over the past six months or so. I have also seen that there are lessons to be learnt from the banking crisis that ***can*** directly read across to the world of insurance.

Let me express a clear personal opinion; financial crises of the past were often, in large part, created by the people at the top making poor decisions – people not possessing the right information; not having due regard for risk; not being properly incentivised. Significant failures have often had their roots in poor governance with insufficient checks and balances to the decisions of powerful individuals. Strong, effective systems of oversight and risk management are paramount in meeting the PRA's objectives for the safety and soundness of firms and insurance policyholder protection. Not surprisingly, governance issues are consistently at, or near the top, of the PRA's agenda whether for banks or insurers. I can safely predict that this focus is not about to lessen any time soon. Firms in tomorrow's world need to aim for governance best practice.

The recent banking crises further illustrated that one of the most obvious ways in which financial stability can be undermined is through disorderly firm failure and the consequent disruption of financial services. The PRA's stance is that unsuccessful business models need to be allowed to fail, but that failure should be in an orderly manner so as not to disrupt the provision of core financial services. And I think we would all agree that the taxpayer should not be asked to bail out a failed firm.

One difference from banking is that failing insurers usually ***do*** exit in an orderly manner. Actually, about a third of the PRA's authorised firms are in run-off. But that is in part a testament to the successful regulatory regime that the UK has been running for the insurance sector. And, whatever the regime, we cannot be certain this will be the case in every conceivable circumstance. For this reason, the PRA continues to place the resolution arrangements for insurers on both the domestic and international agendas.

The banking crisis further taught us all that we need to be looking at potential storms ahead and not to be misled by periods of fair weather. For the PRA this means it will assess firms not just against current risks, but also against those that could plausibly arise in the future, carrying out increased business model analysis. For insurers, this involves monitoring emerging risks and taking preparatory steps to deal with what may result, with firms holding capital commensurate to their evolving risk profile. This approach is embedded as part of Solvency II, for example with the requirement for each undertaking to conduct a forward looking assessment of its own risk and solvency needs.

The fallout from the global financial crisis has accentuated the need for an open, two-way dialogue between regulator and regulated. This is especially true in times of change or stress. To ensure policyholder protection, regulators need to be alert to emerging risks and this is best achieved through a "cards on the table" approach. Indeed, where the PRA judges it is necessary to intervene, we will seek to do so at an early stage. Firms should be open and straightforward in their dealings with the PRA and we in turn will take a risk-based and proportionate approach.

This is being put into practice. For example, enhanced communication is particularly pertinent as we transition to the Solvency II world. From April, firms will be able to make formal applications and we don't need a crystal ball to predict a very busy year for both regulator and regulated. The PRA has had an extensive on-going dialogue with firms, giving detailed feedback on, for example, their internal model developments or their matching adjustment applications. Just over a week ago we issued guidance on how equity release mortgages might be structured for use in the matching adjustment. Right now, the PRA is aiming to provide both general and individual firm feedback, recognising the importance of timely communication allowing firms to prepare thoroughly.

As a consequence of the financial crisis, financial regulation in all its forms has been through a major transition. In the UK we have seen the split of prudential and conduct regulation, the establishment of a single Insurance Directorate at the PRA with an insurance specific secondary objective, and we have moved forward in our application of "judgement-based regulation". The next few years will be about embedding this new approach through Solvency II.

I would like to move on now from regulation to a number of other developments and challenges that are currently on the horizon and to discuss the possible impacts these could have on insurers' business models.

The nature of insurance and the risk transfer role it provides means that insurance cuts across all aspects of society; whether providing at retirement solutions to pensioners to insuring the latest iPhone. It is for this reason that insurers find themselves innovating in step with wider society. As insurers are directly exposed to social changes, the changing world is the very stuff on which they should thrive. There are a number of such societal, regulatory or environmental changes currently at play such as global warming, globalisation, digitisation, demographic changes and cyber risk to name but a few.

Societal and environmental changes

A topical environmental change that is quickly moving up the agenda for insurers is that of climate change.

Climate change impacts insurers on both sides of their balance sheets. Insurers may be impacted by increased claims experience – particularly so given the London Market's prominence in areas like catastrophe risk. But it appears that the asset side may also give rise to unexpected risks.

Let's take these in turn.

We are seeing evermore frequent "record" weather events; storms; floods; hotter summers; intense rainfall; not to mention global concerns such as higher sea levels. Insurers are having to respond to these shifts. However, increases in catastrophic risk events can provide both an opportunity and a threat to insurers.

There is an opportunity for growth in underwriting new products. But the combination of concentrated exposures to large catastrophe losses, inadequate risk management and/or the potential for mis-pricing could undermine the sustainability of businesses.

The insurance industry is already taking steps to stay ahead of the climate curve on the liability side with the establishment of Flood Re; ClimateWise forums; more sophisticated underwriting techniques; the development of climate change products and carbon offsets. However, it is worth bearing in mind that, even though the full impacts of climate change often may not be visible in the short term, it is well worth insurers being alert to the emerging risks, including those emanating from policy makers.

But insurers, as long term investors, are also exposed to changes in public policy as this affects the investment side. One live risk right now is of insurers investing in assets that could be left "stranded" by policy changes which limit the use of fossil fuels. As the world increasingly limits carbon emissions, and moves to alternative energy sources, investments in fossil fuels and related technologies – a growing financial market in recent decades – may take a huge hit. There are already a few specific examples of this having happened.

The Bank of England has been carrying out analysis to better understand these risks. The Bank of England voluntarily accepted DEFRA's invitation to compile a Climate Change Adaptation Report, due for delivery later this year. A project team was established to inquire into the topics of climate change and stranded assets. We are seeking to understand how these changes may impact upon the PRA's objectives and how that could shape our role going forward.

We have noted that change to an insurers' business model can be driven from many sources – which include changing consumer expectations.

Today the consumer demands more control, flexibility and automatism having become accustomed to interactive, accessible and digitised services. Increasingly consumers – that's you and I in our personal lives – expect the same digitised experience for all their buying needs, including insurance.

Digitisation and the prominence of "smart tech" cannot be ignored and already innovation in technology is leading insurers to do business differently. This shift can be felt across the value-chain, whether it be changes in distribution channels and use of cloud-based infrastructure, to enhanced underwriting processes and use of "black boxes".

For the most part, digital includes putting the customer experience at the centre of insurers' strategies. Whilst positive, as with any shift in business model and strategy, business developments need to be carefully managed and monitored to ensure the core objectives of enhancing the customer experience are indeed achieved. And new IT systems don't come cheap, nor are they riskless.

Digitisation and enhanced technology can be a double-edged sword. Technological enhancements bring new opportunities to businesses but the pace of innovation must be met by the pace of corresponding safeguards to deal with the risks. In particular, the risk of cyber-attack is a great concern. The pace here is really changing very rapidly.

As with the other risks, insurers are affected for both good and ill: with ever more frequent and increasingly sophisticated cyber-attacks on businesses and individuals, insurers are being relied upon more and more for protection. A new business opportunity for sure. But, unlike most other insured risks, insurance firms could themselves be significant victims.

It is difficult to predict how cyber-crime – or even cyber accidents – will evolve, and it is very challenging to obtain data for losses that arise out of cyber-events. This makes it all the more difficult to quantify reserves, models and prices as well as develop operational safeguards internally.

An Insurer wishing to expand into any new business area needs to demonstrate to the PRA that new risk exposures are well understood and that the required capital for an altered risk profile has been fully considered. As stated previously, business model analysis forms an important part of the PRA's supervisory approach and a focus for its supervisory activity. Insurers will need to deal with the PRA in an open, co-operative and constructive manner to allow us to understand whether the business model is sustainable and to identify key vulnerabilities. This will ensure a more informed, focussed and proportionate supervisory approach.

Into the unknown

Over the past 25 years we have seen: the introduction of the Euro; break-up of the Soviet Union; a shift from West to East; the introduction of the world wide web to ordinary life; and smart technology – so what will happen over the next 25 years?

As an ex-forecaster I can tell you confidently that the only thing we can be certain of is that there will be changes that no one will predict.

I did not think, some six years ago, when sat at the table of the Monetary Policy Committee for my first meeting, that Bank Rate would continue to be 0.5% this far down the line. One can never be sure what tomorrow will bring and interest rates is a case in point.

The low level of real interest rates today is, in large part, a product of spare capacity in the real economy and low levels of growth and productivity across the developed world. This presents a number of issues for insurers who rely on interest income from their assets as part of their basic business model, especially where these returns back contractual guarantees. Without making any implied comment about monetary policy, just looking at today's yield curve, it is not plausible for insurers to expect high nominal or real rates of return in the near future from low-risk assets. Firms relying on high income streams from their assets may find themselves taking ever greater risks to their balance sheets.

Earlier on I mentioned the importance of governance in the work of the PRA. It is one thing that can help generate robustness in the face of these uncertain developments. Good governance should lie at the heart of every organisation. It is not just about the role of the board but includes management, controls, oversight and management information. Good governance encourages better business practices and outcomes. Of course, well intentioned people can make sub-optimal structures work – just as good structures can be run poorly. But a better structure gives a firm a better chance of avoiding a big business mistake and of surviving an unexpected shock.

Insurance retains highly talented and competent individuals. However, I have observed that the sector can be a bit of a "closed field". I hear some firms – not all – talk of the difficulty in being able to appoint successful executives and even more difficulty in finding qualified, independent non-executives. Insurers also talk about the challenges of attracting young and ambitious individuals to supply the talent of the future. These people issues become particularly relevant in an environment under the Solvency II regime when the system of governance will be given even more prominence. I hope that the new Senior Insurance Managers Regime will be seen as both appropriate and proportionate to the needs of the industry and policy holders alike. To be clear, the Senior Insurance Managers Regime should not be operated in such a way so as to put good people off. The desired outcome is that of effective governance, not enforcement.

Insurance innovation and regulation

Preparedness for what tomorrow's world may bring will likely involve a degree of change – greater risk-awareness, ensuring good governance, collaboration with the regulator – but is the insurance industry capable of that change?

The insurance industry has been founded upon taking the long term view. This is a concept that perhaps evokes a perception of consistency rather than innovation. However, the UK industry has traditionally not shied away from changing with the times, with the London market being a particular example.

Already, in response to changes on the horizon, we are seeing shifts in business models. Insurers are refreshing their product offerings, altering operational structures and enhancing distribution channels. The PRA has an important role to play in this so let me return to the subject of regulation.

To be clear, regulators have no intrinsic reason to stifle innovation. Far better to supervise a successful, profitable, innovating enterprise than a declining out-dated one. Underpinning that view, I would say that there should not be a prohibitive trade-off between insurers' ability to innovate versus their ability to manage risks.

Instead, the PRA will need to work with its regulated entities closely and early in the process of innovation. Let's be clear that the business model and the risk are owned by the firm – the PRA's job is make sure that a firm's approach to risk management is sound and that their policy holders are adequately protected.

I believe Solvency II will help to do this. It will introduce greater risk-sensitivity; co-operation across jurisdictions; and consistency in approach. Being a risk-based regime means that insurers should be able to evolve and adapt to capture all risks they are exposed to and the qualitative risk assessment introduced under Pillar II will further support this move towards a more responsive, reflective and adaptable solvency regime. This in turn will mean that insurers will need to think carefully about the risks they are exposed to and how this is captured and managed. This does not mean that Solvency II should dictate firms' business models. Rather, market forces and expectations of policy holders will inform insurers' pricing and strategies.

As referred to earlier, there is much we can do to prepare for the future by learning from mistakes of the past. One such area where this should be borne in mind is in the use of risk models which will play a huge role in Solvency II for the larger, more complicated firms. Firms need to be able to understand their models and their limitations, and be able to challenge them. As the Governor said last year: "*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*".

There are many things I could say about Solvency II, but I want to concentrate on what it means for the future. One particular aspect is that it sensibly allows for a smooth transition, over a period of 16 years in some cases. It is recognised that for insurers (particularly life insurers), Solvency II with the introduction of a "going concern" regime, is a considerable shift. In particular, firms will have to hold a risk margin to ensure that the insurance liabilities reflect the value for which they could be transferred to a third party. To allow for the gradual introduction of the risk margin, firms will be able to make a transitional deduction from their technical provisions. Together, the various transitional measures within Solvency II should ensure a smooth progression, avoiding the market dislocation, volatility and increased costs that could result should a number of firms have to augment their capital base at the same time. They rightly recognise that the underlying risks have not changed overnight, even if the regime has.

Firms making use of transitional measures will be afforded time to reach the level of financial resources required by the full Solvency II regime. In the meantime we can be sure that the transitional deduction from technical provisions will not result in a firm's resources falling below those required under the existing UK regime. This is because Solvency II caps the amount of transitional benefit a firm may derive. Bearing in mind this cap, and the benefits to be gained from a smooth transition, the take-up of transitional measures should be seen as a viable option for firms to take to assist with their capital planning, and are a feature that the UK authorities strongly supported during the development of Solvency II. They are there to be used where appropriate.

As we shift to a Solvency II world, I think it is worth bearing in mind that, like a smartphone, regulation tends to get new "updates" and "apps" in response to changes in the external environment. Indeed, the path of the future is in global policy development, including the insurance capital standard (ICS) under the aegis of the International Association of Insurance Supervisors (IAIS) which will look to develop risk-based global standards.

Insurance business is fast becoming globalised and interlinked. It naturally follows that so too should regulation. Introducing global capital standards would enhance global cooperation, ensure a level playing field and limit regulatory arbitrage.

For this reason, the PRA supports the development of global capital standards and the establishment of a long term vision in order to achieve a single insurance capital standard predicated on a single valuation basis which is genuinely comparable across jurisdictions.

Concluding remarks

Insurance sits at frontline of innovation and, as seen with climate change and digitisation, insurers can be directly exposed to changes in regulation, public policy and other shifts in society. This is because insurance forms one of the foundations to our daily lives, providing a risk transfer role for all facets of human activity. Risk transfer allows society as we know it to function effectively and as such, insurers oil the wheels for the engine of the economy to function. On the basis of what I have seen since last August, the UK insurance industry is one of the most advanced and successful in the world. The key to meeting the challenges of tomorrow's world is for the industry and regulator to continue to develop and work together.