Philip R Lane: Dual perspectives on the insurance sector – consumer protection and financial stability

Address by Mr Philip R Lane, Governor of the Central Bank of Ireland, at Insurance Europe's 8th Annual Conference, Dublin, 25 May 2016.

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Good morning. I am pleased to welcome you to Dublin for the 8th Insurance Europe conference. This event also marks the 30th anniversary of the Insurance Ireland industry association.

The theme of today's conference is Serving Our Customer in Tomorrow's World. As the regulator of the insurance sector, the Central Bank of Ireland is continuously engaged with the topics to be discussed in today's panel sessions. In addition, from a central banking perspective, the high degree of interconnectedness between the insurance sector and other parts of the European financial system means that we also monitor the insurance sector in relation to our financial stability mandate at both domestic and European levels.

Let me share a few ideas in relation to the themes of the conference.

The first panel addresses the impact of the regulatory environment on consumers. A well-functioning insurance sector is essential in managing the risks faced by households and firms. The importance of the insurance sector to European citizens has motivated the introduction of a modernised regulatory framework in the form of Solvency II, with the twin goals of enhancing consumer protection and maintaining financial stability.

An important property of Solvency II is that it is a maximum harmonisation regime, and so should increase supervisory convergence across Europe. In view of the high degree of cross-border trade in insurance products, the Central Bank of Ireland strongly supports convergence in supervisory standards, which would contribute in a significant way to the long-term resilience of the financial system in Ireland and Europe.

Most of the policyholders of Irish-resident insurance firms are abroad; in the other direction, many Irish policyholders are covered by foreign European firms. Regardless of location, all customers should benefit from the same high standards of supervision and should all rest assured that their underwriters are unlikely to fail. However, much work remains to be completed in attaining the goal of consistent supervisory standards across Europe. Furthermore, the coordination of national protection schemes for policyholders remains unsatisfactory: should an insurance firm fail, citizens are covered in full, in part or not at all, depending on where they are and where their insurers are regulated. Solvency II has also left untouched the processes, conditions and standards for authorisations. I can only encourage EIOPA to press on this issue and ensure that firms that would not be authorised in one country do not find a home in another.

Two of the panel discussions today focus on the customer in tomorrow's world. Let me comment on the role of technological innovation in distribution channels. First, more widespread deployment of online distribution channels has the potential to reduce costs, expand access to insurance products and improve consumer convenience. However, at the same time, online distribution requires a parallel increase in attention to cyber risk. The International Association of Insurance Supervisors has recently discussed this topic, highlighting that the foundation of the insurance business is trust, and that trust could be irrevocably shaken if sensitive data were lost or claims payments disrupted. Our assessment at the Central Bank of Ireland is that cyber risks pose not only financial and reputational risks for individual insurance firms but that there are wider consequences for prudential supervision, consumer protection and financial stability.

Second, the automation of advice to potential customers is a promising development. However, as recently highlighted by the Joint Committee of the European Supervisory Authorities, there are pros and cons to these tools from a consumer perspective. The potential benefits include lower costs, increased convenience and greater consistency in advice. The primary disadvantage is the risk of an unsuitable final recommendation due to the lack of a human advisor. To represent a net gain for consumers, the design of automated advice systems must ensure that consumers are provided with clear, accurate and relevant information and recommended suitable products appropriate to their needs. The properties of suitability and transparency are among the most important principles underpinning the Central Bank's consumer protection framework and are increasingly important in this period of rapid technological innovation.

One of the panel sessions will focus on global and European financial stability. In the international regulatory community, there is increasing interest in the inter-relations between the insurance sector and the stability of the broader financial system. In one direction, excessive risk taking by insurance firms can be a source of financial instability, both directly and indirectly through the interconnections between the insurance sector, other financial intermediaries and financial markets. In the other direction, the insurance sector can make a positive contribution to financial stability, given the potential complementarities between the balance sheet structure of the insurance sector and the balance sheet structures of other sectors.

Much of the current risk discussion has focused on the implications of a protracted low interest rate environment for the insurance sector.[1] The sector needs to reflect carefully on its strategic response to a prolonged low interest rate environment. For instance, for those firms within the life sector that have traditionally included guaranteed returns to policyholders, there is clearly a challenge to this business model. In terms of replacing that business or earning returns to support legacy guarantees, it may be tempting to seek returns from non-traditional and non-insurance activities. However, this strategy has clearly been a source of fragility for firms in the past.

For non-life insurance, buoyant investment returns have subsidised the pricing of core insurance products. The response to a lower-yield environment should not be to chase returns by investing in ever riskier assets. Rather, the focus should be on earning an appropriate return from core underwriting activity.

There is much in the new Solvency II framework that should allow firms to better manage risks associated with the low interest rate environment. In particular, the own risk and solvency assessment (ORSA) process should provide a framework for enhanced corporate understanding of interest rate and investment risks. For regulators, understanding how the insurance sector is likely to be affected by a prolonged low interest rate environment is also a priority. Indeed, the risk posed by the low interest rate environment is the core scenario that is contained within this year's EIOPA stress test.

Finally, I note that there is also a panel session on the global economic shift towards emerging economies. Judging by the disparity in insurance penetration rates, there appears to be significant medium-term growth opportunities in emerging economies. To the extent that the global growth in the insurance sector is partly served by an expansion in the international activities of European insurance firms, the scope for scale economies and diversification need to be balanced by appropriate management of some key risk factors. These include: the limits of managerial control over wide geographic spans; the complexities of local tax, social security and legal systems; and the correlations between underwriting returns in a given region and other exposures such as the performance of various asset

[1] The implications of climate risk for the insurance sector is another prominent topic. I do not address this issue today.

classes and the sources of equity and debt funding. The insurance sector can learn much from the storied history of international banking in negotiating the opportunities and pitfalls associated with financial globalisation.