Cyril Roux: Insurance pricing and supervision

Opening remarks by Mr Cyril Roux, Deputy Governor (Financial Regulation) of the Central Bank of Ireland, at the Committee on Finance, Public Expenditure and Reform, and Taoiseach, Dublin, 6 October 2016.

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I would like to thank the Oireachtas Finance Committee for the invitation to meet with you today. General insurance protects people from financial losses that would disrupt their lives or businesses. Having the appropriate insurance in place, which pays out when needed, enables consumers and businesses to conduct their business on a day-to-day basis.

Before I delve into insurance pricing and supervision, let us remember that behind the cold numbers of motor insurance premiums and claim costs that show up in insurance accounts and in the bills we receive, lie the losses suffered in road accidents. On the one hand, rising insurance premiums affect consumers and businesses. On the other, we know how devastating road traffic accidents can be on the lives of victims and their families. Reducing the number, severity and cost of road accidents is a worthwhile policy goal in itself. As a secondary benefit, it would provide ground for sustainable insurance premiums. Low premiums with high payouts cannot last and ultimately result in failure and further consumer detriment. It is against this backdrop that I would like to set out the role of the Central Bank in the area of insurance and then to give an overview of the motor insurance market in Ireland. I will also briefly cover areas of focus for the Central Bank, together with some thought on how to address the challenge of increasing costs.

Role of the central bank

The Central Bank of Ireland has two specific mandates as regards insurance. It is responsible for the prudential supervision of insurance companies authorised in Ireland. It is also responsible for the supervision of conduct of business in Ireland, also referred to as consumer protection. We describe this dual role and how we discharge it in our Annual Performance Statement, which has been provided to the Committee.

Prudential supervision seeks to ensure that insurance firms remain solvent. That is to say, that insurers are able to pay claims in full, as they fall due. Because claims are paid long after the premiums are set, this requires a forward looking assessment, with respect to the entire business of the insurance and reinsurance company, of its state of solvency, of the establishment of technical provisions, of its assets and capital. The Central Bank is responsible for looking after the solvency of insurance companies incorporated in Ireland, whether or not they belong to international groups.

However, when they do, supervision takes place in an international college of supervisors chaired by the supervisory authority of the head of the group. Such is the case for all major domestic insurers such as AXA, Allianz and RSA, with FBD being the exception.

Insurance Directives have prescribed for decades that prudential supervision of (re)insurance undertakings, including that of business they pursue through branches or under the freedom to provide services, shall be the sole responsibility of the home member state. As such, foreign insurance firms such as Aviva and AIG, Zenith and Enterprise, Qudos, and Setanta, are incorporated, authorised and subject to prudential supervision by foreign authorities, and not by the Central Bank.

In the area of business conduct, the Central Bank has put in place a consumer protection framework to protect the interests of consumers in dealing with insurers. The consumer protection framework also applies to European insurers selling in Ireland on a freedom of establishment basis or a freedom of services basis. The consumer protection framework includes codes and regulations which set out standards for firms when dealing with consumers, including when selling insurance policies, handling claims and renewing policies as well as the provision of information and dealing with complaints.

The Central Bank does not have a role in the setting of premiums, and like all supervisory authorities in the European Union, is explicitly prohibited by European law from doing so by Article 181 of the Solvency II Directive. This is a long-standing prohibition carrying over from Solvency I. In carrying out its dual mandates of prudential and conduct of business supervision, insurance regulators throughout Europe, including the Central Bank, cannot intervene on premium rates, but must rely on other instruments.

This is because the European single market for insurance has been set up by EU legislators on the basis of free market principles. This is in keeping with the guiding spirit of the Treaty of Rome. The contention underpinning this institutional choice is that over the medium term, the free play of market forces brings benefits to consumers which outweigh their costs. However, it also means that the volatility of prices for insurance services cannot be constrained by the Central Bank.

Ultimately, insurance rates are driven by the money coming into insurance companies relative to the costs they subsequently experience, in a similar way to any other commercial concern. But year-to-year insurance rates are also strongly impacted by the competitive environment faced by insurance firms. Prices are affected by the underwriting or insurance cycle which plays out over a number of years.

Insurance firms may fail when poorly selecting risks or underpricing their policies, which is known as ‘underwriting risk’. This, together with limited shareholder support, is likely to have been the main driver of the failure of Setanta in Malta and Enterprise Insurance in Gibraltar, although only their local prudential supervisors are in a position to tell. The Central Bank has adopted an intrusive, forward looking and proactive supervisory approach, including in relation to underwriting risk. Our supervision is conducted through a combination of approaches, including off-site activities and comprehensive on-site inspections. When we are not satisfied with the governance, monitoring and management of risks, including underwriting risks, we issue time-bound requests for remedial action. Such requests can include revised business and capital plans, forms of contingent capital such as parental support and strengthened reinsurance cover.

In discharging our statutory objective in Consumer Protection to ensure that, in regulating firms, the best interests of consumers are protected, the Central Bank has focused on: clarity of price disclosure by firms; strong suitability requirements to make sure that any product sold is suitable for the consumer’s needs, and that any product recommended to a consumer from a range of products is the most suitable from the range available (having regard to the consumer’s individual circumstances and needs); and ensuring that consumers get relevant information sufficiently in advance to equip them to shop around.

Motor insurance market

Let me now turn to the motor insurance market and the way it operates. The Irish motor insurance market is concentrated across 8 firms, which are mostly part of large international groups. There is also an active intermediary sector selling motor insurance on behalf of the insurers. These non-life firms sell a variety of property and casualty insurance policies – there are no pure motor insurance companies among them.

These firms receive premiums from policyholders and investment income from their investments, while they pay out claims to policyholders and injured third parties, commission to their distributors, expenses to their staff, interest and dividends to their capital providers, and premiums to their reinsurers.

For non-life insurance companies in Ireland, the balance of costs and revenues has been off kilter for several years. Premiums and investment income have decreased while claim costs have increased, leading to sustained losses. Regulatory returns submitted to the Central

Bank for companies subject to prudential regulation in Ireland for Irish motor risk shows combined underwriting losses of €684 million for the years 2013, 2014 and 2015.

The returns submitted to the Central Bank by companies subject to prudential regulation in Ireland or operating as a branch show that the gross premium for Irish motor business was €1.26 billion in 2015. This represents a reduction of 25 per cent from the 2005 gross premium. On the other hand in 2015, gross claims incurred (which represent the total of claim payments and changes to reserves for the expected cost of settling outstanding claims) were €1.3 billion, which represents an increase of 42 per cent from 2005 with much of this increase arising since 2012.

The non-life insurance industry has also been significantly impacted by the prolonged low interest rate environment. Non-life insurers balance their underwriting results with investment income, mostly interest income from investments in government and highly rated corporate bonds. In a low interest rate environment, a much lower investment income cannot compensate underwriting losses to nearly the same extent.

The bulk of the insurance firms' payouts are through claim costs. Injury claim costs account for the majority of motor claim costs and, due to the length of time it can take to settle these claims, the true or final cost for an insurer does not emerge for a number of years after they have set the premium and sold a policy. However, there are a number of changes in the claims environment in recent years contributing to a greater overall cost. These changes include an increase in claims frequency as a result of increased economic activity and miles travelled. Average claim costs are also increasing, particularly for bodily injury claims because of a number of factors, including changes in court limits, the introduction of Periodic Payment Orders and the potential impact of lower discount rates. The Aspiro judgement is an additional factor of claim cost inflation.

In the face of increasing premium rates, the consumer protection framework provides that consumers must be given at least 15 working days' notice prior to renewal providing an opportunity to choose an alternative provider. Based on external market research, it is clear that price is the main driver of consumer switching behaviour.

Supervisory areas of focus

Last year the Central Bank conducted a bodily injury review to investigate the trends in frequency and severity of these claims and the quality of firms' approach and governance around the issue. We found a clear if disparate trend towards both greater frequency and cost of bodily injury claims. We also found slower settlement rates, uneven data management quality, and instances where boards exercised less monitoring and oversight than required. This highlighted that some firms were lagging behind peers in taking the full measure of emerging claims in their technical provisions and estimates of ultimate claim costs. We issued recommendations to individual firms and made clear our expectation that up-to-date claims data inform reserving as appropriate.

This year the Central Bank undertook a sample review of motor insurance underwriting and pricing to investigate each firm's governance of its underwriting and pricing methodology, assumptions and decision making. We found that there was a significant time lag between increasing claim costs being experienced and the revision of pricing assumptions. Some of this was due to firms underestimating the extent to which claim cost increases were structural and not cyclical, and some was due to firms taking commercial decisions to delay increasing prices in order to hold market share in the face of some competitors pricing much lower than break-even. The delay in incorporating fully in premiums rates the current trends in claims experience contributed to suppressed premium increases, followed by a large upswing in premiums. Had prices risen earlier and more gradually, some of the heavy losses firms have experienced here over the last few years, in particular those firms that engaged in very low pricing, would have been avoided, and consumers would have started to pay higher premiums earlier, albeit at a more gradual pace.

In addition, given the patchy experience of foreign firms selling motor insurance into Ireland on a freedom of establishment or freedom of services basis, the Central Bank is engaging directly with the relevant home state regulators to ensure that they have a full understanding of the issues affecting the Irish market and to request they act accordingly. The Central Bank is strongly proactive in this regard. We provide our counterparts with clear information about claims in Ireland and remind foreign regulators of their responsibilities towards Irish policyholders. Indeed, as already mentioned, the Solvency II directive squarely places the sole responsibility of financial supervision of foreign firms on foreign regulators, and prescribes that the home state regulator verifies for the entire business the state of solvency, its assets and its technical provisions.

Working toward a solution

As I mentioned at the outset, average premium rates over the cycle are driven by the overall claims charge, if not exclusively. Policy actions that would result in a reduced level and uncertainty of claims would contribute to reducing the rise of average premium levels or might even reverse the trend.

This Committee has heard the many strands that would contribute to that worthwhile goal.

Let me start with comments that are relevant to the topic but lie outside the remit of the financial supervisor. All actions that would reduce the number of road traffic accidents would be welcome. Typical among those are improved infrastructure, stringent enforcement of road safety rules, or continued enhancement of public awareness about the preventable causes of accidents.

This Committee has heard as well the extent of fraudulent claims and uninsured driving that is said to prevail. Policy actions that would help reduce either would also help reduce the claims charge that is ultimately to be borne by premiums.

Finally, the Committee has heard about the role and effectiveness of the Injuries Board, and how it has contributed to speedy and fair settlements that avoid unnecessary legal costs.

I would now stress that greater certainty and reduced volatility of the claims factors would benefit consumers and create a more stable reserving environment. Multiple decisions over the last three years, although taken for valid reasons, have had an opposite side-effect. Since insurance companies need to book reserves with a risk margin, the greater the uncertainty, the greater the claims estimates. I can only welcome the publication of the revised Book of Quantum and hope it will steer very broadly compensation settlements and decisions in the future.

All these policy actions would give a foundation for more sustainable insurance premiums.

Because of the many strands of work involved, the Department of Finance is leading a multi-departmental ‘Insurance Policy Review’. The Central Bank contributes to this work and shares what information it has at an aggregate level to assist the Government to decide on next steps.

Closing remarks

The Central Bank will continue to focus on the adequate protection of policy holders and beneficiaries in accordance with its dual role of ensuring the solvency of Irish insurers and adherence to its consumer protection framework.

The Central Bank recognises that the significant increases in the price of insurance have an impact on consumers, and is committed to working with this Committee, the Department of Finance working group and other stakeholders as is appropriate to the mandate of the Central Bank.