Muhammad bin Ibrahim: Insurance supervision - looking beyond

Keynote address by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the 24th International Association of Insurance Supervisors (IAIS) Annual Conference 2017 "Insurance Supervision: Looking Beyond", Kuala Lumpur, 2 November 2017.

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Welcome to Kuala Lumpur. We are delighted to host the 24th IAIS Annual Conference. The last time this conference was held in Southeast Asia was 14 years ago.

Bank Negara Malaysia has a very long and productive association with the IAIS. Not long after the IAIS was established in 1994, a new insurance legislation was enacted in Malaysia. This was a watershed event, changing the course for development of the industry. A deep and comprehensive reform was instituted and the course was set to modernise the insurance sector in Malaysia.

I recall how useful the Insurance Core Principles and other IAIS standards were in helping to shape our regulatory approach and supervisory practices. As a market with a long history of global insurers operating within our borders, we also benefited from arrangements that enabled us to better supervise cross-border activities.

These arrangements have continued to strengthen over time, culminating most recently, in the IAIS Multilateral Memorandum of Understanding.

We are therefore delighted to host this event in Southeast Asia, where the deepening of insurance markets remains key to support economic risk management and broader development goals for this region.

Looking beyond…

This brings me to the theme of this conference, “Looking beyond”. It is an interesting theme. It is even more interesting if we look at the insurance industry from a broader perspective, from the angle of economic development. Beyond issues of safety and soundness, my experience suggests that we ought to have a keen interest in the development of an effective and efficient insurance market, that serves the advancement of broader goals, from the provision of healthcare, to building resilience against natural disasters, supporting trade, enhancing social security and providing the opportunity for people to improve their livelihood.

Insurance is a great invention, one of those inventions that touches people’s lives. Long before “big data” became in vogue, insurers have effectively used data to turn unknowns into knowns, and perils and hazards into opportunities. The concept of pooling funds to assist the unfortunate and those faced with adverse situations is a very noble idea.

From air travel to the launching of satellites, insurance innovations have enabled many of mankind’s greatest feats, propelling civilisation forward. Innovations in micro-insurance have helped protect our most vulnerable communities from devastation. Today, drones are being used to inspect property damage claims, and machine learning to detect fraud. Indeed, the industry has enabled trade to flourish, serving as the bedrock of modern economies.

Despite these remarkable developments, the world continues to face immense economic, environmental and social challenges. The effects of climate change are real, leaving horrific damage and destruction. Economic losses in the aftermath of this year’s hurricane season in the Gulf of Mexico is estimated to reach up to $265 billion. Events that we once thought to be implausible or highly unlikely, have become the “new normal”.

In many parts of the world, health care costs continue to rise, and many face uncertain futures as public sector safety nets and government finances come under increasing strain. Against this backdrop, financial inclusion for the underserved segments remains an elusive goal.

For the insurance industry, this raises important issues. Two issues come to my mind. First is on the industry's role in addressing a few of the challenges facing our economies and society. And second, the manner in which regulation and supervision can adapt to support broader economic and social development.

In addressing these issues, I shall attempt to advocate the idea that a rethinking in approach is an imperative. New paradigms are needed to anchor business and public policy to the realities of the future. I will touch on three of them: competitive, stability and ethical paradigms.

A new competitive paradigm

In an increasingly interconnected world, traditional models of competition deserve a re-think. Network effects will become more important, both in increasing the value of insurance products and services, and to better manage risks. Rather than see the competitive landscape through a zero-sum lens, co-operative competition or "co-opetition" can result in synergistic benefits.

The example of Hewlett- Packard (HP) clearly illustrates this idea. Just one year after the company started operating its direct cargo trains linking China and Europe, it made the bold decision to allow other producers on-board, giving up what was seen as a significant competitive advantage at the time. But the results were astonishing. By doing so, it was able to increase the frequency of departures which allowed it to move its products more quickly to Europe. Today, HP's Europe-bound trains depart daily from China, with the higher frequency working to its own advantage.

The notion of co-opetition is not entirely foreign to the world of insurance. Insurance marketplaces such as Lloyd's of London have long operated arrangements that deliver advantages from pooling risks and information. In Malaysia, market mechanisms exist to move reinsurance documentation more efficiently between market participants, and to share information on fraud.

The emergence of new technologies will take this further. Open application programming interfaces, or APIs, enable insurers to provide and obtain access to information that will significantly alter the operational process of insurers. But access to information would require a network of service providers who are willing to share data and information, without giving away one's competitive edge. Investments in infrastructure, especially in ICT is very expensive. By pooling funds to build shared infrastructure, the burden becomes more manageable. More investments in IT will enable new possibilities to expand insurance reach, improve efficiency and increase effectiveness.

Not long ago, the natural instinct would be to resist these forces of change. More than ever, corporations' fortunes and survival are now more closely linked. New realities require new paradigms. Co-opetition. How we cope with the new realities will depend on our ability to re-set our minds and leverage on networks to create value; at the customer, the firm, and at the system levels.

There is enormous potential in re-defining strategies in competition and cooperation. Imagine the possibilities that could be achieved with strategic investments in shared infrastructure and the ability to share data securely across individuals and entities. We could significantly reduce costs, improve access, deliver superior customer experience which was previously not possible, with the network of shared information, better management and improved resilience against risks.

A new paradigm on stability

It has been 10 years since the global financial crisis. The global insurance industry is now on stronger and more stable foundation. Industry leaders and supervisors may be satisfied with what was achieved since then, but there is certainly no room for complacency.

Achieving stability objectives will become more challenging as the complexities of risk identification increase. We know that insurance companies can create systemic risks, even though we may differ in our views over the intensity of such risks. There is a 'constructive tension', arising from the need to significantly strengthen regulation and supervision while balancing the need for growth, development and innovation.

In a world characterised by fierce competition, complex product offerings and evolving customers' needs, there is always the risk of administering excessive and complicated regulations. This could lead to unintended consequences that can make the financial system less, rather than more stable. In a dynamic world, regulation and supervision should be agile, pragmatic and dynamic and able to respond to changing conditions in a timely manner. A bit of uncertainty ought to be tolerated. But at the same time, we should not hesitate to reverse course should a particular rule prove to be ineffective. Rules are never meant to remain relevant in perpetuity. It never does. It always run its course. It is from this perspective that regulators must have the courage to change course.

In addition, from another perspective, the importance of proportionate regulation and supervision cannot be overstated. This is an area where I think we must continue to work in developing and refining the approaches to proportionality and support more inclusive insurance markets. In the larger scheme of things, as regulators we cannot ignore the broader objectives of supporting economic growth and improving the overall welfare of society.

Equally important, with environmental, social and governance considerations, becoming an important criterion and increasingly adopted by investors, the ethics and sustainability of insurers' activities will be important factors in creating shareholder value. Consumer welfare and wider social impacts alongside profits will constitute key metrics by which performance is measured. This is only appropriate, as maintaining public's trust and confidence is a good business strategy.

The idea here, is not to view the insurance industry's stability in isolation, but to be seen within the wider context of preserving social and economic value of insurance systems.

A new paradigm on ethics

Technological advances and scientific breakthroughs have opened new possibilities to operate and deliver products to customers. Technological innovations will make customers better off but insurers on the hand, may be confronted with some fundamental ethical issues. For insurance companies, this requires a rethinking of professional and ethical standards. Thus, a need for a new paradigm on ethics.

For example, with greater ability to aggregate and analyse more data from multiple sources, questions arise on the extent insurers should consider using genetic and social preferences in underwriting. Or whether it is acceptable to commit someone to a long-term financial undertaking when they may not fully comprehend the implications of their choices even though insurers might truly believe it is 'good' for them. And then, there is always the dilemma and trade-offs in directing more resources toward social impact investments, in cases where it lowers risk-adjusted returns for policyholders.

As advancements in technology brings about various unknowns and a blurring of business lines, professional and ethical standards need to be embedded into our DNA to ensure the integrity of our industry. When it comes to ethical values and conduct, we must move beyond conceptual discussions to practical applications. Time and effort must be undertaken to raise the standards of competence and developing well-defined codes of behaviour. This should take into account an insurer's legal and professional obligations, the wider impact on society, issues of equity and fairness, and preservation of virtues such as honesty and compassion.

These issues I raised are delicate issues that can involve complex ethical choices. It will test the values of corporations, its people, its leadership.

Specific issues for regulation and supervision

Let me mention a few words on specific challenges for regulation and supervision in the future that is before us. First, the lifespan of regulations is getting shorter and shorter, with new areas of risk emerging faster than regulators can write new rules. Second, and adding to the complication, potential threats are also creeping in from beyond the traditional regulatory perimeter. This can be both from non-traditional players, or unfamiliar business models or technologies. Third, we may have to simply accept that we may never fully grasp or understand emerging risks facing the industry, in a timely manner.

Allow me to offer some reflections on these issues. First, we need a better and effective approach to collate intelligence, including from non-traditional sources. Technological advancement offers additional opportunities. There is clearly vast potential on the use of big data and machine learning to improve risk identification and assessments. Last year, the US SEC successfully charged a bank for failing to adequately train its representatives in the sale of certain complex debt instruments, using custom analytics.

Tools were developed to sift through millions of trading records, a task that would have been impractical with traditional investigative techniques. I conjure that supervisory arrangements to share information across agencies and borders had also assisted in expanding and strengthening the investigation effectiveness.

Second, we need broader toolkits that allow for more targeted and proportionate interventions. Several are worth mentioning. Good progress has been made in recovery and resolution planning that ensures large financial institutions can be unwound in an orderly fashion without threatening broader stability. In Malaysia, the takaful and insurance protection system complements supervision through differentiated premiums that create strong incentives for insurers to maintain prudent risk profiles. And different enforcement approaches, such as enforceable undertakings, can be an effective way to tailor supervisory responses to risks at the institutional level.

Third, we need to recognise that regulation is as much an art as it is a science. Experience suggest that authorities should prioritise rules that are appropriate for their jurisdictions, and at the same time, allow room for regulatory and supervisory discretion to respond to emerging and specific risks. This is important if we are to reconcile and balance the trade offs between the practical limitations that regulators face, the desire to avoid excessive regulation, and the need for authorities to act to mitigate risks.

The exercise of regulatory discretion should be subjected to appropriate rigour and accountability. And it should be supported by a stronger focus to develop *regulatory experts,* rather than just more regulations. This requires deep knowledge of the industry, but also wisdom and discernment. In the current state of constant change, building the capacity of supervisors is one of the most critical priorities to guard against threats to stability without impeding growth and innovation.

Finally, we need to create room for experimentation. While rules are not meant to restrict innovation, they often have the effect of doing so. This might end up leaving customers worse off, and insurers exposed to higher business risks than necessary or appropriate. When faced with the stark choice of doing nothing and risking harm to public interests, or writing rules to control something that we do not yet fully understand, it is only sensible to experiment and learn from it.

This point is also crucial, when technology offers so much potential to increase financial inclusion. Platform-based solutions and insure-tech companies are opening up insurance access to large segments of the population at a fraction of previous costs. To fully benefit from such possibilities, some regulators have adopted "regulatory sandboxes" to test solutions and design regulations that are appropriate. There will no doubt be other approaches taken to experiment and innovate. And when things do not work, we must be prepared to change tactics and strategy.

Conclusion

Over the last few decades, the global regulatory community has come together to build stronger supervisory systems and more resilient markets. Insurers have built extensive networks in their pursuit of growth. Now is the time to build on these foundations and further strengthen them, with a renewed commitment and focus on increasing the utility and impact of insurance.

In a journey of many twists and turns, the IAIS has been incredibly fortunate to have Secretary General Yoshihiro Kawai at its helm, leading the IAIS through a large part of the journey, 14 years in total. While the road ahead remains challenging, I am confident that under the able leadership of Secretary General-designate Jonathan Dixon who succeeds him, the IAIS will no doubt continue to strengthen its important role in building stronger insurance systems that work for all.

On that note, allow me once again to warmly welcome you to Malaysia, and to an engaging and productive conference ahead.

Thank you.