Ed Sibley: Towards a more resilient insurance industry

Opening remarks by Mr Ed Sibley, Deputy Governor (Prudential Regulation) of the Central Bank of Ireland, at the Central Bank Insurance Conference "Thriving in Challenging Times", Dublin, 15 February 2019.

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Introduction

Good morning ladies and gentlemen. It is my pleasure to welcome you here on behalf of the Central Bank of Ireland to this insurance conference with the theme of "Thriving in Challenging Times".[1]

Today's conference brings together domestic and international thought leaders and policy makers with a rich understanding and experience of the insurance industry. I would like to thank them for their participation and all of you for attending. I would also like to thank the Central Bank staff who have organised today's event.

The aim of today's conference is to provide a forum for discussing some of the strategic challenges the insurance industry faces. These short and longer term challenges are as diverse as the insurance sector itself, but equally so are the opportunities. This must be the case, given the raison d'étre for insurance in mitigating the risks of uncertainty.

In my brief opening remarks this morning, I will touch on some of these challenges. I will focus my remarks on resilience, one of the key Central Bank priorities outlined in our strategy for 2019 to 2021[2], and how it pertains to insurance.

The Central Bank strategy 2019–2021

The Central Bank serves the public interest by safeguarding monetary and financial stability and by working to ensure that the financial system operates in the best interests of consumers and the wider economy. A core element of our approach is to ensure that the financial system is sufficiently resilient to withstand future shocks and that the impact of these shocks is mitigated.

This public service mandate, together with the specific responsibilities laid out in legislation, underpins all that we do, and connects our five strategic priorities for the next three years. Specifically:

- Resilience
- Brexit
- Strengthening consumer protection
- Engaging and influencing
- Enhancing organisation capability

Resilience

We recognise that the only way that the financial system can serve the needs of the economy and its consumers is for its participants to take risk. In other words, risk-taking benefits the economy and consumers. But poorly understood or insufficiently controlled risk-taking is clearly undesirable, given the associated negative consequences of uncontrolled failure. No one in Ireland should need reminding of the costs of systemic failure.

So the work of regulation and supervision is complex. While it must be evidence-based and outcomes focused, it does require finely-balanced judgement to operate in the grey areas between the two ends of this spectrum of risk.

Insurers must operate in line with the domestic and international regulatory regime. Our risk-based supervision of insurance firms is delivered in line with this regime, anchored by our PRISM[3] methodology. It strives to deliver effectively in ensuring that the system as a whole is, and individual firms operating within it are, appropriately resilient. It seeks to ensure that regulated firms:

- have sufficient financial resources (capital and liquidity), including under a plausible but severe stress;
- have sustainable business models to allow them to prosper through the economic cycle;
- are well run, appropriately governed, have effective risk management and control functions and appropriate cultures; and
- can recover if they get into difficulty, and we can resolve them without significant externalities or taxpayer support if they cannot.

A more resilient system is better able to withstand shocks and continue to support the economy and its customers in good times and bad. It becomes less of a transmission mechanism for shocks and, potentially, plays more of a smoothing role in reducing volatility. In recent years, volatility in the cost of insurance in Ireland has undoubtedly caused challenges for insurance customers.

I expect the boards and management of regulated firms to ensure that their firms are sufficiently resilient. I also recognise and support system wide efforts to address some of the factors causing volatility and higher insurance costs than in other comparable countries. These efforts include the work of the Cost of Insurance Working Group. An associated recommendation of the Personal Injuries Commission[4], chaired by Nicholas Kearns, is for the establishment of judicial guidelines for appropriate general damages for various types of personal injury. Such guidelines should lead to greater levels of consistency in the assessment of general damages in Ireland, which should help in better enabling the domestic non-life insurance sector to support its customers.

Recovery & Resolution Planning

Recovery and resolution planning for insurance firms also requires further work. The regulatory regime for insurance is not sufficiently robust or consistent across Europe. This issue is accentuated by the inconsistency in insurance compensation schemes across Europe – an issue for both home and host supervisors. As well as pushing for further developments at a European level, the Central Bank is driving firms to improve how they execute recovery planning as well as advancing our own approach to resolving insurance firms.

Culture

Culture is also important for a firm's resilience. As you all know, the culture of a firm is pervasive, and relevant to all aspects of how the firm is run, how decisions are made, how risks are considered, how customers are treated, and so on. It is therefore of interest to both prudential and conduct supervisors. And, as is well documented, a cause of legitimate concern both domestically and internationally. Diversity can also be seen in the same light.

Rightly, a lot of focus has been on the need for cultural change in banks[5]. However, this need for change goes beyond the banking system. Certainly, our focus on culture and the lack of diversity at senior levels in the financial system extends beyond banks. It will include work in the insurance sector in 2019.

It is noteworthy that a recent Central Bank's enforcement investigation[6] found that certain individuals were:

- manipulating claim reserve estimates by recording claim reserve estimates that were significantly lower than that recommended by the claim handlers; and/or
- significantly delaying the recording of the claim reserve estimate increases recommended by the claims handlers in relation to certain large loss claims.

In order to manage the large loss claims subject to the under-reserving process, a list, was maintained. The list detailed, amongst other things, the existing claim reserve estimate recorded on the firm's claims database, as well as the claims handlers' recommended claim reserve estimate. Frequent, undocumented meetings were held between those individuals involved in the under-reserving process to discuss the large loss claims.

There were multiple associated governance and control failings in the firm, as well as issues around the presence and effectiveness of challenge and so on, all of which speaks to the prevailing culture within the firm at that time. I recognise the work that the firm has done subsequently to address those failings. These issues are relevant to all firms, and it is important that the lessons are learned by all.

If we look internationally, the Hayne report, published in Australia by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry[7], identified issues across banking, financial advice, pensions and insurance. The report outlines the damage done to individuals and to the overall health and reputation of the financial services industry. The report found that apologies and promises to do better, have not prevented recurrence. The report advises that because it is the entities, their boards and senior executives who bear primary responsibility for what has happened, close attention must be given to their culture, their governance and their remuneration practices.

The recent G30 report on "Banking Conduct and Culture – A permanent mind-set change"[8] reminds us that management focus needs to become a permanent, fundamental, and integral part of how business is invariably done rather than being addressed through a series of ad-hoc initiatives.

Brexit

As I and others have spoken about Brexit[9] on multiple occasions recently, and it will be discussed in later sessions, I will only cover it briefly now.

We are only in the foothills of the potential testing of the resilience of the financial system that a hard Brexit will cause. It has short-term and long-term implications for the structure of the Irish economy and the Irish financial system. Any form of Brexit will be damaging for Ireland, with a hard Brexit especially so. Recognising these risks, the Central Bank has been focused on Brexit risks since before the 2016 UK referendum. In recent months, we have stepped up our work on mitigating the most material 'cliff-edge' risks of a hard Brexit.

From a financial regulation perspective, our work has sought to ensure:

- the financial system is resilient enough for a hard Brexit not to cause significant financial stability risks;
- that financial services providers are discharging their responsibilities by taking all necessary steps to protect their businesses and customers to the risk of a hard Brexit;
- that risks to consumers are mitigated to the greatest extent possible; and
- we are delivering a proportionate, robust, efficient and effective authorisation process in line with European regulatory norms, for those firms seeking authorisation in Ireland as a result

of Brexit.

For insurance, I am satisfied that the majority of firms covering the vast majority of policies written are taking appropriate action. However, there are some remaining risks of consumer detriment. The Central Bank has worked with the Department of Finance to support the drafting of legislation to protect customers of insurance products in event of no deal Brexit. The draft legislation provides for a temporary run-off regime, which will allow certain UK/ Gibraltar insurers and brokers to continue to service existing insurance contracts with Irish policyholders in the event of a "no deal" Brexit.

Even with this mitigation, there will be negative consumer impacts. For example, the supply of niche insurance products may reduce or end altogether, given the increased costs and frictions of serving EU customers from the UK.

Finally, Brexit is not the only uncertainty that we face. To touch on three others:

1. Firstly, the effects of climate change, in the form of more frequent and severe storms, floods and droughts, have already affected insurers. Further increases in the number and severity of disruptive climatic events look certain.

Furthermore, as the Governor of the Central Bank recently remarked[10], the financial system (including the insurance industry) has a crucial role to play in the transition to a lower carbon economy.

2. Secondly, insurance is also at the forefront of the opportunities and challenges that arise from disruptive technology change both in how services are provided and the services that are needed.

3. And thirdly, demographic changes across Europe are profound, with an increasingly aged population needing to be served for a longer period of time.

To conclude on resilience, as risks evolve, so should the insurance industry. I expect insurance firms to be anticipating future significant risks and opportunities to ensure that they remain resilient over the long term. Through this, I expect that you will not only be rising to the challenges that are in front of us today, but are also resilient enough and sufficiently future-focused to successfully support the needs of the economy and your customers long into the future.

Regulatory regime

I have touched on our work and expectations on the necessary enhancements to recovery and resolution planning for insurance firms. I would also note that we are undertaking work in 2019 on PRISM, to ensure that it continues to evolve and remains fit for purpose as our approach and the risks in the financial system change.

It is over three years now since Solvency II came into effect. I am very pleased to welcome Karel Van Hulle here today who was instrumental in the introduction of the Solvency II regime. The introduction of Solvency II represented a significant milestone for the insurance industry. We can, and must continue to develop the Solvency II regime, to ensure it remains relevant and appropriately protects policyholders and beneficiaries.

Solvency II will be reviewed in 2020. This review will provide the opportunity to examine the practical implementation of Solvency II, ensure it remains fit for purpose, adapts to changes in market conditions and evolving business models, while continuing to meet its fundamental objectives.

Input to the 2020 review of Solvency II will be a key area of focus for the Central Bank this year. I look forward to hearing Karel's contribution on this critically important topic. For my part, I will be interested in recovery and resolution and the insurance guarantee schemes. Two areas that are not included in the scope of the Call for Advice but could be considered by EIOPA in the call for advice are i) When an insurance firm holds a large reinsurance asset that is not collateralised, the firm is exposed to significant credit risk which may not be fully reflected in the capital charge and ii) the ability for national supervisory authorities to apply a capital add on where there are prudential concerns.

Thank you for your attention this morning. I will now pass you to our first keynote speaker of the morning, the Chairperson of EIOPA, Gabriel Bernardino. I am delighted to be introducing him at our conference. Gabriel will address "Challenges and Opportunities for the Insurance Sector: The European Perspective".

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1 With thanks to Brian Balmforth, Jenny Minogue, Attracta Jennings, Jade Crofton, Chris Joyce and Tim O'Hanrahan for their assistance in preparing these remarks.

2 Central Bank of Ireland Strategic Plan 2019 – 2021 (2019).

3 The Probability Risk and Impact System (PRISM) is the Central Bank's risk-based framework for the supervision of regulated firms. It supports our challenging firms, judging the risks they pose to the economy and the consumer and mitigating those risks we judge to be unacceptable.

4 Personal Injuries Commission: Second and Final Report of the Personal Injuries Commission (July 2018)

5 Central Bank of Ireland: Behaviour and Culture of the Irish Retail Banks (2018)

6 Central Bank of Ireland: Enforcement Action (2018)

7 Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry: Final Report (2019)

8 Group of 30: Banking Conduct and Culture - A Permanent Mindset Change (2015)

9 Lane, Philip R.: The Brexit Discontinuity (2019); Sibley, Ed: Safety and soundness – Strategic priorities for the next three years (2019)

10 Lane, Philip R.: Economic Letter – Climate Change and the Irish Financial System (Vol. 2019 No. 1)