Ed Sibley: Functioning of the insurance market, key industry issues and challenges ahead

Address by Mr Ed Sibley, Deputy Governor (Prudential Regulation) of the Central Bank of Ireland, to Insurance Ireland Annual Industry Lunch 2019, Dublin, 8 May 2019.

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Introduction

Good afternoon ladies and gentlemen. I would like to thank Insurance Ireland for the invitation to speak at today's Annual Insurance Lunch.

As you all know, insurance serves a critical role in the functioning of a modern society, through reducing uncertainty by protecting people and businesses against the risks of future events. Policyholders rely on insurance to provide support in the event of loss or serious accident, to plan for retirement, to enable them to confidently invest in and run their businesses and much more besides. On the other side of their balance sheets, insurers provide a stable flow of funds to support the investment flows modern economies and societies need.

In other words, a functioning financial services system that sustainably serves the needs of the economy and its consumers, needs functioning and trustworthy insurance markets and firms. In Ireland, the Central Bank applies a risk-based supervision of insurance firms in line with international norms anchored by our PRISM 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.

So with this, and the strategic theme[1] of today's event in mind, I will cover the functioning of the insurance market today, key issues that affect the whole industry and discuss the challenges ahead that need to be addressed.

Market functioning

Of course, to speak of one insurance market is a gross oversimplification. There are multiple markets, most of which function well, covering life, non-life and health sectors; with domestic markets served by firms authorised in Ireland and abroad and significant volumes of insurance services exported from Ireland[2]. Our approach to regulation and supervision must be appropriate, proportionate and effective for all these markets and the complex array of firms operating within them. To this end, we seek to operate to and influence the European norms of regulation and supervision[3].

Our focus on improving the resilience of Irish authorised insurance firms from both a financial resources and a business model perspective, together with driving improvements in governance, risk management and culture should contribute to the stability of those insurance markets while ensuring that policyholders can continue to have confidence that their policies will pay-out when required.

Of all these different markets, the domestic non-life insurance market spends the most time in the spotlight, due to both its importance and the challenges in it, including the volatility of premiums over the last few years and the availability of insurance in certain sectors and for certain risks.

Before, moving into areas within the remit of the Central Bank, it is important to emphasize that all actions that reduce the frequency and impact of injuries are obviously worthwhile. Improvements in transport infrastructure; enforcement of road safety rules; public awareness campaigns; and on-going emphasis on health and safety can all contribute to a reduction in the frequency and impact of injuries. There is also work underway to reduce the impact of fraudulent claims and uninsured driving.

The Irish non-life market is served by firms authorised in Ireland and elsewhere in the European Union. Indeed, this provision of service from abroad is an important element of the market in Ireland, as it facilitates:

- greater competition,
- lower premiums than otherwise would be the case; and
- greater choice.

Nonetheless, as we have seen with the failure of overseas insurance providers, there are inherent risks with this model, which require continued work at a European level to drive improved convergence of supervisory practices and, critically, greater consistency in insurance protection schemes and the approach to resolving failing insurance firms. This continues to be a priority in our engagement at a European level. It also requires those intermediating between some of these firms and Irish consumers to take more responsibility for assessing the financial soundness and resilience of the underlying insurer.

The actions from the Cost of Insurance Working Group[4] are focused on addressing some of the underlying factors contributing to insurance costs being higher in Ireland than many other EU countries. I welcome these measures, including those set out within the second Personal Injuries Commission (PIC) report[5] to bring greater consistency and standardisation to personal injuries awards.

The Central Bank has delivered on the various actions relating to our mandate arising from the Cost of Insurance Working Group. These actions include:

providing greater transparency to policyholders at the point of renewal for certain non-life insurance products;

- providing for the extension of the renewal period;
- establishing the national claims information database (NCID), initially for private motor insurance; and
- preparing to publish the first report on the data collected in the NCID in the second half of this year.

Given the concerns regarding the availability and cost of Employers' Liability (EL) and Public Liability (PL) insurance, and the associated impact on small and medium-sized enterprises in particular, the Central Bank will report to the Working Group this year on the feasibility of including EL and PL data in the NCID.

The courts system also plays a vital role in the functioning of the insurance market. It provides an independent, fair and impartial mechanism to settle more complex insurance claims. This process also sets precedents for settlement of other claims.

However, as recognised by the Honourable Mr. Justice Frank Clarke, Chief Justice, "an overall set of judge made guidelines would contribute not only to consistency but also to the proper calibration of the overall level of awards"[6]. I also note the views expressed by many at the Personal Injuries Assessment Board (PIAB) conference of 10 April, that the Judicial Council Bill[7] needs to be progressed. One of the tasks of the Judicial Council, once established, will be the compilation of guidelines for general damages for various types of personal injury.

This is important as average premium rates over an insurance cycle are driven by the overall cost of claims. This includes a risk margin to deal with the potential uncertainty of the cost of settling the claim. The greater the uncertainty, the greater the risk margin and overall claims charge. Policy actions, such as judicial guidelines, that lead to greater certainty and reduced volatility of claims and create a more stable reserving environment for insurance firms are needed. A more stable claims environment could contribute to an increase in the availability of insurance, and a reduction in premium levels, providing the insurance industry shares the benefits of the changes with their customers.

Key issues

In considering future strategy, it is important to consider the current landscape, issues and risks as well as the desired future. In this context, I will cover seven issues relevant to all sectors and firms.

a) Brexit

To touch briefly on Brexit, since the June 2016 referendum, the Central Bank has sought to ensure that all insurance firms operating in the state are appropriately prepared for a 'hard' Brexit, the risk of which remains, and that risks to consumers are mitigated to the greatest extent possible.

We have also seen significant volumes of financial services firms seeking authorisation to protect their ability to provide services across the European Union. In Ireland, we have approved 14 Brexit-related insurance applications for new authorisations and notifications of material changes of business for existing firms.

The business models we have received and considered to date typically include:

- Domestic Irish risk - that has been written from the UK on a Freedom of Services (FOS) / Freedom of Establishment (FOE) basis. This includes material levels of with-profits[8] business; and
- Pan-European specialty risks - that have previously been written from the UK on an FOS/ FOE basis - this includes: marine, aviation, trade credit and political risk, and cyber risk insurance.

As well as discharging our critical gatekeeper role, by ensuring these firms meet our requirements, the Central Bank has been enhancing the regulatory and policy framework to reflect changes in the sector, for example, making enhancements to our framework for third country branches and with profits insurance.

b) Operational Resilience

Operational resilience is a broad and increasingly important topic. The management of outsourcing arrangements and safeguarding IT resilience are two critical components of operational resilience.

Many firms outsource a significant amount of their activities to an intra-group service company or third party. With all outsourcing arrangements, boards and senior management must understand that they are placing the resilience of their firm into the hands of a third-party (or a group company) and while they may be able to monitor the service during normal operations, when something goes wrong, they are reliant on someone else to fix it.

To my mind, in some firms and for some risks, the levels of outsourcing are potentially excessive and bring into question the substance of the operation of the firm in Ireland. We have taken action to address specific instances where this is the case, and will continue to prioritise improvements in this area, including the use of service companies. As noted by my colleague, Derville Rowland last week: “when it comes to outsourcing arrangements, governance and risk management standards are emphatically not where they need to be.”[9] From the board down, this needs to change, such that insurance firms can demonstrate that they are discharging all of their obligations when they outsource any insurance activities, as if they were performing them themselves. Among other things, the Central Bank expects:

- boards to have appropriate oversight and awareness of outsourcing arrangements and the associated risks;
- operational oversight to be clearly designated to relevant individuals, functions and/or committees;
- firms to make sure they have the appropriate skills and knowledge to effectively oversee and understand arrangements, and their associated risks, from inception to conclusion; and
- firms to prepare for the worst – considering what the loss of service providers would look like, identify the potential triggers for this and finally, what actions would the company take to minimise consumer detriment and interruption of service in such circumstances.

Turning to IT resilience, the dependence on technology in insurance services continues to increase. Too many firms are still not getting the fundamentals right, including regarding IT security and continuity of services. This is not a solid foundation for the building of digital-based strategies and greater investment in technology, processes and people is required.

Within the Central Bank we have a developed a common methodology across all financial sectors to assess technology risk within regulated firms, and are continuously updating our approach in line with regulatory developments and best practice. For 2019, we are continuing to push firms to focus on the fundamentals while also enhancing their cyber and operational resilience to be able to withstand, absorb, and recover from IT incidents.

c) Reinsurance

The overall levels of reinsurance across the Irish insurance industry are relatively stable. However, we do see some firms increasing their levels of risk cession[10] and in particular firms with a heavy reliance on other group entities. We have seen firms seeking to rely on significant levels of outsourcing and reinsurance to the extent that the firm and its board cannot demonstrate it is discharging its responsibility and capacity to manage the risks that it has written. This should be outside of the board’s risk appetite, it is certainly outside of ours.

Where individual firms use extensive reinsurance, both counterparty and concentration risks need to be closely managed and exposures may need to be collateralised to reduce the associated risks.

d) Investments

Recent Solvency II returns are showing a slow but noticeable shift towards a riskier asset allocation at the industry level. In particular, we have seen a marginal shift from sovereign debt towards corporate debt[11]. In the search for yield, this is understandable. I would emphasise that the prudent person principle under Solvency II expect firms to consider the security, quality, liquidity and profitability of their portfolio when assessing their investment exposures. While the shifts we are seeing may increase the yield on investments, it is important that boards and executive management are ensuring that these changes are not at an undue cost to security, quality or liquidity.

e) Individual Accountability and the Fitness and Probity (F&P) regime

The Central Bank continues to see significant shortcomings in compliance with F&P obligations and a lack of awareness in the industry regarding the scope of the F&P regime. This is concerning given firms are the first line of defence under the F&P regime, which is why Derville Rowland and I wrote to all firms[12] early in April 2019 to highlight obligations and areas where compliance was found to be lacking.

As you are aware the future ambition of the Central Bank is to introduce an Individual Accountability Framework which will provide more powers to make senior management in regulated undertakings accountable for their actions. This would also see enhancements to the current F&P regime, with further obligations on firms.

Regulated firms can expect to see a continued supervisory focus on F&P. I expect that the boards and senior management of all firms to be fully aware of their F&P responsibilities and to ensure that all individuals within firms comply with F&P Standards.

f) Recovery planning

Internationally and in Ireland, insurance is behind banking in recovery planning, both in terms of the regulatory framework and firms' preparedness. This needs to change.
Effective recovery planning, should include "triggers" for implementation, escalation processes, recovery options, and the identification of financial or operational impediments to recovery. I expect you to be formally considering recovery planning as part of strategy setting and capital planning, including consideration of the some of the issues I have discussed already – outsourcing, reinsurance, IT resilience and so forth. I also expect firms to address impediments to resolution as they are identified.

The Central Bank's and EIOPA's focus on resolution planning will continue to increase. The 2020 Review of Solvency II for example, which the Central Bank is taking an active role in, is wide ranging in scope covering many fundamental areas of the regime, including insurance guarantee schemes and recovery and resolution.

g) Diversity

In March 2019, the Central Bank published its third annual report on the levels of gender diversity of the most senior appointments in the Irish financial services sector[13].

On both an absolute and comparative basis, there is a woeful lack of gender diversity at senior levels in the insurance sector. In insurance, 22% of applications for approval for these most senior roles were for women, compared to 23% in 2017. In other words, the insurance industry went backwards in 2018. Applications for board positions increased to 36% in 2018 in the banking sector with insurance stuck at 20%.

The analysis continues to show a pronounced gender imbalance at board level and in revenue generating roles. In the insurance sector, in revenue generating roles, the male to female ratio is currently 6:1 at directorship level (15% female representation). For risk management/ control roles, the male to female ratio is 4:1 (20% female representation).

While some firms are starting to make progress, much more needs to be done to increase the diversity of experience, thought, background and attributes at senior levels to:

- reduce the likelihood of groupthink;
- reduce overconfidence and improve decision-making;
- enhance culture and improve risk management; and
- increase the level of internal challenge in firms and reduce excessive resistance to external challenge.

The Future

Turning now to considering the future. Thinking about our uncertain future and preparing for the opportunities and risks that it presents should be in the DNA of insurance firms, but we are not seeing enough of this thinking. Insurance is at the front line of so much of this uncertainty – be it climate change, technology disruption, or demographic changes. Not only does the insurance industry need to adapt to these changes, but it can also shape the wider societal response to them. Each of them could be the subject of speeches on their own, but in the interests of the limited time I have left, I will be brief.

The insurance industry is materially exposed to climate change. Physical risks will impact liabilities (including the costs of claims) and assets; and transition risks could be extremely costly on the investment side. EIOPA has calculated that 13% or €1.4trn of European insurers' assets are exposed to climate transition risk - i.e., the change in asset values that might occur in the shift to a low-carbon economy. But, this also presents an opportunity for the insurance industry to play a positive and proactive role in shaping the wider response to the climate change risks[14] – in terms of the investment choices that you are making.

Ihave already touched on the fundamentals of IT resilience and risk management. I expect insurers to be able to assess the financial and operational impacts of a cyber-attack on their own systems, but also to quantify the cyber risk exposures, including so called “hidden” cyber exposures, within the policies they have underwritten. More broadly, technological changes will affect both how insurance is offered, and what is insured. The increasing use of technology and data analytics to understand and influence customer behaviour also raises important ethical and cultural questions regarding the use of this data and the significant asymmetry of information between firms and their customers. This requires active board consideration.

Finally, insurance also has a critical role to play in the changing demographics in Ireland. It is estimated that by 2050, 40-47% of Ireland’s population will be over 65, compared with 20% in 2016[15] . Insurance solutions will be required to contribute to the challenges of an aging population including pension provision, health-care, non-life insurance and housing.

Assessment of the long-term resilience of the insurance sector is a fundamental part of our supervisory mandate. As such, regulated firms can expect the Central Bank to increase its focus on the adequacy of firm’s emerging risk management. In particular, I expect firms to:

use scenario analysis and stress testing to help determine the potential impact of their exposure to emerging risks;

- evidence how they will mitigate these risks, including a credible plan in place for managing exposures; and
- disclose in a clear, meaningful and timely way, for example through the ORSA and SFCR.

Conclusion

The insurance industry is facing a period of uncertainty and change. Effective strategy setting is difficult in such times; delivery of strategy even more so. Both require:

- solid foundations;
- a strong understanding and effective management of risk; and
- an ability to anticipate, plan for, and be agile in the face of future developments.

More work is required by all of you to be confident that you have sufficient strength in these areas. Improvements are required for you to be confident that you can sustainably the serve the needs of all your policyholders and the wider economy long into our uncertain future.

Thank you for your attention.

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1 Strategic priorities of the Insurance industry.

2 Gross Written Premium Year to Date Quarter 4 2018 – Life €34,869m, Non-Life €16,068m, Reinsurance €16,703m; Source Central Bank of Ireland Regulatory Returns.

3 Sibley, Ed: Innovation and insurance in Ireland: a supervisory perspective (2017).

4 See Department of Finance: The Cost of Insurance Working Group. The Cost of Insurance Working Group, chaired by Minister of State Michael D'Arcy TD, has undertaken a review of the factors which are influencing the increased cost of insurance. The Working Group brings together all the relevant Departments and Offices involved with the process. Its objective is to identify immediate and longer term measures which can address increasing costs, while bearing in mind the need to maintain a stable insurance sector. The first phase involved an examination of the Motor Insurance sector. The second phase involved an examination of the Employer Liability Insurance and Public Liability Insurance sectors.

5 Department of Business, Enterprise and Innovation: Second and Final Report of the Personal Injuries Commission (2018)

6 Clarke, Frank: Statement on the occasion of the Opening of the New Legal Year (2018).

7 Humphreys, Heather: Launch of the PIAB Conference 2019, Department of Business, Enterprise and Innovation (2019).

8 A with-profits policy is typically one that allows the policy to participate in the profits of a life insurance company, through a ring-fenced fund with its own characteristics and specific fund rules.

9 Rowland, Derville: Opening remarks at the Central Bank Outsourcing Conference (2019).

10 Cession refers to the portions of the obligations in an insurance company's policy portfolio that are transferred to a reinsurer. Ceding a portion of risk to a reinsurer allows an insurance company to more effectively and efficiently manage its overall risk exposure. The agreement between the ceding insurance company and the reinsurance company will include comprehensive terms under which the cession is ceded.

11 The percentage of total non-linked investments allocated to Sovereign debt reduced from 34% to 28% while the percentage of total non-linked investments allocated to corporate debt increased from 25% to 31% from Q1 2016 to Q4 2018. Source: Central Bank of Ireland Regulatory Returns.

12 Central Bank of Ireland: Compliance by Regulated Financial Service Providers with their Obligations under the Fitness and Probity Regime (2019).

13 Central Bank of Ireland: Demographic analysis of PCF Applications (2019).

14 European Insurance and Occupational Pensions Authority: Financial Stability Report (2018).

15 Central Statistics Office: Population and Labour Force Projections (2018).