Insurance Ireland - PwC CEO Survey Report Breakfast Briefing - Deputy Governor Ed Sibley

27 September 2019 **Speech**

Address at the Insurance Ireland - PwC CEO Survey Report Breakfast Briefing

Introductory remarks

Good morning ladies and gentlemen. I am pleased to be here this morning, and would like to thank Insurance Ireland and PwC for inviting me to speak to you all today.[1]

The Insurance Ireland / PwC CEO Survey, published today, contains some interesting insights, including the resilience of CEO optimism about the future, some of the challenges the industry faces and the potential disruption from innovation. In my last speech[2] on insurance, I focused primarily on the current functioning of the insurance market in Ireland, so today I will take my lead from the survey and focus my remarks on the future and on areas that I believe warrant your attention over the short and longer term.

Specifically, I will:

- urge you to continue to prepare for the plausible scenario of UK leaving the European Union without a deal;
- highlight that the insurance industry is arguably the most exposed financial services sector to the risks, challenges and opportunities of innovation, climate change and demographic developments, and needs to be taking action now to meet these challenges successfully;
- update you on the Central Bank of Ireland's (the 'Central Bank') increased focus on recovery and resolution planning; and
- outline the work that we are doing to drive the insurance industry to address its disappointing lack of progress in improving diversity at senior levels.

Brexit

The economic, political and societal risks to Ireland arising from the UK leaving the EU without a deal (a 'hard' Brexit) are well documented and so I will not repeat them here, beyond stating they are clearly material to the Irish financial services sector, over both the short-term (cliff-edge) and the longer term.

Based on the work we have undertaken in the Central Bank, the work of the Oireachtas, the actions taken by the European Commission and the work in individual firms, I am satisfied that the Irish financial system as a whole is sufficiently resilient to withstand a hard Brexit. That is not to say that it will be unscathed, as it and consumers of financial services clearly will be negatively affected. Frictions will inevitably arise. However, the system as a whole should not amplify the shock and will continue to be able to serve the economy, consumers and investors afterwards.

Nonetheless, it is also true to say that not all regulated financial services firms are adequately prepared. There is no excuse for this, even accepting that there remains considerable uncertainty as to what will happen at the end of October and thereafter. So, I continue to urge you to make sure your firms are prepared – to make sure that Brexit fatigue and uncertainty does not lead to risks not being sufficiently mitigated. It is critical that regulated firms have considered all the impacts that Brexit could have on their businesses and that they have developed and fully tested their contingency plans in respect of these. You owe all your stakeholders, including most importantly your customers, a duty of care to ensure that you are prepared.

I noted with interest the questions and responses in the survey on regulatory competition and the attractiveness of Ireland as a destination for UK firms seeking alternative EU locations. There are many reasons that Ireland is an attractive location for internationally active financial services firms.

Regulatory arbitrage is not one of them. Numerous international studies[3] and our own experience in Ireland[4] demonstrate the folly of seeking for it to be so.

The Central Bank continues to be successful in seeking to operate to and influence the European norms of regulation and supervision. We have discharged our gatekeeping function effectively, pragmatically and transparently and in line with these European standards. We have robustly challenged firms to make sure that they have sufficient financial and human resources, are well governed and have business models that are likely to be sustainable through the economic cycle. As a result of Brexit, more than 100 firms have been newly authorised or approved to significantly expand their operations having met our expectations.

Our approach not only delivers on our mandate of safeguarding financial stability and protecting consumers and investors. It also helps to ensure that there is substance in these firms and that consumers across Europe can have the same levels of confidence in the products and services sold from Ireland, as those originated elsewhere – that they are regulated and supervised to the same standard. The long term success of the Irish financial system depends on its reputation, on the trust and confidence in both the firms and the regulatory environment. This has long been the case. It is even more important now in the context of Brexit.

Change

We live in an era of continued change and uncertainty. The insurance industry will be significantly affected by two of the defining developments of this era – technology change and climate breakdown. These developments present both significant risks and opportunities for the sector and individual firms and there are likely to be winners and losers. Taking each in turn:

Technology change

The survey results highlight the importance and opportunities of innovation. It shows that the majority of respondents are planning for greater use of automation and the increasing importance of data analytics. Technology changes will affect both how insurance is offered, and what is insured.

Investment in talent and technology is therefore critical to ensure your firms are able to anticipate and keep pace with these changes. History is littered with failed firms and, in some cases, industries that did not.

But you also need to ensure that your foundations are solid. Too many of your firms are not getting the fundamentals right[5], with ineffective IT risk management practices, weaknesses in IT security, a lack of effective oversight of IT, and weaknesses in the management of outsourcing[6]. You run the risk that the investment in the new is being built on the sand of a lack of resilience in the old. Our continuing expectation is that the Boards and Senior Management of regulated firms fully recognise their responsibilities in relation to IT and cybersecurity governance and risk management and place these among their top priorities.

Moreover, the increasing use of technology and data analytics to understand and influence customer behaviour raises important ethical and cultural questions regarding the use of this data and the significant asymmetry of information between firms and their customers. The survey highlights that only 22% of respondents believe that the industry has sufficiently responded to changing consumer habits. I am concerned that even fewer of you and your boards have adequately considered the ethics of how data and technology are increasingly being used in your key interactions with your customers, and are ensuring that this is being done in consumer centric way, consistent with your stated values and branding.

Climate change

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. Since the 1980s the number of registered weather-related loss events has tripled, and inflation-adjusted insurance losses from these events have increased five-fold in the same period.[7]

In addition, transition to a low carbon economy also presents risks, particularly if disinvestment from carbon intensive activities occurs in a disorderly manner. According to analysis by EIOPA, roughly 13% or €1.4trn ($1.6trn) of European insurers' €10.6trn of assets are exposed to climate transition risk[8] - i.e. the change in asset values that might occur in the shift to a low-carbon economy.

"The providers of capital – banks, insurers, asset managers and those who supervise them – all need to improve their understanding and management of climate-related financial risks…. Firms that align their business models to the transition to a net zero world will be rewarded handsomely. Those that fail to adapt will cease to exist."[9]

Moreover, as my colleague Sharon Donnery recently highlighted[10], with climate change, the past is unlikely to be a good guide to the future – catastrophes are getting harder to predict in terms of frequency and impact but it is clear that both frequency and impact are increasing materially. The dynamics of climate change present a major challenge to modelling future impacts[11], but it is clear that the worst possible year is getting worse every year.

There is also a very real risk of a collective withdrawal of insurers from covering risks that they consider uninsurable. The International Association of Insurance Supervisors (IAIS) shows that the insurance 'protection gap' for weather related losses is already significant, with roughly 70 per cent of losses uninsured in 2018[12]. As outlined in a recent Economist article, the worst case is that "swathes of the global economy become uninsurable"[13]. In some jurisdictions, such as the UK, this has prompted the state and insurance firms to work together to supply affordable insurance for homes that are at high risk of flooding.

It is clear that, as The Network for Greening the Financial System[14] has highlighted, climate related risks are a source of financial risk, particularly to the insurance sector. This is why the Central Bank has joined the NGFS and is committed to its aims, including assessing climate related financial risks in the financial system and integrating them into prudential supervision.

As well as risk, there is an opportunity for the insurance industry to play a positive and proactive role in shaping the wider response to the climate change risks. After all, insurance, at its core, is about quantifying the financial impact of uncertain future events: just as the first underwriters in Lloyd's coffee house understood the impact that storms would have on the loss of ships in the 18th century[15] so today's underwriters, actuaries and risk managers must understand the impact of our changing climate, albeit with much more sophisticated data and models to meet these challenges.

The Central Bank expects Irish insurance undertakings to give full consideration to assessing climate related risks and to adopt a longer-term perspective. Risk management frameworks, and firms' ORSAs[16] in particular, should reflect these considerations, including taking a prudent approach to the high degree of modelling uncertainty. We expect to see evidence of robust analysis, prudence and challenge, including from the board, and timely and effective action. In this context, I do recognise that some insurers have begun to consider the implications of the investment and underwriting[17] decisions for sustainability[18]. Many more of you need to do likewise, and more besides.

Recovery Planning and Resolution

Turning now to a key regulatory development that will require you to take action.

Insurance matters. Failures of insurance firms can cause considerable stress and financial loss for policyholders and claimants and financial stability risks. But the Central Bank does not have a zero failure regulatory regime. It is important that firms can take risks otherwise they could not sustainably serve the needs of the economy or they customers, and it is inevitable that some will get into trouble as risks crystallise and a few will fail.

In this context, the Central Bank aims for firms to be able to recover if they get into difficulty and for them to resolvable in a manageable way if they cannot recover, minimising losses to policyholders and claimants and without recourse to state support. However, internationally and domestically, the insurance sector is not sufficiently advanced in being able to mitigate the risks of these failures, both in relation to the regulatory framework and to firms' preparedness for crises.

Recovery Planning

Pre-emptive recovery planning is necessary to facilitate increased awareness and preparedness within firms. Adequate preparation and planning in the form of pre-emptive recovery planning will reduce both the probability of insurers failing and the impact of such failures. Recovery planning is, therefore, an important part of the overall risk management process of insurers and should be considered a governance arrangement within the meaning of the 2015 Regulations[19].

While some firms articulate potential management actions in capital plans linked to their ORSA processes, these capital plans and related management actions are poorly developed and in the main they reflect limited thinking around the practicalities of recovering from a severe stress event. Recovery plans should be pre-emptive and cover a wider range of scenarios (liquidity, solvency and operational) than those currently dealt with in ORSAs or required under Solvency II for SCR or MCR breaches[20]. To be comprehensive, recovery plans need to address potentially less probable, but more severe stresses, they should contain full detail of "triggers" for implementation, escalation processes and recovery options to be taken in different crisis-scenarios and they should identify also potential financial or operational impediments to recovery.

The Bank expects firms to consider recovery planning as a key part of the strategy setting and capital planning and take action now to enhance their ability to recover should they get into difficulty. With this in mind, the Bank plans to go to public consultation next year on proposals to introduce formal recovery planning requirements for insurers under Section 48[21] of the Central Bank (Supervision and Enforcement) Act 2013.

Resolution Planning

The current powers available to the Central Bank to deal with insurer failures have significant limitations. All three powers (administration, examinership and liquidation) are predominantly Court-controlled. Once the Central Bank has successfully petitioned the Court, it no longer has direct control over the process. The availability of other resolution tools, such as the ability to appoint a special manager, or the development of a new write-down and/or conversion (bail-in) power for the Central Bank could potentially better mitigate the impact of failure and cost to the public / policyholders, particularly for large, systemically important insurers.

To this end, we will continue to engage domestically and at a European level to seek to develop an effective regime for resolving insurers. The need for a harmonized, Solvency II-linked approach to resolution is now widely recognised across Europe. The calls for such an approach have become pronounced as proposals for home-state managed insurance compensation schemes[22] gain ground in the EU. However, progress is slow and uncertain, hence the need to consider action at a domestic level, particularly in the context of the potential for considerable contingent liabilities for the Irish compensation scheme.

The Central Bank will therefore continue to develop its own approach to resolving insurance firms and we will consider using the Central Bank's existing powers to seek to remove impediments to resolvability as necessary and in a proportionate way. This work will dovetail with the work we expect insurance firms to be undertaking on recovery planning.

Diversity & inclusion

The Central Bank is committed to driving improvements in the levels of diversity of senior managers in financial services firm. This is based on the compelling evidence, including our own experience, that higher levels of diversity of experience, thought, background and attributes at senior levels and an inclusive environment in firms can meaningful contribute to:

reducing the likelihood of groupthink in and across firms;

reducing overconfidence and improving decision-making;

enhancing risk management; and

increasing the level of internal challenge in firms and reducing excessive resistance to external challenge.

Moreover, addressing the lack of diversity at a leadership level across the financial services system will contribute to cultural change and evidence to your customers that this necessary change is meaningfully taking place.

In March 2019, the Central Bank published its third annual report on the levels of diversity of the most senior appointments in the Irish financial services sector[23]. On both an absolute and comparative basis, there remains a concerning 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 in the banking sector increased to 36% in 2018, 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).

I recognise that meaningfully addressing such an entrenched issue cannot be achieved overnight. But that is not to say that the Central Bank is accepting of the lack of progress. So, as well as following up on the actions being taken in the banking sector following our Behaviour and Culture review last year[24] we are continuing to enhance our supervisory framework and approach to the supervision of behaviour and culture, including diversity and inclusion.

To this end, the Central Bank is currently undertaking a review of the insurance sector, which we have prioritised due to the lack of progress and the associated risks in the sector. During this review, we:

- are assessing the diversity of the most senior role holders in 12 insurance firms, considering gender, nationality, education, experience and so on;
- are assessing the policies and initiatives being put in place by companies to improve diversity and inclusivity; and
- have also extended our analysis to examine companies' approaches to fixed and variable remuneration, to assess incentivisation and the size of gender pay gaps within these insurance firms.

As well as expecting individual firms to address any specific issues we identify, we will publish the overall outcome and themes arising from this review early in 2020. And, we will learn ourselves from completing the work and so continue to enhance our own approach to the supervision of behaviour and culture.

Conclusion

I will conclude here. Clearly, there is much for CEOs, Chairs and the Boards of insurance firms to focus on. Most importantly, you need to continue to improve the running of your businesses and not to lose sight of the fundamentals of effective governance, effective risk management, the adequacy of your resources, and the sustainability of your business models.

These are the foundation of your future success, as you face into the considerable challenges ahead.

To finish on a positive note, some might say that insurance is looking quite exciting and dynamic. Perhaps you could better use this excitement to attract, develop and promote more diverse leadership teams.

Thank you for your attention.

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[1] With thanks to Brian Balmforth, Brendan Nagle & Antoinette McDermott for their assistance in drafting these remarks.

[2] Sibley, Ed: Speech, Insurance Ireland Annual Industry Lunch - (2019).

[3] Dagher, Jihad: IMF Working Paper No. 18/8 Regulatory Cycles: Revisiting the Political Economy of Financial Crises

[4] Central Bank Reform Act 2010 amended the Central Bank Act 1942. It repealed S.57BD to remove a "consultative industry panel'. The Government's policy position was influenced by the Honohan report as evidenced by comments made in 2010 in the Select Committee On Finance And The Public Service.

[5] Sibley, Ed: Financial Centre Summit address "The need for resilience in the face of disruption: Regulatory expectations in the digital world" (2018).

[6] Rowland, Derville: Opening remarks at the Central Bank Outsourcing Conference (2019). "One of the particularly disappointing conclusions of our outsourcing review was the unsatisfactory level of board awareness of outsourcing risk."

[7] Munich Re, NatCatSERVICE.

[8] EIOPA: Financial Stability Report (2018)

[9] Carney, Mark: UN Secretary General's Climate Action Summit (September 2019).

[10] Donnery, Sharon: Sustainable Nation Ireland Conference (May 2019).

[11] For example, uncertainties, non-linearities and potential cliff effects could prove difficult to model.

[12] IAIS: Issues paper on climate change risks to the insurance sector (2018)

[13] Economist- Changing weather could put insurance firms out of business (September 2019).

[14] NGFS: Press Release (April 2019)

[15] Lloyds: Corporate History webpage

[16] Own Risk and Solvency Assessments, a core requirement of Solvency II (Directive 2009/138/EC) are processes insurance undertakings use to measure their current and future solvency needs. This requirement of EU law is based on IAIS core principle 16. Other jurisdictions, notably the US' NAIC (National Association of Insurance Commissioners) have imposed similar requirements.

[17] https://www.chubb.com/us-en/about-chubb/chubb-coal-policy.aspx

[18] https://www.avivainvestors.com/en-ie/about/responsible-investment/our-approach/

[19] S.I. No. 485/2015 - European Union (Insurance and Reinsurance) Regulations 2015 transposing Solvency II into Irish law. Regulations 44-51 provide for systems of governance.

[20] "SCR" (Solvency Capital Requirement) is the level of capital required to ensure that the (re)insurance company will be able to meet its obligations over the next 12 months with a probability of at least 99.5%. "MCR" (Minimum capital requirement) (MCR) is the level of capital below which the national supervisor (regulator) would intervene. The MCR is intended to correspond to an 85% probability of adequacy over a one-year period and is bounded between 25% and 45% of the SCR. SCR and MCR are used by Regulators as "soft" and "hard" floors respectively. Solvency II articles 138 and 139 provide for intervention measures regulators take when the capital holding of the (re)insurance undertaking falls below the SCR.

[21] Central Bank (Supervision and Enforcement) Act 2013 s.48(2)(w) provides for regulations requiring regulated financial service providers to establish and maintain plans for (inter alia) recovery from any deterioration in specified financial circumstances etc.

[22] EU Commission: White Paper on Insurance Guarantee Schemes (2010).

[23] Central Bank of Ireland: Demographic analysis of Applications for Pre-Approval Controlled Functions (2018)

[24] Central Bank of Ireland: Behaviour and Culture of the Irish Retail Banks (2018)