Risks surrounding the insurance industry

A number of important risks surround the insurance industry, such as typical insurance risks, regulatory risks, the low interest rate environment and the lack of knowledge about the insurance business model. Overall, one would think that there is a great deal of potential for the insurance industry. However, the sector needs to adapt itself to the changing environment and approach the changes in a proactive and strategic manner rather than a reactive and a defensive mode.

Insurance risks

It is very likely that private insurance will have to take over a number of tasks which are presently delivered by social security. This is particularly the case for health insurance and long term care. This development which is linked to the ageing society provides new opportunities for the insurance industry. Other areas where insurance will be on call concern pensions and climate change. People want to retire comfortably. They will need protection in the form of guarantees. Similarly, climate change will create more severe natural catastrophes also in areas where this has not yet been the case. It is of utmost importance that private-public partnership regimes are set up to deal pro-actively with the potential damage that will result from these catastrophes. In many countries, there is no satisfactory regime in place yet.

Regulatory risks with regard to solvency

The biggest regulatory risk with regard to solvency is that nothing happens: the present solvency regime is deficient and it needs to be replaced urgently with a solvency regime that attaches more importance to risk. However, we see that some insurers are afraid of the risk logic. They like a risk based solvency regime but would like to delete certain risks such as market risk. I believe that this is wrong: we should not shoot the messenger but find smart ways of dealing with the volatility that result from a market consistent valuation of assets and liabilities. It is perfectly possible to design a way in which insurance liabilities can be calculated in a manner that does not create artificial volatility. I hope that EIOPA will help Member States and the European Parliament to resolve this issue in a manner that is respectful of the logic of Solvency II without being overly bureaucratic. The longer the liabilities are the more freedom there should be in calculating them as nobody knows for sure what will happen in 20 years. It is interesting to note that the concept of a risk free discount rate is looked at very differently today. There was a time that government bonds were considered risk free.
There is a tendency under Solvency II to exaggerate the mathematical aspects of the reform: Solvency II is not just about pillar 1; it is also about pillars 2 and 3 that are of equal importance. One of the biggest challenges under Solvency II is to develop a good

and fruitful dialogue between the actuaries, the supervisors and the industry. In that sense, Solvency II will cause a cultural shock.

Consumer protection

Consumer protection is high on the regulatory agenda. The financial crisis showed that many people have bought financial products which they did not really understand. The people selling these products were often not themselves aware of the risks attached to the investments. They were more often more concerned with the commissions that could be made on the sale of these products than with the needs of the consumers. At all regulatory levels, the message is now clear: this attitude must change. Financial services are complex and the concerns of the consumers must come first. That message has been passed by the Financial Stability Board, the International Association of Insurance Supervisors, the Organisation of Economic Cooperation and Development, the European Union and the European Insurance and Occupational Pensions Authority.

A number of regulatory initiatives are on the table in the EU: the revision of the Insurance Mediation Directive and the Packaged Retail Investment project. The supervisory architecture is changed in several countries reflecting a higher concern for consumer protection. For instance, the split between prudential supervision and market conduct supervision. Consumers are also become more engaged in the process: they increasingly buy their products themselves through the internet or set up pools so as to obtain lower premiums. The insurance industry will have to adapt its way of operating reflecting these changes.

Systemically important insurers

The financial crisis showed that the failure of a major bank can cause a breakdown of the financial system. It has therefore been agreed to introduce specific (more regulatory) rules for banks that are systemically important. The question is whether insurers can also cause a failure of the system. That is less evident for classical insurance but many insurers are engaged in activities which look very much like banking (for instance, various types of investment products without much insurance). Should these insurers be dealt with differently from a regulatory perspective? That is a difficult debate: What is traditional insurance? What “sanctions” should be imposed on insurers that engage in non-traditional insurance business? Should additional capital be imposed upon a systemically important insurer? How can this be done in the absence of an internationally agreed solvency framework? Should there be rules on the resolution of a systemically important insurer?

The banking agenda

There is no doubt that a reform of the banking regulation has for the moment the highest priority. Unfortunately, that leaves little time to deal with the insurance sector

which also needs its reform. Furthermore, there is a tendency to combine prudential supervision of banks and insurers within central banks. That may not always be a good idea: central bankers are familiar with the problems of banks but not necessarily with the particularities of insurance. Central bankers tend to look at the asset side whilst for insurance the liabilities side of the balance sheet is more important. Whilst the insurance industry has been able to pass the message that insurance is not banking, it has been less clear in identifying where the differences are between insurers and bankers and what this means in terms of regulation. The message seems to be that what is good for banks in terms of regulation, should be equally good for insurers. I believe that more importance should be paid to the particularities of insurance.

Low interest rate environment

One of the problems insurers face is that they do not have a lender of last resort. They cannot benefit from macro-prudential tools such as a regulation of the interest rate. The present low interest rate environment should help the banks to survive the financial crisis. For insurers, low interest rates create major problems. These problems do not appear immediately as insurance is very often a long term business. However, there is no doubt that strategies will have to change if the low interest rate environment continues.

Delays in the adoption of Solvency II

Since the adoption of the Framework Directive in 2009, it seems as if the enthusiasm that was present at the adoption of the Directive has somewhat diminished. The main reason is the financial crisis, which has created volatility in the valuation of assets and liabilities thereby causing the capital requirement to move up and down in a manner that was never intended. Insurers have been afraid about the consequences of this volatility which may be difficult to explain to the outside world. They fear that supervisors might react immediately by imposing additional capital. This has led to fierce lobbying with finance ministers and with the European Parliament and has resulted in difficult discussions between the co-legislators (Council and European Parliament) in the context of Omnibus II. EIOPA has now been asked to carry out a technical assessment of the various solutions that the negotiating parties have put on the table to deal with the volatility particularly in the context of life insurance. I believe that – once the results of this technical assessment will have been examined – it should be possible to finalise the discussions on Omnibus II so that the implementing measures can be tabled and agreed. It is therefore good that EIOPA has taken the initiative to table draft guidelines which should help supervisors and insurance undertakings to prepare themselves for the start of Solvency II.

It would be irresponsible to further delay the process: more than ever do we need a strong insurance industry that is capable of tackling the many challenges to which our

society is exposed today. That will only be possible of the industry can start from a modern and forward looking solvency regime.

Main challenges for the insurance industry

More time and effort should be spent explaining the role of insurance to the outside world. It is amazing to see how such an important economic sector is often misunderstood. This is in part due to the insurance industry itself which does not necessarily like transparency. Solvency II should contribute to improving that situation.

Sound risk management is another challenge for the industry. The logic of a risk based solvency regime should impact the way insurers design and market their products. It is in the interest of the industry to improve its risk management as this might result in lower capital requirements.

The insurance industry should learn to operate in a principle based regulatory environment. There is a risk for over-regulation. That risk follows automatically from a natural tendency of supervisors to regulate but it is also a consequence of a wish of the industry to have clarity about everything. This leads to more and more detailed regulation. That is not in the interest of parties concerned as it might produce a behavior whereby form becomes more important than substance.

Prof. Karel Van Hulle, May 2013