Day 2 The future of global insurance regulation

Opening statement

Anderson Caputo Silva from the World Bank gave the opening impulse statement on the second day. He addressed the effects of the pandemic in accelerating long overdue sustainability challenges and the role of the insurance sector.

Many stakeholders are involved in addressing the tremendous gaps needed to ensure sustainability, he said. The pandemic has increased the annual investment gap needed to reach the sustainable developments goals and climate objectives to US$3.2tr per year.[1] This economic landscape is 'super challenging'. There are significant challenges surrounding the shape and timing of the recovery, elevated macro financial vulnerabilities (including a potential tightening of financial conditions) and significant disparities between the developed and developing world. We are seeing technology-induced transformation. But most important of the challenges is the growing importance of climate change in shaping the real economy and the financial sector. Climate related risks are material for the insurance sector and supervisors should assess and contribute to the assessment to these risks, Anderson said.

We are seeing, in the financial sector, a much greater focus on the opportunities for green investments. The NGFS (Network for Greening the Financial System) and the development of a green taxonomy are two key elements to the scaling up of green finance, including green bonds.

Climate change carries big risks for insurance companies, notably underwriting losses from weather anomalies and losses in the capital value of invested assets. But climate change also presents huge opportunities for the insurance industry. There are two main channels.

First, the scope for investing the insurance industry's sizeable assets in sustainable investments. There are clearly differences between portfolios (e.g., between life and non-life companies) but the insurance sector can play a big role in the development of sustainable investment.

Second, insurance coverage is now even more critical. Many different techniques of risk pooling, risk reduction and risk management are possible and there is a wide range of different providers.

The World Bank group has a new climate change action plan to guide its interventions over the next five years. A core part of this will focus on the systems (energy, agriculture, food, water and land, cities, transport and manufacturing) that generate over 90% of global greenhouse gasses. These face significant adaptation challenges, natural disasters being a clear example. Around three quarters of natural disasters are directly linked to climate change.

Good development outcomes are directly at risk from the climate crisis; and, conversely, acting on climate change can unlock significant economic opportunities. The World Bank's Climate Change Action plan is a concerted effort to support countries and private sector clients to address climate change together. It represents a real paradigm shift for the World Bank to support green, resilient and inclusive development. The insurance industry, through several channels, including addressing and managing climate-related risks, plays an important role in making this effort successful.

[1] From US$2.6tr before the pandemic.

Panel discussion

The panel members were:

Romain Paserot, Deputy Secretary-General, International Association of Insurance Supervisors (IAIS)

Michaela Koller, Director General, Insurance Europe

Tim Grafton, Chief Executive, Insurance Council New Zealand

David Altmaier, President, National Association of Insurance Commissioners

Tomás Soley, President of Latin American Association of Insurance Supervisors (ASSAL) and Superintendent of Insurance, Costa Rica

and the Moderator was

Karel Van Hulle, KU Leuven and Goethe University Frankfurt

What regulatory initiatives are needed to ensure that increased digitalisation will ultimately be beneficial for policyholders?

Romain began by saying that digitalisation will affect the environment and core operations of insurance companies, including underwriting and pricing. This creates new risks. In this environment insurance supervisors need to ensure that existing regulations are still fit for purpose. Romain does not think that the answer is a massive change in regulations, more a case of making sure that the tools available are still relevant in a changing environment. Innovation also provides a great opportunity to increase access and reduce protection gaps. The IAIS has a fintech forum with the view to gaining a clear understanding of the different aspects of these changes in different parts of the world. The aim is to look at risks and opportunities, especially those for increasing access. We need a good process in place and a good dialogue to ensure regulators are still ahead of the risks.

Michaela said that the key issue with consumers, who are increasingly digitally literate, is to make their digital journey easier. There are three key objectives in doing this. First, making digital use friendlier. Disclosure forms are still typically in pdf format. If a consumer wants to use a smartphone or tablet, this should be made easier. Second, consumers need to have the same level of protection and benefits whether they are engaging with an insurer online or offline. Third, there should be the principle of 'same activity, same risks, same rules'. Start-ups, traditional insurance companies and tech companies are often treated in different ways in different member states. We need convergence of treatment and activity-based supervision.

Tim echoed Michaela's comments. Insurers need to be focused on their customers and the role of the regulators is to uphold policyholder protection. Regulators are competing with the private sector for skills and resources and in this light greater cooperation between the industry and the regulators is key. Paper based requirements are not present in the New Zealand market, which has legislation permitting electronic transactions.

Tomás said that we need to be clear about what is beneficial for policy holders. It is clear that digital technology has transformed consumer expectation. They want simplicity, 24/7 access to information, transparency and a 'one click' solution. But Tomás sees three main concerns. First, is there a risk that digitalisation will involve less transparency for policyholders? If so, more regulation may be necessary. Second, with regard to data protection: do regulations in this respect need strengthening? Third, we could get a new era of digital discrimination if big data analytics lead to more individualised pricing.

Poll results

In response to the poll question "which regulatory initiative is the most urgent after Covid?", an international agreement on a green taxonomy was ranked highest by the conference participants. That was followed by stricter rules for insurers on market conduct, then agreement on an international capital standard. Mandatory digitalisation of insurance distribution was the least urgent of the four choices.

In reaction, **Romain and Michaela** both said that they were not surprised by the high importance of the green taxonomy. It is important not just for the insurance industry but for the broader economy. While agreement on international capital standards were not ranked highest, both agreed that this was still very important and that to be effective it had to be truly global. Michaela also stressed that a robust quantitative comparison between the ICS (Insurance Capital Standard) and the Aggregation Method is essential.[2]

Tim was delighted to see the Green Taxonomy ranked highest. New Zealand will have mandatory reporting under TCFD (Task Force on Climate-Related Financial Disclosures) from 2023. Having a clear green taxonomy across different regions will be of fundamental importance in providing clarity about what is a genuine green investment.

Tim questioned whether we really need stricter rules on market conduct. Rather, the issue is having a clearer insight into the digital transformation and the different types of tools that may be needed in a digital world.

Tomás thinks the green taxonomy is a must for the global economy and the insurance sector. However, the taxonomy may not have the same focus for all economies. In Costa Rica, for example, 99% of house energy is from renewable sources; the problem is more with transport.

Is regulatory action needed to ensure the operational resilience of insurers?

The second subject for the panel discussion was whether regulatory action was needed to ensure the operational resilience of insurers. **Michaela** began by saying that regulatory action can help boost resilience in a number of ways. Currently there are a number of proposals under consideration covering the security of network and information systems and DORA (Digital Operational Resilience Act). Michaela's concern is that such regulatory actions need to be proportionate and implemented in a risk-based manner. Insurers themselves can contribute to operational resilience by, for example, providing cyber insurance. In Europe when the insurance sector offers cyber insurance this has to be done on the basis of modelling because there is lack of data.

Tim said that cyber vulnerabilities exist in New Zealand, as everywhere. There have been a number of cyber-attacks on banks. However, we do not know the scale of the risks, particularly because of the dependence on a small number of high tech providers. So, just as we look at climate risks in a certain framework (e.g., TCFD), a similar approach could be adopted for cyber risks.

Tomás commented that because the supervisory authorities have a governance framework with international standards, there is a good framework already in place for dealing with shocks. However, this could be more precisely defined for emerging countries. One important aspect to consider is proportionality – between bigger and smaller players in the market, for example. Operational stress tests could be an important part in assessing operational plans.

Romain pointed out that operational resilience of insurers has been demonstrated by Covid. They continued to provide services to their policy holders at a time when they had to respond very quickly to the new environment. In a sense it was a 'crash test' for the insurance industry.

If we look at all the risks that insurers and policy holder face – including climate change and cyber risk – the potential for another big event is high. If the insurance industry is to be important in managing such risks, it has to demonstrate operational resilience in extreme scenarios. It is also important for supervisors themselves to be resilient. They have to

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[2] See, for example: https://www.eiopa.europa.eu/media/speeches-presentations/contribution/ics-time-engage-now_en

show they can adjust, as required, even in a degraded environment. Insurers, of course, rely on others – notably large IT providers – so they should be able to seek reassurance from them about their ability to cope in a stressed environment.

Karel concluded by saying that he, also, was impressed by how well insurers could operate in a totally virtual environment. This experience has highlighted that we need to have flexibility in looking at vulnerabilities in a different way.

Is regulatory action necessary to promote sustainability?

Tim started by saying that sustainability would not happen by itself, without intervention of some kind. If we look at the 17 sustainable development goals (SDGs), for example, failure in any one of these could have a cascading effect on others. From an insurance supervisory perspective, we cannot hope to be knowledgeable about every aspect of sustainability. We need, however, to be reassured that there is a culture within the insurance sector of addressing these issues. We need to recognise, from a regulatory perspective, that this is an emerging area where much further progress is needed. We do not yet, for example, have a globally-agreed sustainability taxonomy. Supervisors cannot be expected to supervise all these aspects. The scope of the challenges is so great that we cannot presume to have perfect knowledge. This means there is a greater requirement to work together rather than focussing solely on the risks that lack of attention to ESG might be posing for insurers.

Tomás thought that regulatory measures needed to be gradually intensified. In Costa Rica, a four-step roadmap has been defined with higher levels of intervention at each step. In the first stage, the requirement is that codes of conduct for insurers need to be clearly understandable by consumers. These could be voluntarily decided by the industry but can, as has been the case in Costa Rica, be encouraged by the regulator. In the second stage, the regulator expects that ESG requirements should be incorporated as part of the entity's corporate governance and risk management. The third step in intensifying regulatory action is defining regulatory standards. The fourth step is assessing solvency and capital adequacy, including the use of stress tests. Tomás sees the first two stages taking around two years, the third stage starting in around three years' time. This gradual process of promoting awareness of sustainability is important in preparing the industry for the next steps.

Romain was asked in which areas there was the most urgent need for action. He identified climate change as the key issue. It impacts regulation, not just insurance regulation, broadly. It is the role of the insurance supervisor to ensure that insurers are appropriately managing their exposure to climate risk. There is an expectation from the public that insurers will play a leading role in achieving climate objectives. Romain's organisation, the IAIS, published an application paper[3] in May 2021 to signal the key steps insurance supervisors could take.

It is also important that insurers integrate climate risk with their overall enterprise risk and understand the risks on both sides of their balance sheet. Later this year, the IAIS will publish a paper on the risks on the assets side of insurers' balance sheets. The availability of data is key to this assessment and the related scenario analysis about the potential impact on insurers' balance sheets.

The next steps in the IAIS's analysis will involve a gap analysis of global standards for insurance supervision to consider whether changes are needed to consider growing climate risk. Regulatory standards need to be fit for purpose.

Karel commended the IAIS for the important action it is taking. **Michaela** agreed with Romain that it is important to look at climate risk not just from an insurance perspective but from an overall perspective. In Europe, there has been an early

[3] https://www.iaisweb.org/page/supervisory-material/application-papers/file/97146/application-paper-on-the-supervision-of-climate-related-risks-in-the-insurance-sector

recognition that regulation is needed to promote sustainability. The insurance sector was one of the first sectors the European Commission turned to, recognising the important role it could take both in underwriting and investment. The Commission also quickly saw that the financial sector's ability to play this positive role only works if all sectors of the economy play their part. That is why the Commission developed the Green Deal, which, for example, imposes the requirement for green reporting on all sectors of the economy. This is an important first step in guiding investment and underwriting activity. The EU's objective of reducing greenhouse gas emissions by 55% by 2030 is also supported by Insurance Europe, Michaela's organisation.

There are a number of areas where the insurance sector is being asked to play a part and two elements are key. First, ensuring appropriate outcomes of the sustainability requirements. For example, the availability of ESG data needs to be improved. In this respect, the Commission's Corporate sustainability reporting directive is intended, by 2025 at the latest, to deliver such data. By November this year the European Commission will make a proposal for a single access point for company information. Insurance Europe also welcomes the EU's Green taxonomy.

Second, as investors, the insurance sector needs appropriate assets in which to invest. The US$3.2tr annual investment gap identified by Anderson in his introduction to the day highlighted the enormous need. For the insurance industry to help, Michaela sees a need for regulatory disincentives (under Solvency 2) on insurers making long-term investments to be removed.

Michaela concluded by saying that we need good international coordination in order to achieve global standards. It is clear that different regions and countries take very different approaches, so that is not an easy task. However, Michaela has high hopes for COP26. Mark Carney has recently advocated the establishment of country platforms, with the aim of the different approaches converging over time. This will take patience and time. There is no policing at the global level, so the need is to work on common convictions.

What lessons have insurers and supervisors learned from Covid?

Tomás identified three lessons insurers and supervisors have learned from Covid. First, the regulator must incorporate different scenarios and recognise countercyclical buffers are important as a tool for difficult times. Second, modelling the systemic scenarios is very important. Statistical models based on 'normality' are inappropriate in stressed markets. Models should allow for systemic risks and regulatory holidays in time of crisis. Third, systemic crises bring different degrees of government intervention. In Covid, for example, some Latin American countries allowed individuals to make withdrawals from their pension funds, endangering the stability of pensions funds, which Tomás described as "bread today, hunger in the future". There is a technical role for supervisors due to the political risks that could emerge.

Tim commented that "every catastrophe we experience shows that every catastrophe is different". Just as we did not anticipate the pandemic, we did not anticipate the political reaction or the vast changes in consumer behaviour. So, even though there is much discussion of systemic risks, it is hard to see how these will evolve. The next pandemic and the rection to it might evolve in a very different way to Covid.

We have also learned that there are limits to what insurance can do. Insurance had limitations because of the scale of the effect, the systemic nature of the effect and the lack of insurability. Insurers insure physical damage, not the effect of the virus, consumer behaviour and government changes. That the insurance sector fared well should not make it complacent. It did show that the insurance sector is fundamentally customer-focussed. The insurance sector is not setting out to do any mischief. Another key lesson was the level of collaboration with supervisors, notably in New Zealand, where there is one supervisor for the banks and insurance companies. The attitude of the regulator was to concentrate on what was necessary to deal with the situation, rather than carry on with a business as usual basis.

Insurers have a fundamental job of pricing risk. With more granular data, we can identify new signals. We should guard against any moves that seek to mute or change these signals. Different policy mechanisms can be used. Insurance should assess and signal risk.

Michaela underlined Tim's comments. They worked together on mapping the approach of insurance companies through their members and were encouraged by the pragmatic approach taken in the crisis, with a focus on the consumers.

Karel responded to a final question about the consequences of the political risk of insurers being pressured to take measures not in the interest of policy holders. There were some examples during Covid. The response of insurance supervisors has been "to remind politicians that this is not the way to do it".