Industry Seminar – 16 November 2016

Insurance Supervision and Policy Division Presentation

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Good day and thank you for coming today. Normally you hear from me for 5 minutes or so before I hand over to Caroline Bradley for another 15 minutes or so. Caroline is currently working for the Commission in Hong Kong so today I will be speaking to you for 20 minutes or so. My two colleagues, Manus Carvill and Martin McHugh, will later be available to answer any questions you may have on my speech, as will I.

I spoke earlier today to the banking sector and exceptionally included an intentional joke as I thought the bankers needed cheering up. However, I cannot think of any jokes about insurance, so this is a joke free speech. At least that is the intention.

Slide: Synopsis

I intend to start by speaking on this year's theme of corporate governance. I apologise to the exceptionally dutiful among you today who are attending both the banking and insurance session because I have already spoken earlier today along similar lines to the bankers. However I think corporate governance is equally important for the insurance sector, and not least in comparison with the banking sector where there are some differences.

After corporate governance, I will comment on insurance trends in Guernsey and offer some thoughts around opportunities for the Guernsey insurance sector. No seminar address would be complete without consideration of regulatory trends as they affect Guernsey. I will finish with a summary of the Commission's work this year in connection with the insurance sector.

I am conscious that the PWC report on the Guernsey insurance sector has recently been published. I am sure that like you I found the report very helpful. However, this is not the forum to consider the report which I am sure we will all do at a later date.

Slide: Corporate Governance Caveats

Today the first issue I would like to consider is corporate governance.

The general theme of this year's seminar is 'the interaction of business culture to regulation'. I am going to address this through examining the composition of insurance boards in Guernsey.

In order to make the results as meaningful as possible, I will be comparing the outturn with comparators. I have not been able to find one optimal comparator but instead have been obliged to use several different comparators, including Guernsey subsidiary bank boards as a whole.

There are some caveats. For Guernsey insurance boards, there are only really 8 comparable boards. This, along with the fact that there are only 14 bank subsidiary boards to act as a comparator mean that it is a relatively small base from which to make any generalisation. Guernsey insurance firms vary substantially in nature as well as in ownership structure. Some of the comparable boards are from firms that individually owned or through investment holding groups and remain relatively independent in terms of board level decision making. Others however, are subsidiaries of larger groups and are therefore subordinate to some extent to the group board.

Incidentally, while there are many studies of corporate governance at the group level discoverable on the internet, there are very few on subsidiary level boards; which is surprising as there are inevitably going to be differences between the two.

Nevertheless, I have set out some quantitative data on the following slides.

Slide: Board Composition

For the first slide, the general comparator is the FTSE 150. This is an unusual comparator but it is the only one I could find on the internet.

Looking at the slide, it seems natural that the boards of subsidiaries or individually owned insurance firms will on average be smaller than main boards of the largest UK companies. That the average board age is somewhere in the fifties seems unsurprising. The balance of executives to NEDs in Guernsey also seems uncontroversial.

Slide: Board Composition (continued)

Here is the second slide. This chart is taken from the FT and covers all industries. I have however added the results for Guernsey bank subsidiaries and insurers. The former are in line with the norm but the insurers show a marginally younger profile. However the difference is only a few years, so we should not read much into this.

Slide: Board Composition (continued)

The third slide uses the most relevant comparator for our Guernsey sample – that is UK financial services companies.

It is worth noting that women directors make up 21% of FTSE 150 companies. The slide shows that the proportion in UK financial firms is lower at 12.3%; showing that women make up a far lower proportion of boards in finance than in other industries. The Guernsey numbers for both insurers and banks are a little lower than the UK financial services average. However we should not read too much into this as, given the small sample size, a few more, or a few fewer, women would materially affect the outcome. So here Guernsey is broadly in line with the optimal UK comparator, even though the latter shows the finance industry to be out of kilter with the rest of industry.

If the numbers on women are compatible with those in the UK financial services sector, there is a marked divergence in Guernsey in that there are about double the number of NEDs serving on boards serving for more than 9 years in Guernsey than for UK financial firms.

The Financial Reporting Council's Code of Practice considers that a board needs to explain formally as to why a NED on a board serving more than 9 years is still independent. Our approach at the Commission is more subtle and there are several other factors relevant to the composition of a board. However the question of the independence of long-standing directors is primarily one you yourselves will want to consider.

The Commission generally encourages company boards to contain at least one independent non-group NED. The actual average shown in this slide is higher at two; no doubt to encourage solidarity. This suggests that group employees are indeed being challenged by non-group influences. This is surely positive.

To conclude the analysis, the results for the banking and insurance in Guernsey are remarkably similar. Insurance board executives are a little younger but the most interesting fact – namely around the length of tenure for local NEDS – applies equally to banks and insurers.

Slide

I started with some caveats, so I will finish this section with some more. I am not suggesting that the average numbers shown here are optimal for your particular firm. This speech is not intended to signal any regulatory direction. All these figures have to be considered in the context of subsidiary boards – a largely unstudied question - and the constraints of the Guernsey employment market.

There is at present a general call for more 'diversity' in boards. This can be interpreted as a somewhat crude call for specific quotas of types of people on boards. However, the word 'diversity' comes from the verb 'divertere' which means 'to cause a change of direction'. This seems a more productive way of thinking about diversity. We want to see on boards people who capable, both technically and through force of character, of causing a change of direction. Gender, longevity, background are all relevant but they are not the key determinants in this.

Nevertheless, I hope that these figures will lead you at least to reflect about ways to think about the composition of your own governing body.

<u>Insurance trends</u>

In terms of 2015 year insurance trend statistics, I can here for the first time show the relevant numbers for international insurers in the following slide. You will be familiar with these graphs from our website. AS you can see, there is an increase in gross premium for 2015 which is encouraging but otherwise the numbers are more-or-less flat. 2015 was a reasonably good year for Guernsey due to some larger deals and strong ILS activity. It is too early to consider 2016 trends although our sense is that business levels have been reasonable.

I would now like to consider wider issues within the Guernsey insurance sector, turning first to future opportunities.

Slide: Opportunities

I am relatively optimistic about the future of the Guernsey insurance industry. In the first place Guernsey is a well-respected and long-established insurance centre. It is multi-faceted, and generally not based on tax breaks. It embraces several international insurance managers in Guernsey who bring expertise, depth and international business to the jurisdiction.

I think, by the way, we sometimes overlook Guernsey's status. As you know I chair a body of 19 insurance regulators, most of who would give much to replicate Guernsey for themselves – the point being that it is no easy task to build from scratch a position such as that which Guernsey occupies. There are also fewer small IFCs who offer insurance than say trust business – and with Bermuda being equivalent with Solvency II even fewer outside the Solvency II net.

Another reason for my optimism is that, unlike for the formal banking sector, the global insurance sector is bound to grow as more and more people become sufficiently affluent to want both general and life insurance products. IFCs should be able to ride on that growth – for example one forecast sees the Bermuda insurance sector growing at a rate of over 10% per annum at least until 2019.

So I am optimistic about the future of the sector in Guernsey. Nevertheless, there are also some questions we need to address in order to maximise these opportunities. Let me for example go through a few of these opportunities to explain what I mean.

One opportunity is for Guernsey insurers to undertake more UK non-compulsory retail insurance; albeit without marketing in the UK. However, were Guernsey to do this on a greater scale, it brings the risk of greater UK focus on our regulatory regime and our lack of an insurance protection fund. An allied option, following Brexit, is to extend our offering to compulsory business. This of course would raise the stakes even higher. I am not arguing here one way or another, I am just saying that an opportunity such as this also brings risks, and we have to think about this.

Another example is alternative re-insurance. On the one hand extending the ILS offering is attractive. On the other hand, this is a risky and still relatively new product, and we need to take care that it is only offered to those customers who understand this. I think we do this but the cost of failure here could be high.

Traditional re-insurance is another opportunity. In the past, we have not undertaken much of this business but recently we have begun to do so in a more material way. However what sort of re-insurance centre do we want to be? On the one hand, we could be a traditional centre on the lines of Bermuda. This direction signals tough local solvency requirements, strong qualitative oversight and, dare I say it, possible Solvency II equivalence. On the other hand, we could offer ourselves as a lighter regime aiming in particular at the Asian market? I not here trying to pre-determine the answer to this question, but it is one we will have to resolve in due course.

Another opportunity is longevity risk where the jurisdiction is rapidly carving out a market niche. Full marks here by the way to the lawyers and actuaries as well as the insurance management sector. Even this however raises a question. We have limited resources on Guernsey. Do we have the capacity to maintain our hold on the captive market, whilst at the same time taking advantage of the opportunities mentioned here? If we have to prioritise, what do we choose and who makes that choice?

So, there are plenty of opportunities for growth in insurance. We are still a smaller regime than Bermuda and even than the Isle of Man. But we will have to make some decisions as we go forward.

Slide: Regulation

I would now like to turn to regulatory policy challenges. Let me first say that these are generally not coming for the Commission but from other sources. The exception is the Revision of Laws project where we want to do some tidying up of the insurance and insurance intermediary laws, both of which have become a bit dated in places. However, other than this, the regulatory policy challenge comes from elsewhere.

One such is IAIS – the global standard. As you know, sometime ago we looked at the gaps between our policies in Guernsey compared to the new IAIS Insurance Core Principles. We then plugged these gaps – for example with our new solvency approach. However, the ICPs are constantly evolving, not least as they are now being linked more explicitly with COMFRAME, which sets out more detailed supervisory expectations. So, inevitably, we will in due course need to undertake another gap analysis and I expect plug some more gaps.

There is another IAIS challenge worth mentioning, though it is still somewhat down the road. This is the nascent International Capital Standard or ICS - issued by IAIS. We as yet do not know the details of this but, in straightforward terms, it is designed to be a minimal capital requirement for large international insurers. In this sense, it can be seen to the insurance equivalent of the Basel capital standard for banks. And, like the Basel standard, although aimed at large international firms, it may become a de facto capital standard for smaller insurance firm. At some point we will need in Guernsey to think about the relevance of the ICS for us.

Other regulatory challenges come from the UK - for example the Insurance Act. This is not the time to debate the pros and cons of the Act but the Act creates a degree of legal uncertainty, both because it is a new, and because it deliberately creates a more judgemental approach to pay-outs. The Insurance Act also creates a modest challenge around the disclosure of risk for company risk managers on captive boards. Although neither of these challenges is going to go away soon, the industry is well aware of both and is prepared to meet them, with minimal disruption. Another challenge from recent UK legislation is BEPS. Feedback from the captive industry however suggests that the industry itself is already BEPS compliant, but it needs to document compliance in more detail.

Another regulatory challenge due to come, either from the EU or from the States, depending on your point of view, is the forthcoming General Data Protection Regulation, where everybody needs to start thinking about implementation soon.

I said a few moments ago that the forthcoming regulatory challenges were not coming from the Commission but from other sources. I am afraid that I have one more challenge to mention. Most large insurance regulators have by now rolled out their own interpretation of the new IAIS ICP on solvency – and recently for instance the Geneva Association published a handy summary of them, covering for example Australia, Switzerland, China and so on. It is unsurprising that some of these regimes are beginning to ask other regimes whether their approach is equivalent if firms from other jurisdiction want to do business there. We have already seen obvious signs of this around equivalence for Solvency II and equal-status in the US. But, basing my views on questions we are beginning to be asked by other regulators, I think we are likely to be asked more and more to justify ourselves to other regulators. That's is easy if say you follow Solvency II, but it is more difficult to explain if you are a small IFC with a bespoke solvency regime, however good it may be. So, in the future we may, as an authority, be under the microscope to prove, not just adherence to the ICPs, but equivalence of some sort to other regimes in undertaking cross-border business.

This is quite a list of regulatory policy challenges in the pipeline. Let me make two points. Firstly, as you can see these challenges are global, we the Commission are not inventing them as a subtle form of torture for you. Secondly, we the Commission are committed to implement global standards and to ensure so far we can that the Guernsey insurance sector adheres to mandatory laws and regulations. However, we also here to help you. By this I mean that we will implement global standards sensitively and in a way appropriate to the jurisdiction. Let me give a recent example of this.

Earlier this year we were approached by GIIA, given a draft set of rules on ILS and asked to implement them. These draft rules were very helpful but some of them were not written along lines compatible with other Commission policy documents and, in our opinion, some of them were a bit too liberal for our liking. We were also able to network with other regulators to understand better their supervisory experience in this area. As a result we continued to work with GIIA and produced an agreed second draft on the ILS rules which are along the lines eventually issued. I suggest that this is an example of the Commission and industry working together, albeit sometime disagreeing with each other, to produce an appropriate regulatory outcome.

Slide: Work Review

I would now like to summarise the Commission's insurance work over the last year. 2016 has not been too eventful for the Commission's work with the local and international insurance sectors. However it has not been without interest and I would just like to summarise developments domestically and internationally.

In 2016, GIIA recommended radical shift in fees in favour of ILS and at the cost of general insurers and re-insurers. The Commission included this proposal in its 2017 fee consultative paper. This proposal occasioned a fair deal of due diligence within the Commission as well as some negative comments during the consultative process. Nevertheless, the Commission has concluded that this proposal was the right one. However I would like to mention that this should not imply any implicit endorsement of the ILS market; nor that the Commission does not see general insurance and re-insurance as an important part of the Bailiwick's insurance offering.

Domestically, we have continued with our routine PRISM work which is now increasingly established in our routine working practices. We continue to deepen in particular our knowledge and dialogue on both board expertise and business strategy. 2016 has seen the roll-out of our solvency model, both in terms of the categorisation on insurer and in terms of the on-line portal. The latter has inevitably been a bit bumpy at times, not least as this is its first year and the on-line portal is not yet universally up-and-running. However first year results have not been too bad. A plea here if I may. When your annual regulatory return arrives at the Commission, it goes through an automatic check around certain key indicators. I am not giving anything away when I tell you that these KRIs include such items as the combined ratio and profitability. It is not unusual for these checks to produce false positives – often because the firm has entered the wrong figures by mistake say with a decimal point in the wrong place. On-line reporting will eventually reduce this problem but please can I ask you to try to sense check the returns before they are sent. We are still spending too long following false trails.

Going back to our work this year, on enforcement, this year has seen no new material cases, following previous problems around long-term life insurance intermediaries.

Internationally, Caroline Bradley and Nick Herquin visited the Cook Islands to support insurance supervisors there; funded by the Commonwealth Secretariat. For the Group of International Insurance Centre Supervisors (GIICS), there was another meeting at director level in London this summer and we will hold a December mid-level training session again in London, supported by supervisors from the other Crown Dependencies and Gibraltar.

At IAIS, William has been re-elected as one of the two EXCO members for the offshore region, I have continued to represent Guernsey on the Financial Stability and Technical Committee and Caroline is working on the IAIS Re-insurance Task Force. All of this gives us as regulators a better idea about current business and global regulatory trends.

So what will be looking out for in 2017? In practice we will be dealing with supervisory issues as they emerge. Supervisors are mostly reactive, however much they like to appear proactive. Capital and profitability will continue to be key to the regulatory process. However, it will come to no surprise to those of you who were here last year, that conduct issues are increasingly part of our remit for insurance. Are policies easy to understand to the man in the street? Is charging clear and fair? Is there an effective complaint process? Are policies being sold in line with local regulatory requirements? And so on.

As I see it, the most pressing regulatory insurance issue in 2017 is the oversight of low impact local insurance life and general intermediaries in Guernsey and that is where the Commission will be undertaking thematics in due course, and subject to resource constraints.

However we will also be considering how best we can effectively supervise insurance managers, given their pivotal significance in the local market; and we will begin this by applying the PRISM approach in 2017 to some of these firms.

Slide: Summary

Over the last 20 minutes or so I have outlined and compared the board composition of the Guernsey insurance sector, outlined insurance trends, talked about opportunities, reviewed the division 2016 work as well as giving some pointers to work in 2017.

I hope that you have found all this to be of interest. Manus, Martin and I would happy to discuss these issues either now or later.