

CHAPTER SEVEN

Insurers and Changing Regulation

Financial services regulators were heavily blamed for their part in the financial crisis and changes to their structures, institutions and leadership were implemented quickly from 2009 onwards in the UK, EU and USA.

This swift reaction of political decision-makers was a reminder of the huge reliance political leaders have on regulators' performance in managing the risks of sophisticated, interconnected and highly complex financial markets, the size of which easily overshadow national economies. Failures in regulation contributed towards the collapse of significant financial institutions in the UK, USA and continental Europe, costing billions to these economies in lost shareholder value, output failure, credit shortages, low tax returns and higher welfare costs.

With the creation of the European Supervisory Authority for insurance comprising the European Insurance and Occupational Pensions Authority (EIOPA), the European Securities and Markets Authority (ESMA) and the European Systemic Risk Board (ESRB) in the EU, the Prudential Regulation Authority (PRA), Financial Conduct Authority (FCA) and Financial Policy Committee (FPC) in the UK and the Federal Insurance Office (FIO) and Financial Stability Oversight Council (FSOC) in the USA, the main structural changes have been completed for the time being with new leadership teams established. This chapter explores the extent to which trends have emerged which the UK and EU institutions will follow and explores the key issues likely to shape their future development. While the UK regulatory system is now based around two separate prudential and conduct regulators, their establishment at the same time and in the wake of the worst UK financial crisis in 80 years has led to a very similar initial outlook across both bodies.

Trends shaping the future for UK regulation of insurance are:

- i. A focus on judgement and outcomes
- ii. Early intervention in a low-trust environment
- iii. Customer-centricity, repositioning the customer/insurer balance of responsibility
- iv. Better understanding of the big companies and market dynamic
- v. Emphasis on the culture of insurers and self-regulation

A focus on judgement and outcomes

The new UK regulators have been tireless in proclaiming their adherence to a new focus on judgement-based regulation, centred around outcomes, not principles. This is unsurprising but may not prove as big a change as it sounds, given the limited degree to which the FSA lived up to its proclaimed ethos of principles-based regulation.

A key challenge will be to establish a greater degree of certainty about what regulators consider 'appropriate' outcomes actually mean in given circumstances, including the extent to which such outcomes are solely a matter between the regulator and the regulated company or whether in practice they take into account the wider impact on society. The initial cageyness of regulators to talk specifics should give way over time to recognised best practice emerging, whether regulators intend it to happen or not.

Where regulators have not been cagey is in their insistence that they do not see their job as being to prevent failure of regulated companies, merely to ensure orderly resolution which protects the broader financial system as well as the interests of customers. This is unsurprising, given the reputational risks for the new regulatory institutions of being perceived to have failed when a regulated company collapses, but it remains to be seen how practical the proposed resolution regimes would be in the event of a major failure and whether the new regulators could really escape the reputational risk such a failure would bring.

Early intervention in a low-trust environment

Early intervention as a core method of operating is now explicitly stated as being central to the approach of both prudential and conduct regulators when conditions demand. This is partly borne from the PPI scandal but it also reflects an explicit lack of trust as the starting point for supervision and regulatory engagement; companies will have to prove, not assert, their overall health and the performance of their product suite and expect early intervention if they fail to convince regulators. Even so, a judgement-based approach does not necessarily mean that such judgements can be reached more quickly; early intervention may prove to be more of a threat than a routine and will always carry risks for regulators.

Customer-centricity, repositioning the customer/insurer balance of responsibility

Being responsible for customers is not just a conduct issue; it is central to the statutory objectives of both the PRA and the FCA and top of EIOPA's stated priorities. In practice this means is a repositioning of the balance of responsibility between insurer and customer; the customer is now viewed as being less responsible for their own decisions and needing greater protection from insurers. Given their differing timescales this will be easier to rebalance in practice for the FCA than for the PRA.

Better understanding of the big companies and the market dynamic

Both regulators place explicit credence on the importance of fully understanding the business model of a large regulated company and analysing the competitive dynamics of the market. For a company, this is an approach which seeks to work upwards from the bottom line to identify core profit drivers, scrutinise the resilience of current product offering and future strategy and understand the strengths and weaknesses of the business. It is also reflected in the FCA's move away from the Arrow system to greater face to face meetings, the focus on issues and products and greater use of thematic reviews and Section 166 powers. The downside of this approach may be cost to the industry, especially if regulators rely heavily on consultants for commercial expertise. More broadly, the focus on competitive dynamics requires a different way of thinking from both regulator and regulated, raising challenges about the extent to which a market overall is working for the benefit of customers rather than the sole focus on compliance that many firms have become used to. This raises an interesting dynamic for an industry that is continuing to think collectively about issues of market dynamics and raise them proactively with regulators as has happened increasingly with motor insurers' engagement with the OFT and Competition Commission inquiries.

Emphasis on the culture of insurers and self-regulation

Again, regulators have been clear in their emphasis that regulated firms having the right internal culture is a 'must-have' with a leadership team from Board downwards that aims to do the right thing for customers and which prioritises the long-term health of the business above short-term considerations. This means companies being increasingly challenged to view regulatory standards as a minimum they should operate above, rather than play strictly to the rules and find ways to game them. However, it is unclear how wide the spectrum of permitted behaviour will be and the extent to which firms want to be invited to judge this for themselves rather than being given a set of rules and operating by them. This could potentially impact the appetite of the industry to self-regulate. Particularly problematic will be requests to operate 'within the spirit' of

regulations in the absence of hard guidance from the regulator especially when the FCA has begun to articulate a more negative view of the role of behavioural economics than has been in evidence in the auto-enrolment debate.

Key regulatory issues for insurers to address are:

- i. How do regulators manage 'post-crisis bias'
- ii. How to ensure regulators balance domestic responsibilities with international focus and perspective
- iii. How to develop and contribute to regulatory thinking on the customer
- iv. How regulators should manage the increased visibility and public profile they now hold
- v. How can regulators ensure the most productive relationship with the politicians to whom they are ultimately accountable

How do regulators manage 'post-crisis bias'

A key challenge facing the new institutions will be avoiding 'post-crisis bias' with regulators becoming overly institutionalised in thinking that is shaped by the events that led to their creation, rather than focusing on future risk. This is partly demonstrated in the priority given to **resolution arrangements** over the prevention of failure. While it is hard to argue with regulators revising an agreed set of resolution processes, the key future challenge will be the prevention of avoidable failure by taking rational and clear-sighted judgements on what constitutes a fundamentally healthy company. As the 2007-8 market failures demonstrated, when crisis hit it was the swift co-ordination of decisive action by governments, central banks and industry leaders that mattered more than orderly resolution regimes, not least because it is hard for any resolution regime to be quicker than the markets. A similar challenge exists for prudential regulators in relation to asset allocation; if regulators' views are too influenced by the last crisis, they risk creating new sources of systemic risk.

The other area where 'past-bias' may be too evident is in **conduct risk**. While more analytical on the drivers of detriment and over-arching risks, the FCA's recent 'Risk Outlook 2013' document still highlighted over 60 pages some 40 areas of individual conduct risk, exploring every conceivable angle of potential detriment. In this, the ghosts of the FSA's handling of the PPI scandal are all too evident in seeking to ensure that no future risk could possibly emerge that has not been publicly flagged. While the scale and reach of the PPI scandal make it an obvious starting point for a new conduct regulator, the danger is that this single scandal is relied on too much by regulators to inform a future in which entirely new products will increasingly be sold using multi-channels, the workplace and specialist brokers. While both the PPI and Libor scandals demonstrated lamentable practice within the financial services industry from which lessons must be

learned, both relied on long established operational practices rather than being automatically relevant to a future world which could operate very differently.

How to ensure regulators balance domestic responsibilities with international focus and perspective

Equally challenging is the extent to which the new UK regulators understand and are equipped for the future international regulatory framework.

Having failed to address relationships outside the UK in their early pronouncements, both the FCA's and PRA's main recent policy documents¹⁵ have now stated the importance of engaging early and proactively with **EU and international regulatory institutions** to ensure the formulation of high quality regulatory policy that is consistent with UK practices and markets. It is also encouraging that the new UK regulators have already demonstrated a degree of flexibility in interpreting complex EU legislation such as MiFID passporting rights for AIFM firms. Both are vital; UK regulatory leaders have been noticeably insular in recent years with only a few honourable exceptions. Exercising leadership effectively outside our national borders will only become more important in the 2020s to regulators who will have to form ever more sophisticated judgements about how economic and regulatory inter-connections can be managed. Equally importantly, UK and EU regulators will have to be mindful of the regulatory approaches taken in increasingly important Asian markets if EU-based insurers are not to suffer from relative over-regulation.

Even without these globalisation challenges, UK regulators face the challenges of an **uncertain political environment** with the 2014 Scottish independence referendum, the proposed EU referendum in 2017 and the proposed Banking Union for Eurozone member states. The regulators who succeed in this environment will be those who keep their focus outwards to understand the changing world, influence it and navigate its difficult terrain.

How to develop and contribute to regulatory thinking on the customer

The emerging thinking of both UK regulators looks likely to reframe the relationship between the customer and insurer over the period ahead with the long-standing principle of **'caveat emptor'** (buyer beware) which has underpinned much of English consumer law being **diluted** significantly in favour of the insurer taking primary responsibility for the product from its design through the sales process and into its life after purchase. Although the recent Consumer Insurance Act 2012 also rebalanced the burden onto insurers, the UK regulatory approach goes further, viewing the customer as a fundamentally weak counterparty capable, whatever the purchase, of being hoodwinked during the sales process or inadequately protected by a long-dated product.

Although insurers have supported consumer legal reforms and understand the regulatory climate, it is questionable whether this view of such a weak consumer is fully future-proof. Thanks to the internet revolution, the consumer has significantly more power in their relationship with an insurer because of the correction of much of the **information asymmetry** that traditionally made the relationship so unequal. It is true customers may not understand much of their new-found information either because it is too complicated or their transactions are too infrequent to build understanding. But nonetheless, given the scale of connectivity that is going to happen over the next 15 years and the inexorable rise of public customer ratings and feedback mechanisms, there is a danger that at the very time when customers are better informed and empowered than at any time in recent history, they are being wrapped in compliance-driven regulation which dumbs down their relationship with a product provider.

A similar question mark must exist about the extent to which regulators can deny any responsibility for wider **socio-economic outcomes** that frame the society in which customers live and which they are conditioned by. This is critical for insurers whose products hold up a mirror to the realities of society. In establishing the FCA, its leaders have been very quick to assert they are not responsible for wider socio-economic outcomes and are limited to the implementation of their statutory objectives. While strictly true, it is hard to see this approach surviving far into the future. This is because ministers, who are paid to worry about socio-economic issues, will always apply pressure, subtle or otherwise, for regulators to take account of government policy in choosing how they implement their statutory objectives. Secondly, if regulators are to be genuinely focused on what is best for customers, it is difficult to divorce this from the fast-changing wider society in which these customers will be buying and using insurance products.

A broader challenge for both the regulators and the industry will be how to differentiate appropriately between the interests of different groups of customers. This is particularly relevant to insurance which relies on the principle of pooling risk and a degree of educated consent by the customer to the content of the insurance contract.

How regulators manage their increased visibility and public profile

The future public profile of the new regulators and its impact on how they operate is also a fascinating future dynamic. Both the new CEOs of the new UK regulators and the Chairman and the CEO of EIOPA have adopted relatively high profiles, accepting that the environment in which the new bodies have been created is one in which these powerful regulators will expect to be more publicly accountable for their organisations and more willing to speak out on issues of public concern.

¹⁵ The Prudential Regulation Authority's approach to insurance supervision, April 2013, Journey to the FCA, October 2012.

“The biggest consumer challenge we face is how to provide advice to the mass market. Regulators, politicians, financial advisers and insurers need to find a way forward if we are to meet the needs of customers and employers.”

Phil Loney, Group CEO, Royal London Group

On the whole, this is a healthy development; anonymity has sometimes allowed mediocrity to flourish. It is also inevitable given the digital revolution and the premium placed within our information-rich world on leadership views and official sources of information. The challenge for the future will be the extent to which this **high profile, public leadership** interferes with the relationship of trust and engagement that also has to exist between regulators and the CEOs of the major companies they oversee. In the past, the critique of such relationships was that they could be insufficiently robust and too close. Clarity of communication will be essential to ensure that regulatory leaders can be both credible public figures with the political accountability and media scrutiny that brings, without sacrificing some of the balanced judgement and understanding of complexity that will give them credibility with the CEOs they interact with.

This reflects a broader future tension between visibility and effectiveness. Given the circumstances of their establishment, the new regulators will be under significant and ongoing media pressure to demonstrate their value with **public criticism of industry practices** as well as high profile enforcement action. Indeed, the FCA lists among its three-year metrics for the period to 2016 that it aims to have ‘successfully intervened to ensure customer benefit’ as well as to have used its early intervention power. Setting targets to use intervention powers is potentially at odds with the stated aim of a framework in which firms exceed regulatory minimums and minimising conduct risk is inculcated throughout customer-facing activities. Insurers will expect to find their new regulators staffed with high quality professionals who are capable of meeting the challenges of the future and whose skills levels justify the fees increases. Indeed, if fees continue to rise without tacit industry consent, it will do much to damage the relationship. While at this stage, public targets about intervention may just reflect the trade-off necessary to establish credibility, the tension for regulators between building professional and meaningful relationships with regulated firms and using the soapbox of public visibility to maintain licence to operate and leadership credibility will be a permanent dynamic in the future.

How regulators can ensure a productive relationship with the politicians to whom they are ultimately accountable

Managing the tension with politicians between **public policy and regulatory requirements**, will also prove a

challenge, especially in the early days when regulators will be keen to demonstrate their statutory independence from political pressure. The challenges are real however as the Government’s recent enthusiasm for Defined Ambition (DA) pension schemes has demonstrated when guaranteed retirement schemes, such as the mooted DA model, are increasingly out of favour with both conduct and prudential regulators in Europe and the US because of their risk to insurer capital, the difficulties of resolution and the risk of consumer detriment. Ministers will need to be increasingly aware of the need to engage with regulators in developing public policy ideas, while regulators will find themselves being asked to health check policy proposals in a way they may find uncomfortable.

More broadly as the debate on stimulating economic growth dominates ministerial thinking in all the major capitals of the West, regulators will increasingly find their major projects scrutinised against its impact on growth, such as the challenges to Solvency II over its potential effects on infrastructure financing. In a future world where tighter more intrusive regulation is the norm and can emerge from a range of international forums as well domestic institutions, ministers and regulators will find it impossible to operate in separate silos and will need to establish better protocols to frame their relationship.



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- How significant is the danger that the UK and EU over-regulate in relation to Asian competitor markets?
- How can the industry help our national regulators operate effectively and proactively at EU and international level in the future?
- How can insurers increasingly help illustrate to regulators the need to analyse socio-economic factors in judging consumer outcomes?
- What can the industry do to bridge the gap between political and regulatory imperatives and how best can it avoid being stuck in the middle between them?

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