THE VIEW FROM THE OTHER SIDE OF THE TABLE
REGULATION, TRUST AND SOCIAL LICENCE

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INTRODUCTION

Good morning, I’m pleased to be speaking with you today.

As you know, up until late last year I was an industry participant – a supervised entity - as many of you are. During that time I attended these types of gatherings and found they play an important part in helping industry learn from each other and collaborate positively, in environments that are always uncertain and forever morphing. The sessions before me and those to come illustrate this point. Changing times call for changing methods, strategies and approaches. They also demand a change in mindset. It is this mindset that I want to challenge today, against the notion of trust and social licence.

As you are aware, the financial sector has received plenty of negative press in recent times. No industry has been spared - banks, life insurance companies, health funds and general insurers have all been the subject of allegations relating to the customer experience. As a result, consumer sentiment and trust in the financial sector as a whole has arguably diminished. Heightened government, regulatory and public scrutiny is an inevitable consequence in this environment and the spotlight has increased on how financial sector companies conduct themselves in relation to the customer.

In observing the various industry reactions to such adverse community perceptions, it is apparent that financial services is not as well-prepared to respond effectively to these issues. Perhaps the necessary focus by regulators and institutions both globally and here in Australia on capital strength and solvency, especially since the global financial crisis, has meant not enough focus on the equally important need to maintain strong community trust in the financial sector.

Today I want to talk with you about this notion and how it fits within APRA’s regulatory mandate. In this context, I will also offer my observations, after some ten months in my new role, on how my perspective of APRA from the inside is different from the one I had during my time in industry. And I could not let this opportunity go without providing some insight into where APRA is focusing its attention in the general insurance sector, including the reinsurance industry which plays such a vital role for all Australians.

Trust and social licence

Let me start with trust, an aspect gaining more attention by regulators both here, and globally. I spoke recently about the importance of trust and social licence during a speech detailing the results of APRA’s 2015 life insurance industry stress test. The life insurance sector is going through a challenging time. The message to the life insurance industry participants is the same for the broader insurance industry; trust is central to long-term financial health and goes hand-in-hand with ensuring strong capital and solvency ratios.

Financial services is not the only sector reassessing community trust. The concept of a Social Licence to Operate was first proposed by Canadian mining executive Jim Cooney in 1997 as an essential requirement for the future survival of the mining
industry. The International Resource Journal describes social licence as a metaphor for the quality of the relationship between a mining project and its host community. It describes how it arises from the community’s perception of a mining project or company. It is granted by the community, is intangible, informal, non-permanent, and dynamic. It has to be earned and then maintained. It is an expression of the quality of a ‘relationship’.

The Minerals Council of Australia, simply defines social licence to operate as an unwritten social contract. It goes on to say that unless a company earns that licence, and maintains it on the basis of good performance on the ground, and community trust, there will undoubtedly be negative implications.

APRA’s over-arching mandate is to maintain financial stability and this can be threatened when the community doesn’t have trust in the financial institutions whom they rely upon to provide them with valuable services. Let me be clear: we are not entering consumer protection territory when we speak of trust. This sits squarely with our ASIC counterparts, who we work collaboratively with on a range of issues, and this collaboration has increased in recent times. Our point is that institutions, despite having stronger financial settings since the global financial crisis, are now arguably less ‘trusted’. Trust is at the heart of most financial businesses: you are, after all, managing other peoples’ money. Any lack of trust has the potential to impact the viability of your business, in one form or another. So it is our business, as it is yours and others, to have this conversation in the interests of long-term financial stability.

Insurance companies (and in using this term, I mean reinsurers as well) enjoy a great privilege in our society. They are justifiably proud suppliers of critical benefits for the Australian people during times of need. In return, these companies become successful in their own right, sharing their prosperity with shareholders and other stakeholders, and impacting positively on the economy. We know that general insurance companies have paid out $130 billion in claims, across all classes, just in the last five years.

In the aftermath of the devastating series of natural catastrophe events in 2011, insurers paid some $5 billion, assisting thousands of people to get back on their feet.

Despite the current headwinds, such as the low interest rate environment constricting investment returns, the general insurance industry has also maintained very healthy capital ratios. As at 30 June 2016 the industry Prudential Coverage Ratio was 1.72 with an annual net profit of $3 billion and a solid ROE of 10.8 per cent. So, from a capital and profitability perspective, the industry is in good shape. I propose to you though that such solidity can be compromised if community trust is broken.

For insurers, there are two points in the value chain most vulnerable to breaches of trust – at point of sale and come claim time. When people buy an insurance policy they need that policy to be both affordable and appropriate for their needs. How

1 Source: APRA statistics
2 Source: Insurance Council of Australia
certain are insurers that they get this right? And do customers know what they are buying? The complexity of insurance law, and product disclosure documents, combined with issues concerning financial literacy across Australia make it difficult for many policyholders to understand their coverage clearly. So, it is no wonder that, come claim time, there are a myriad of misunderstandings and misalignments that impede the ability for insurers to meet customer needs.

As stated earlier, the insurance industry settles claims effectively for the vast majority of Australians. The challenge is to do better. Judging by my conversations with executives and Boards there is both a desire and considerable effort to lift performance in this area and improve customer centricity overall. Attention to this area is critical because, whatever the cause of issues that invoke customer discontent, bad news travels fast and, in the current environment, faith in the industry drops each time we hear of a new problem in insurance. At the same time, public scrutiny, with the potential for outside intervention markedly increases.

Insurers need to ensure the customer is at the heart of their business, have processes that reduce the risk of unfair customer outcomes and be prepared for adverse sentiments. And they should do this with the same energy they expend to protect capital. I repeat my message to the life insurance industry not long ago: ultimately, capital will not help if your customers don’t trust you.

I want to extend this notion of trust to a different party: APRA. It is my view from the other side of the table that how much APRA trusts you is also important. This is the area that surprised me most when I stepped into the regulator’s shoes. While in industry, I had a rather narrow view of APRA and how it monitors the financial health of its regulated entities. It was very clear to me that APRA was highly focused on capital, risk management and governance. Armed with a comprehensive set of rules, together with a cadre of highly experienced and dedicated supervisors, I observed at arms-length APRA doing an effective job at influencing positive changes in industry. What was less obvious to me was the weight that APRA placed on the calibre of the people they were dealing with in institutions; their willingness to be open and transparent with the regulator, the prevailing cultural norms, attitudes and behaviours exhibited by Boards and senior management, and whether these characteristics were ‘trustworthy’.

The extent to which APRA trusts an institution is critical to our supervisory intensity settings and is taken into account against the more quantifiable financial metrics to form an overall view of an institution’s risk profile. We expect institutions to be open, and tell us the truth but also to volunteer information, both in good times and in bad. In my first speech as APRA member at the Insurance Council of Australia’s Annual Forum in March I used the referee analogy to describe the way APRA supervises institutions. I mentioned then that it was important for relationships between institutions and APRA to be based on openness and trust and especially so when institutions ask for the ‘benefit of the doubt’. APRA is more likely to extend such a benefit to institutions where trust has been built over time, than to those who have broken that trust. An example of a breach of trust between APRA and an entity is where we are not informed of a known problem within an entity before it hits the media. In such instances, we immediately ramp up our supervisory effort and retain that stance until the institution restores its standing with the regulator.
Before I go on to talk about some of the general insurance issues on APRA’s radar, let me make a few related points on risk culture. APRA will soon publish an update on our work in this area and while I won’t duplicate this here, I want to highlight one simple point that, in my view, is rather telling. In developing our thoughts on risk culture, APRA undertook a series of engagements with some of our largest regulated institutions across banking, insurance and superannuation, probing them on aspects of their risk culture, including whether they believed they had a strong risk culture. Most believed they did. Why then, are we observing such a flurry of damaging issues to do with trust and conduct that go to the heart of risk culture? While arguably less pronounced in the general insurance industry, these issues do present an opportunity for all financial institutions to reflect on the effectiveness of their own risk cultures and this is an opportunity I encourage you to take.

**General insurance issues**

I said at the outset that it would be remiss of me not to leave you with points of supervisory emphasis for the general insurance industry. Let me start with stress testing. Many of you would be aware that APRA has extended its stress testing framework to the insurance sector, having just completed a comprehensive stress test for the life insurance industry. A similar exercise is underway for a selection of general insurers, with results due by the end of this October.

Some of you may feel we’ve already been through a real-life stress test - the spate of natural catastrophes experienced in 2010/11 where as I mentioned earlier some $5 billion in claims were paid. I cannot argue with this - this was a stressful time for the insurance sector, which emerged from this experience, for the most part, with balance sheets and consumer sentiment intact.

There was another stress 16 years ago: the failure of HIH. This collapse had a significant impact on the community. Confidence in the insurance sector dried up, as did some vital forms of insurance, such as public liability cover. It caused great pain to ordinary Australians. As you know, APRA has invested heavily in recent times to improve its resolution capacity in the event of an entity failure. APRA’s Chairman Wayne Byres spoke about this recently during a speech to the Actuaries Institute in Sydney. These failure preparedness improvements will go a long way to ensure the pain endured from HIH would be substantially lessened in the event (unlikely as it may be) of another insurer failure. I ask you though: how raw are the events of HIH in your minds? Has the memory faded? We know such events hurt, but we often forget how much, and complacency can set in all too readily. This is why stress testing is so valuable. We need to be on the front foot for adverse events - they will come, and usually in a different form than experienced, or anticipated. The more insurers can prepare for them, the better placed they will be to respond. I like the Mark Twain quote ‘History does not repeat itself, but it often rhymes’.

We will disseminate at an aggregate level the outcomes of the general insurance stress test in early 2017, with lessons learnt expected to be employed by all insurers, including those not involved this time around. For those that missed out, we plan to extend the participation soon enough, at least every three years, but potentially more often. So, the message is: be stress test fit - it will hold you in good stead when you need it most.
Aside from stress testing, APRA has observed with some concern the emerging trends in commercial property insurance. While there are some recent signs of stabilisation in pricing, it is too early to predict whether this will hold in coming years. We continue to hear anecdotes of pricing anomalies and in the intense competitive environment there appears to be an element of ‘finger-pointing’. APRA does not intend to debate price settings with insurers. But when we see deterioration in key product areas over time we need to ask the question: how are insurers managing this risk and how sustainable is the current situation?

APRA is monitoring closely commercial property claims trends and loss ratios and, while we are comfortable to leave any necessary corrections to industry for now, we will adjust our supervisory intensity in this area in response to worsening trends. In the meantime I point to a series of better practice observations outlined in our September Insight article on commercial property pricing, intended to lift industry standards in this area.

We are also well aware of the challenges in CTP, particularly in NSW. APRA welcomes the current reform activity by the state regulator and we remain alert to similar patterns of deterioration across other states. We are currently monitoring claims experience of those insurers with large CTP exposures in light of potential implications for reserving and reserve releases, which may not always be available as the environment shifts.

Finally, let me turn to the bread and butter of your business: underwriting. I mentioned earlier that the industry is in good shape from a capital and solvency perspective. But investment returns are not what they used to be and if the ‘lower for longer’ interest rate predictions are correct, insurers need to adjust expectations. We’ve seen in recent years insurers taper back their insurance profitability targets, including their insurance trading ratios towards more reasonable settings and this is considered prudent in the current environment. What we don’t want to see though is a material shift towards sub-grade investments to chase yield. To date, we’ve only seen small movements in this area. While our capital rules capture higher risk investments, insurers need to take care not to adjust their investment portfolios outside of their risk appetite and without due consideration to the risk-return trade off.

The more positive opportunity, however, of the current low interest rate environment lies in underwriting improvements. This is the time to improve robustness in pricing for risk to ensure healthy underwriting ratios are maintained in this low yield environment.

Turning now to reinsurers specifically, our observation is that the market is stable and operating effectively. Capacity is still strong and we see little evidence of that changing in the immediate future. Pricing volatility has slowed but there is a need for caution. Pricing levels set in an environment of strong reinsurance capacity may not be sustainable under conditions where capacity narrows. We know that a spate of catastrophe events usually triggers reinsurer pricing adjustments and we need to be prepared for market hardening. The reinsurance market in Australia is also highly concentrated. Two reinsurers currently underwrite 79% of the reinsurance business
locally. This is why APRA’s supervision efforts, including interactions with offshore reinsurer parents and peer regulators is so important.

Finally, a brief word on cyber risk. We in APRA are watching this and have recently completed work with a sample of our regulated entities designed to assess experience and readiness. We are also keeping a close eye on developments in the small but growing cyber-insurance market. While I will leave a more thorough conversation on cyber risk to the next speaker, I simply say that if you are not asking yourselves the question ‘are we adequately protected from cyber risk?’ then you should be. It appears that the insurance sector is less focused on this area than their banking counterparts. But attacks will not discriminate - indeed, they are likely to search out the weakest link - and the industry needs to get on the front foot to deal with this challenge.

Conclusion

To conclude, let me reiterate a few key points. The general insurance industry is essential for our economy. It does great good for the Australian community during times of extreme stress and has demonstrated this time and again in the wake of natural catastrophes and attritional events. It is in sound financial shape but faces many headwinds. The potential for erosion of trust is a threat that must be dealt with and the industry should be more proactive in responding to this, while also being vigilant over other challenges facing the sector. Developing stress test scenarios that extend beyond the usual scope is important and we expect the industry to make advancements in this area in the near term.

APRA’s mandate is to promote financial safety and system stability. Regulation, trust and social licence are all essential ingredients. We must remember however that complacency puts financial stability at risk. Applying the mind to the ‘what if?’ question keeps this habitual tendency at bay. And putting the customer and the communities you serve at the forefront of your business will help preserve the social licence under which you operate.

I thank you for the opportunity to share the view from the other side of the table, I wish you well for the remainder of your conference.