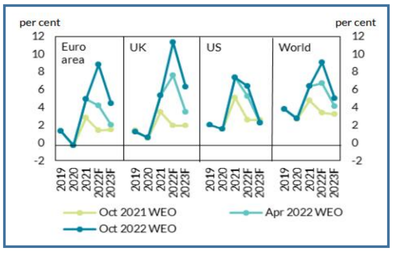
Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Insurance Newsletter

Merry Christmas

DECEMBER 2022



Insurance Insights

Inflation – Monitor, Monitor, Monitor

A prolonged period of double digit inflation has not been experienced in many countries for a generation. This change in the external environment has brought a new focus on inflation and ensuring that policyholders remain protected during the period ahead.

Allowing for the future inflationary outcomes requires a change in tack within risk management systems to analyse and monitor inflation at a more granular level across a diverse range of lines of business, segments and geographical areas, whilst also allowing for consideration of the potential secondary impacts. Development of risk management systems requires increased consideration of modelling methods and assumptions, and for a period of time, enhanced communication and monitoring of the evolving uncertainty and risks associated with inflation.

Granularity of Analysis

More granular monitoring and analysis of inflation risk by firms is required in response to the changing environment and the various drivers impacting inflation. This involves considering both the current and future range of inflation, incorporating both economic inflation[1] and excess inflation[2], including social inflation[3]. (Re)insurers should explicitly assess and understand the specific types of inflation which are relevant to their business and model them accordingly.

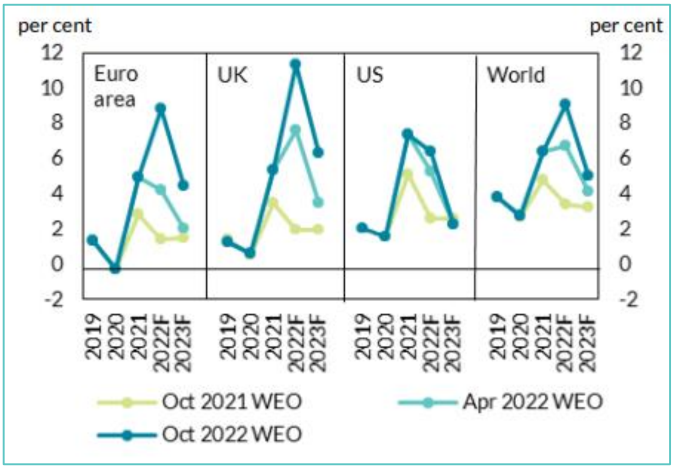


Figure 1 – Inflation Forecasts (Source: [Financial Stability Review 2022:II](#))

Where (re)insurers might have previously had a single overall assumption for inflation, an emerging trend is for (re)insurers to split inflation into its varying components. For non-life insurers this can for example involve splitting inflation into components such as general economic inflation and excess inflation. While the former may be strongly linked to common inflationary measures such as Consumer Price Index (CPI), excess inflation might encompass specific inflationary measures, such as legal and medical costs, as well as other factors such as societal attitudes towards claims and litigation. For life insurers, we see a trend of firms splitting inflation into components such as price inflation, and separating expense inflation for various costs such as salaries, rents and IT.

There may be several iterations of monitoring and analysis before key factors influencing the level of claims inflations are understood. Factors may vary depending on a range of variables including currency, geography mix, and additionally for non-life lines of

1. Economic inflation relates to the changes in claims costs as captured through published economic indices relevant to a (re)insurer's mix of business, such as CPI, RPI or a wage index.
2. Excess inflation relates to changes in claims costs beyond what is captured in economic indices, including factors which are specific to a (re)insurers' business and including social inflation. Examples of this include changes in technologies and medicine, changes in legal environment, evolving social attitudes towards claiming and changes in political developments.
3. Social Inflation is a subset of excess inflation and more narrowly pertains to claims inflation as a result of societal trends. For example, this includes rising costs of claims resulting from increased litigation, larger compensatory jury awards and social movements.

business: heads of damage, class of business, time to settlement, claim size, judicial decisions, contract changes, policy terms and conditions. Given the differences in composition and risk profile between (re)insurers in Ireland, there is unlikely to be one approach that is appropriate for all. Rather, we expect (re)insurers to assess their own risk profile, identifying and managing the risks specific to them.

Methodology Changes

As historical data is unlikely to be representative of the future, and traditional reserving methods in particular do not address this, modelling methodologies have started to evolve. In addition to a shift in the likely impact of inflation on reserves, implications for reserve risk volatility should be considered in addition to the shift in correlation between risks within capital models and Own Solvency Needs Assessments.

Crude inflation modelling methods that were appropriate in the past may need to be revised, to ensure balance sheets provide appropriate policy-holder protection (Table 1 below includes some examples relating to methodology changes). When determining the appropriateness of methods, attention should be paid to the key assumptions e.g. use of explicit or implicit inflation assumptions, use and credibility of historical data relied on for modelling method. It is possible that different approaches will be need for prior years of account compared to the current and future years of account. Companies may need to consider if additional validation is warranted, and for firms in scope of the peer review of reserves, extra focus may be needed from the Reviewing Actuary in relation to inflation risk modelling.

Timely Communication of Risk

Head of Actuarial Function holders in particular should use governance frameworks within their firms to communicate appropriately and quantify inflation assumptions within the baseline scenario as well as the materiality of downside risks. The future level and path of inflation is uncertain and can materially impact the adequacy of a firm's reserves. In such

- Shift from implicit assumption to explicit inflation adjustments in traditional reserving methods. For non-life business, this might entail use of methods such as inflation adjusted chain ladder.
- Uplifts applied to the projected expenses and/or claims cash flows analysed using various assumptions about the future level and path of inflation, such as high short term excess inflation and lower levels into the future, or constant percentages across the full duration of the liabilities.
- Overlaying the past data with expert judgement, to account for possible uncertainty regarding inflation that may be yet to emerge.
- Shift from a single inflation assumption to an inflation curve to measure the impact of inflation on future cash flows over the longer term.
- Explicit allowance within assumptions (for example, adjustments to frequency /severity assumptions and additionally for non-life or health business, changes to IELRs, IBNR loading).
- Explicit inflation provisions based on stress and scenario testing.
- Allowance for varying correlations: for non-life lines: between CPI or relevant inflation drivers and reserve inflation, by line of business, nature of claim and tail length, and for life business: between inflation and other assumptions such as interest rates, credit risk and lapse rates

Table 1 – Examples of Methodology Changes - Reserving

circumstances, it is appropriate that (re)insurers explicitly consider this uncertainty. (Re)insurers may need to incorporate additional sensitivity testing to help communicate this uncertainty and the potential range of outcomes to key stakeholders such as the Board. Strong interlinks and regular communication between various aspects of the business functions will help ensure clarity, consistency and control of inflation risk. Table 2 below illustrates the wide ranging impact of inflation.

We have seen welcome improvements in the transparency of expert judgements, limitations and risks relating to adequacy of reserves over the last number of years; we expect firms to be transparent about the expert judgements, limitations and risks associated with inflation. Transparency regarding expert judgements, data limitations and forward looking inflationary assumptions and risks is the starting point for setting out paths to analyzing and taking timely action in response to the changing environment.

We expect undertakings and Boards to have clear visibility of the inflation assumptions embedded within their reserves, whilst also understanding the potential impact should the future level and path of inflation diverge from their assumptions.

Timeliness of communication, including communication of inflationary risks will facilitate decision making and avoid an unnecessary delay in response, for example not waiting to see inflationary impact come through in the data before taking action where there is a clear link between inflation drivers and risk exposure.

Conclusion

Ensuring that there is a central focus on inflation risk and bringing together various aspects of the business to assess, manage and monitor this risk, will no doubt ensure the clarity of action needed to protect policyholders during the period ahead.

Grace von Offenberg Sweeney
Head of Function - Actuarial
Insurance Supervision Directorate

- **Under-reserving** due to insufficient account being taken of inflation on claims costs and operational expenses and/or insufficient attention being paid to the different and complex inflation drivers.
- **Inadequate premium** rates/product charges that do not adequately reflect the impact of inflation and potentially affect business model viability when combined with other economic and financial market headwinds.
- **Inadequate capital** being held as a result of a new inflationary environment, the volatility of inflation levels or correlations not being appropriately reflected in capital modelling. Consideration should be given to the impact on capital management tools such as derivatives, Asset Liability Management or reinsurance structures. For example the potentially disproportionate impact of inflation on claim costs for policies with high excesses or excess of loss reinsurance policies if the excess or attachment points do not index in line with inflation.
- Prolonged high levels of inflation give rise to changes in **consumer behaviour**, which combined with economic downturn may have implications including unintended under-insurance and higher propensity to claim.
- Heightened **operational risk**, including cyber-related risk, resulting from firms' search for compensating cost efficiencies to offset the impact of inflation. Business plans and budget inflationary assumptions may be out of sync with pricing assumptions.

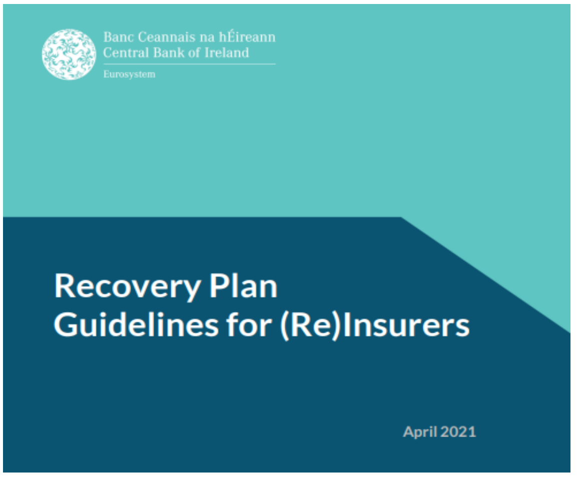
Table 2 – Examples of the wide ranging impact of inflation for (Re)insurers

Thematic Review of (Re)Insurance Recovery Plans

The Central Bank of Ireland introduced [pre-emptive recovery planning requirements in 2021](#) and all (re)insurance undertakings have been required to have a recovery plan in place since 31 March 2022. Following a recent thematic review of recovery plans received[4], we share our main observations below. These observations focus on four key elements of the plan: Scenario Analysis; Recovery Options; Recovery Indicators; and Governance. A more detailed version of our observations, including the strong and weak practices that were identified across the recovery plans, have been shared via letter with (re)insurance undertakings.

As with any new initiative, we observed variance in the quality of the recovery plans submitted and we would expect that they will develop and mature in future iterations. At a broad level, we observed a common misconception around the purpose of the plan: which is to ensure that each insurer has a credible and feasible recovery plan, capable of being implemented in a crisis and restoring the financial position of the insurer. It is not to assess the likelihood of the plan being needed. Other common themes identified across the submissions include:

- Significant reliance being placed on the existing risk management framework including the ORSA process, risk appetite statement and capital management planning. While this approach ensures that recovery planning is integrated into the broader governance and risk management frameworks, the scenarios used to test plans were insufficiently severe or were applied to a very high starting solvency position. There is a risk that such an approach does not adequately challenge the effectiveness of recovery options and hence does not prepare firms for financial stress scenarios. The purpose of the plan is not to demonstrate that severe financial stress is very unlikely, but to articulate what actions could and would be taken if such a crisis ever arose.
- The more limited shortfall in solvency or liquidity under the stressed scenarios allows greater reliance on more marginal recovery options, which would have minimal impact or timeliness in a more severe stress.
- Many plans did not demonstrate the level of formality and urgency we would expect to see in an escalation process for an insurer in crisis. We observed too much discretion around escalation paths and required actions and a lack of timeliness in communicating to key stakeholders, including the Central Bank.



Observations about each of the four key elements are noted below.

Scenario Analysis:

Most (re)insurers included the required number and type of scenarios being insurer specific, system-wide and a combination of insurer specific & system wide. The scenarios selected were generally relevant to the insurer taking into account their business, operating model, group and external interconnectedness, and any identified vulnerabilities. In general, the impact on SCR coverage (combining own funds and capital requirements) and liquidity were considered both pre and post recovery actions. The most common issues were stresses not being sufficiently severe to cause failure in the absence of recovery actions and the timeline over which the scenarios develop and the impact of recovery actions is realised not being clearly described.

4. 71 plans comprising 36 High & Medium-High insurers' plans and a sample of 35 Medium-Low and Low insurers' plans were assessed against the legislation and guidance, using a standardised assessment methodology.

In addition, the section on Overall Recovery Capacity ("ORC") was generally poorly developed. ORC can be defined as the extent to which an insurer could restore its capital and liquidity in exceptional but plausible crisis situations by implementing recovery options.

Recovery Options:

There was a wide range of options selected by the undertakings reviewed. This included options based on recapitalisation, de-risking, trading out as well as more structural changes such as portfolio sales or closure to new business.

Options to increase own funds are heavily dependent on Group support (including capital injections and subordinated debt). A limited number of undertakings reference non-group capital or debt.

The next most popular options relate to de-risking with a commensurate reduction in solvency capital requirements. These options include using reinsurance to reduce risk, changing investment mix and reducing the level of premium written and/or changing business mix.

Structural type options such as exiting or selling parts of the business were referenced by half of undertakings, while slightly fewer undertakings included trading type options such as retaining future earnings (i.e. not paying planned dividends), cost savings or pricing increases.

There were minimal liquidity only options with the most common being a drawdown of lines of credit.

In general, plans didn't include a description of how the continuity of operations would be ensured when implementing a recovery option. Other areas of weakness included limited consideration of alternatives if group support is not forthcoming, lack of clarity on how recovery options would be operationalised, and undue reliance on trading options which may have limited feasibility in a severe crisis.

Recovery Indicators:

Further work is required so that undertakings have a robust indicator framework capable of alerting them in a timely manner. In particular, it was noted that there is limited use of "lead" or forward looking indicators.

We expect the indicator frameworks to evolve to better reflect specific vulnerabilities, and to be more explicit on the basis for the calibration of thresholds including an explanation of any underlying assumptions. We encourage undertakings to consider incorporating relevant lead indicators in their recovery plans going forward.

There is no standard measure for liquidity within Solvency II. Notwithstanding this, a majority of undertakings included some form of liquidity indicator, typically based on the measures they currently use within their risk appetite framework. However, a significant minority of undertakings do not include any liquidity indicator as required by the Regulations.

The Regulations require that the framework of indicators should include, if relevant, the point at which the insurer would consider solvent run-off as the most appropriate recovery option. While many plans addressed this point, some did not reference it at all even when closure to new business was identified as being a potential recovery option.

Governance:

Overall, we consider that undertakings have made good progress in documenting the governance processes supporting the development and ongoing maintenance of the recovery plan. Plans generally would benefit from increased clarity on what would prompt an "out of cycle" update of the plan. In addition while undertakings have documented their process for escalating recovery indicator breaches those processes would benefit from being more precise and time bounded.

John FitzGerald
Head of Function – Cross Border
Insurance Supervision Directorate

Key Sectoral Risks for (Re)Insurers in Ireland

The Central Bank's supervisory engagement model for the insurance sector incorporates periodic "Risk Scanning" in order to identify the key prudential risks arising from the external environment, and to assess their potential impacts on the Irish insurance sector.

The risk scanning process consolidates input from a number of sources, including engagement with firms, risk research and publications, as well as the inputs of subject matter experts, including in relation to actuarial science, regulatory policy and IT & cyber risks, to name a few. The output of this process informs supervisory priorities for the coming period.

The purpose of this article is to provide an overview of the key risks identified during the risk assessment and scanning process of 2022.

Elevated ***Macroeconomic and Financial Risks*** are a key current focus, and include:

- **Volatility in financial markets** related to uncertainty in economic outlook, inflation and geopolitical events. Significant and/or rapid changes in asset valuations and related liquidity issues and/or counterparty default risk. Additional risks could stem from foreign exchange rate volatility. Insurance firms are exposed to these risks through their significant investment assets as well as the investment risks associated with some insurance liabilities and risk management strategies.

- **Economic downturn.** The macroeconomic environment has deteriorated significantly and represents a threat to insurance business models over the medium term. There is a risk that a global economic downturn combined with an inflationary environment could reduce demand and increase lapses impacting both non-life and life insurance.

- **Increased inflation.** Inflation has reached multi decade highs across global economies due to a confluence of factors and is likely to stay elevated at least into 2024. Insurers will face numerous challenges: cost of claims/expenses which exceed allowances made in pricing; setting claims/expense inflation assumptions using general measures of price inflation (reserve risk); competitive pressures when establishing uncertain inflation assumptions in pricing (new business); reduced profitability of and demand for insurance products.
- **Geopolitical risks** are elevated in 2022, arising both from the current conflict in Ukraine and through a shifting political landscape and social unrest (e.g. increased immigration, food crises), which could in turn amplify the other macroeconomic risks discussed above.

Operational Risks include:

- **Outsourcing risks** arising from a significant reliance by some insurers on third party or group support for key activities. Risks are exacerbated by a lack of appropriate governance and oversight arrangements in place to monitor the activities of outsourced service providers.
- **IT and Cyber risks** related to the risks of disruption to IT services, data and/ or financial loss due to cyber attacks and criminal data breaches. Business continuity management and IT continuity and data integrity are increasingly important aspects of firms' risk management framework.

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Digitalisation and Technology development in the financial sector poses both opportunities and certain risks for insurance firms:

- **Impact of technology on business model** risk is the risk that firms may fail to keep pace with the adoption of innovative technologies within the sector, which may affect the firms capacity to compete with more agile undertakings or new entrance to the market such as InsurTech. Increasing use of technology is daily life of consumers affects consumer behaviour and also may affect the range of products insurance companies offer.
- **Artificial Intelligence and use of Big Data** pose both prudential and consumer protection risks for insurance firms. Increasing availability and use of data and advanced analytics may have potential negative impact on vulnerable consumers.
- **Cyber underwriting risks** relate to risks stemming from increased underwriting of intended and/ or non-affirmative cyber insurance cover or multi-peril policies and related clear understanding by insurance firms of their exposure and potential ambiguity of policy wording.

Climate Change remains a key long term challenge. Risks may relate to the transition to a low-carbon and climate resilient economy; risks that arise from physical effects of climate change of particular weather related events or potential liability arising from compensation for losses related to climate change.

Regulatory and Legislative changes both in domestic and international space remain a prominent risk, could pose operational or strategic challenges for insurance firms. Risks arising from regulatory change include also those originating in other jurisdictions and differences in interpretation of existing regulations, which may have a material effect on the business models of cross border insurance firms. Divergence in regulatory frameworks and approaches may also affect ongoing efforts in relation to supervisory convergence and cross-border co-operation.

Given the potential impacts on the Irish insurance sector, the Central Bank expects insurance undertakings to consider these risks as part of their risk management framework, and to carefully analyse their potential impact.

Natalia Fusco
Advisory Team
Insurance Supervision Directorate

Insurance Updates

Insurance Directorate - Recent Stakeholder Engagement

Under the "Open & Engaged" theme of our organisational strategy, the Central Bank of Ireland undertakes regular speaking engagements, providing an opportunity to engage with our stakeholders, to outline forthcoming regulatory developments and supervisory plans, to highlight emerging risks, and to summarise the key findings and required actions arising from recent review work. A summary of stakeholder engagements from Q4 2022 is provided below.

Domhnall Cullinan, Director of Insurance Supervision, spoke at a Financial Services Ireland event on 6 October. He outlined the current uncertain environment in which insurers operate; why the Central Bank of Ireland's approach to authorisation and supervision remains appropriate; and some current and future areas of focus, including unit linked life products, digitalisation and climate change. The insurance industry was urged to meet these various challenges in a manner that is responsive and forward-looking. Full details of Domhnall's speech can be found here.

Domhnall also attended the Insurance Risk & Capital EMEA Conference in London on Thursday 1 December, where he participated in a panel of insurance supervisors and industry representatives. Discussion focused on the impact of the current macro-economic environment, and other challenges facing the (re)insurance sector, and on key developments in regulatory frameworks, including Solvency and the IAIS International Capital Standards.

Andrew Candland spoke at the KPMG Insurance Briefing on 6 December. Under the four themes of the Central Bank's Strategy (safeguarding, future-focused, transforming, and open & engaged) Andrew gave an update on key initiatives related to insurance and reinsurance in 2022 and the priorities for 2023. Andrew took the opportunity to highlight the value of the Insurance Newsletter in providing feedback, summarising key developments domestically and from EIOPA, and pointing to upcoming deadlines.

NST Taxonomy Updates

The Central Bank is introducing changes to some of its national specific templates (NSTs). The NSTs capture information specific to the local market and/or the nature of insurance undertakings supervised in Ireland and which are not catered for in the set of Solvency II harmonised reporting templates.

The majority of these taxonomy updates arise from changes to the income statement under the new insurance accounting standard IFRS 17. The updates are summarised in the table below.

The revised taxonomy together with validations is to be published on 16 January 2023. External user acceptance testing (UAT) is to be done in the week commencing 6 February 2023. The taxonomy will have an implementation date of 28 February 2023.

Summary of NST Taxonomy updates

NST.01 – Non-Life Income Statement (annual and quarterly)
Addition of new rows to allow for reporting of non-life income statement under the new insurance accounting standard IFRS 17.
"Other Comprehensive Income" line item added after "Operating Profit" line item.
"Fire and other damage to property insurance" line of business split into "Home insurance" and "Other property insurance".
NST.02 – Life Income Statement (annual and quarterly)
Addition of new rows and columns to allow for reporting of life income statement under the new insurance accounting standard IFRS 17.
"Other Comprehensive Income" line item added after "Operating Profit" line item.
NST.07 – Non-Life Premiums, Claims & Expenses – Detailed Split by LOB & Distribution Channel
"Fire and other damage to property insurance" line of business split into "Home insurance" and "Other property insurance".

Insurance Updates

Consumer Protection expectations in relation to Data Migration

The Central Bank expects insurers to adopt a consumer-centric approach in all their actions and decisions to ensure that consumers' interests are protected and potential risks mitigated. Poor business practices and weak business processes is one of the five key Cross Sectoral Risks identified in our [Consumer Protection Outlook Report 2022](). In particular, *"weak business processes can result in incorrect migration of consumers from one product or provider to another. Where firms do not have adequate processes and procedures to control and mitigate operational risks, this can have a severe impact on the quality and availability of the service provided to consumers."*

Increasingly, insurers are embarking on data migration projects arising from the evolving insurance landscape and in order to realise the benefits gained by migrating from legacy systems. Where data migrations are not meticulously planned, insurers may suffer negative financial and reputational consequences, including loss of premium profits, reduced customer retention and potential legal repercussions, particularly where issues result in a negative impact on the customer. Carefully planned data migration projects will enable insurers to reduce the cost of legacy system maintenance. However, insurers should engage in any such projects from the perspective of consumers' needs and best interests and any changes in insurance services stemming from new system agility should bring about benefits for consumers also.

Data migration can be complex and requires careful planning. This can be compounded by a number of additional factors, including product complexity, volume of data, importance of historic data and regulatory requirements. This is particularly relevant for the migration of life insurance contracts.

Poorly executed data migration may lead to consumer harm, as a result of sub-standard data quality of migrated policies, lost policies, errors and data breaches. Therefore, in considering existing and future data migrations, the Central Bank expects that Firms will plan data migration carefully, to ensure that:

- All policies are transferred to new systems in a correct and consistent manner;
- Systems are in place to facilitate existing terms and conditions for all migrated policies, with all guarantees awarded to consumers at policy inception honoured; and
- Consumers are not disadvantaged in any way by data migration.

The expectations set out above are not exhaustive. Insurers should continually evaluate the effectiveness of all arrangements and controls relating to data migration to ensure that they are meeting the highest standards of consumer protection and delivering fair outcomes that put consumers' interests to the fore.

Helena Daly
Associate Supervisor, Life & Health Supervision Team
Consumer Protection: Insurance & Intermediaries

Forward Planner

Upcoming Dates

28 February 2023 – Implementation of NST Taxonomy Updates

Dec → Jan → Feb → Mar

March 2023 – Publication of Q1 Insurance Newsletter

Central Bank of Ireland – Recent Speeches/Research of Interest

Date	Topic	Link
1 December 2022	Economic Letter Vol. 2022, No. 8 – Engagement, switching and digital usage in consumer insurance markets: who does it and why it matters. - Shane Byrne, Jane Kelly and Anuj Pratap Singh	https://www.centralbank.ie/docs/default-source/publications/economic-letters/engagement-switching-digital-usage-in-consumer-insurance-markets.pdf?sfvrsn=e9f49b1d_5
17 November 2022	'Charting the course - leading financial services through complexity and change' - Remarks by Deputy Governor Sharon Donnery at Financial Services Ireland Annual Dinner	https://www.centralbank.ie/news/article/charting-the-course-leading-financial-services-through-complexity-and-change-remarks-by-deputy-governor-sharon-donnery-at-financial-services-ireland-annual-dinner-16-nov-2022

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