After the storm: rebuilding trust in the wake of the royal commission

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John Lonsdale, Deputy Chairman – Insurance Council of Australia 2019 Annual Forum, Sydney

Good afternoon. Let me start by offering apologies on behalf of Geoff Summerhayes, who has represented APRA at this event for the past three years. Geoff has overseas commitments and asked me to speak in his place.

I am tasked with leading APRA's work on several significant issues that cut across all of the industries we regulate, such as culture, remuneration and our approach to enforcement. I hope to provide you with some insights on this work, as well as our perspective on how your industry is tracking and regulatory developments that are being considered.

My knowledge of general insurance stems primarily from personal experience. Like the vast majority of Australians, I insure my home and contents. I have insurance for my car, and I would never dream of heading overseas without travel insurance. I recognise that an insurance policy buys protection from major financial loss, as well as valuable peace of mind. From my years in Treasury, I know all too well the crucial role that general insurance plays in encouraging investment and economic growth by giving home and business owners the confidence to take measured financial risks, and the ability to continue or start again when misfortune or disaster strike. Indeed, the general insurance industry is often at its best in the aftermath of a catastrophe, such as a flood, bushfire or cyclone, as small armies of assessors, builders and tradies descend on battered communities to help policyholders rebuild their homes, businesses and lives.

Following the release of Commissioner Kenneth Hayne's Final Report, financial institutions, including general insurers, face a very different rebuilding challenge: rebuilding trust and rebuilding their reputations. Although APRA regards the Royal Commission as a positive for the financial services sector, the fallout has harmed companies and individuals who were shown not to have met the high standards the community – and the law – rightly expect. General insurers suffered less damage than banks or superannuation licensees, but the industry did not escape unscathed. Moreover, the industry arguably hasn't always heeded the advice it gives to its policyholders – to understand their exposure to risks, and take steps to mitigate against them.

Reflections on the Royal Commission

In APRA's experience, the general insurance sector is generally mature, well-run, soundly capitalised and responds promptly and effectively to regulatory principles and requirements. While the stories aggrieved policyholders presented to the Commission were confronting and clearly unacceptable, we also acknowledge that their experiences aren't representative of the service or outcomes delivered to the majority of policyholders. Despite this, Commissioner Hayne made several legitimate criticisms about general insurance that lend support to the overarching theme delivered in his interim report: that misconduct across the financial sector has been primarily driven by greed, and the pursuit of short-term profit at the expense of basic standards of honesty and ethical behaviour.

One of the general insurance industry's key messages, amplified by the ICA, has been that home and business owners should make themselves aware of what hazards their property is exposed to, and take steps to mitigate the risk. This is an entirely sensible message; once policyholders understand that their home is built on a flood plain, or their business could be exposed to bushfire, they can take action to combat the risk. Reviewing Commissioner Hayne's report, however, I'm prompted to ask whether the general insurance industry has taken its own advice.

Is anyone in this room surprised that the Royal Commission team zeroed in on the sale of add-on insurance sold through car dealerships? The industry has been aware of serious concerns around the sale of add-on products, including consumer credit insurance, for many years. It was at this event three years ago that then-ASIC Commissioner Peter Kell criticised the industry over its poor standards in the provision of these products, describing them as "unacceptable". So why is it that, nearly three years later, the focus of much of Commissioner Hayne's comments on general insurance was about the ongoing business of add-on insurance? The industry's long overdue reform process has seen commissions fall from as high as 80 per cent of premiums to 20 per cent, which is a welcome improvement. However, recent ASIC data shows that add-on insurance loss ratios, while increasing, remain significantly lower than home or car insurance. Insurers are still making a lot of money from these products, with the fear of "first-mover disadvantage" seemingly holding back some individual insurers from more fully addressing the problems, or even getting out of this contentious market altogether. Fundamentally, this reticence seems to come down to money, and not forfeiting market share to competitors.

Ultimately, that extra revenue has come at a cost, and not only in terms of reputational damage: the industry's reluctance to address fully the problems such as add-on insurance means that some issues have been taken out of insurers' hands. A deferred sales model will be imposed while ASIC will impose a cap on commissions. Likewise, insurers now have less ability to control the process of change on significant issues including consumers' duty of disclosure, making insurance policies subject to unfair contract terms laws and the review of the exemption to the ban on conflicted commissions. They have lost that control because the community has lost trust in the industry's ability to self-regulate in a manner that adequately protects policyholders.

The root of the problem

The question of whether or not specific products or sales channels are suitable for consumers is one for the Australian Securities and Investments Commission (ASIC). As a prudential regulator, APRA's key focus is that insurers retain sufficient financial strength to pay all legitimate claims from policyholders. By making substantial profits through the sale of add-on insurance, they have arguably bolstered their prudential strength (notwithstanding the $128 million-plus the industry has had to remediate to customers since 2010). However the spotlight of the Royal Commission has highlighted behaviours and practices that suggest the basic principle of insurance – utmost good faith – has not always been adhered to. The result has been an undermining of trust. As we have emphasised repeatedly, trust is an essential component in all financial service businesses. Its erosion is very much a prudential issue and, appropriately, a matter of concern for APRA. The Royal Commission has therefore encouraged us to do much more in examining culture within financial institutions, and what drives it.

Furthermore, we are alert to the fact that some companies may struggle to adjust to the impact of the Commission's recommendations on their business models and sales practices. As the prudential regulator, APRA must ensure that insurers retain the means to pay all legitimate claims from policyholders, even if they are exiting particular business lines or exiting the industry entirely. Our supervisors will continue to closely monitor and engage with insurers to ensure they retain sufficient capital strength and profitability, and that risk management frameworks are updated and embedded, as the industry adjusts to the new environment.

The importance of identifying and mitigating against risks also goes to the heart of our cross-industry risk management standard, CPS 220. As part of their day-to-day risk management practices, we expect regulated entities to put in place systems to identify, manage and mitigate material risks to their businesses. But as last year's Prudential Inquiry into the Commonwealth Bank of Australia (CBA) demonstrated, those systems are difficult to get right in even the largest and most sophisticated organisations.

With that in mind, we last year asked 36 of the country's largest APRA-regulated entities to undertake and submit a self-assessment to gauge whether similar issues to those highlighted in the CBA report might exist in their institutions. We received those self-assessments in November and they have recently been reviewed by the relevant supervisory teams. We are in the midst of benchmarking the results to get a clearer picture of how industries and individual companies stack up, as well as the cross-industry themes that emerged during the review.

Nine of the institutions we formally asked to perform a self-assessment were general insurers, and all were at the larger end of the spectrum. We're not yet in a position to provide detailed feedback on how they performed but I can briefly give you some high-level insights into what we've learned from the general insurance self-assessments so far.

First the good news: although there is some variation in how assessments have been undertaken by different institutions, it would be fair to say that, generally, a great deal of thought and effort was devoted to this process by institutions. Not unexpectedly, there will be areas where APRA will be seeking greater insights on issues which have been identified that may require further work.

We have observed some common themes. The management of non-financial risks in the sector is less mature than for financial risks, and culture is an area of challenge that isn't particularly well understood. Remuneration frameworks and assessments also need to be further developed and embedded to better reflect risk and customer outcomes and take into account observations in our 2018 information paper on remuneration practices at large financial institutions.

Where insurers have identified weaknesses, most have developed remediation plans, some of which incorporate a significant number of actions. Our focus is on whether institutions have properly identified the root causes – the "why" and "how", rather than the "what". As a result, you can expect APRA supervisors to focus strongly on challenging boards and management on root cause identification in the months ahead.

We intend to publish an information paper in the second quarter of this year with broad feedback from the self-assessments, while we will also contact participants to provide entity-specific feedback. I'd also like to acknowledge those insurers that were not formally asked to conduct a self-assessment but did so voluntarily. To those of you that have not yet done this, our supervisors are likely to ask you over coming months what steps you have taken to respond to the issues raised by the CBA report. More importantly, conducting the self-assessment can help you pinpoint and deal with the issues at the heart of any problems facing your business, which is an essential step in rebuilding the trust of wary policyholders and a jaded community.

Regulatory rebuilding

Of course, insurers and other financial entities are not the only organisations facing a rebuilding period. APRA, too, is continuing to invest in lifting its capabilities and reviewing its approach to regulation, supervision and enforcement after the Royal Commission identified areas where we needed to help more forcefully address misconduct. This process commenced with the development last year of our Corporate Plan for 2018-2022, where we identified the need to broaden our supervisory focus, increase inter-agency collaboration and improve performance measurement and accountability. The Royal Commission's recommendations regarding APRA align with those goals and will help to accelerate their delivery: a capability review will help APRA be well equipped to fulfil our mandate into the future; and the creation of a new regulatory accountability regime, similar to the BEAR, and a new regulatory oversight body, will make us more answerable for our decisions and actions. Increased accountability is beneficial for financial institutions, so I am confident it will also help APRA to lift its standards and performance.

We continue to delve into the link – emphasised repeatedly during the Royal Commission –

between financial incentives and misconduct or poor consumer outcomes. Following the release of our report on executive remuneration in major financial institutions last April, we have been working on strengthening the prudential framework in this area to support a more robust and credible implementation of its objectives and to reflect overall evolving international standards and practice. We expect to release a revised prudential standard on remuneration for consultation around the middle of the year, which will focus on better alignment of remuneration with prudent risk management outcomes and long-term institutional soundness. It will also have regard to measures designed to reduce the risk of misconduct.

Closely related to this has been the work on embedding the Banking Executive Accountability Regime (BEAR) in major banks, and preparing other authorised deposit-taking institutions (ADIs) for its introduction from 1 July 1 this year. That work has now broadened to include preparations for the scheme to expand to cover other APRA-regulated sectors, including general insurance. APRA supports this decision, recognising that insurers and super trustees can benefit from the same sharpened focus on the clarity of accountability arrangements within financial institutions.

The creation of the BEAR, alongside the Royal Commission and CBA Prudential Inquiry, prompted us to embark on a review of our enforcement approach and capabilities. The Review won't be finalised until the end of next month, so I don't want to jump to any definitive conclusions at this point. What I can say is that it is likely to recommend an increased enforcement appetite, which will mean industry can expect an APRA that is less patient on the time taken by uncooperative entities to remediate issues, more forceful in expressing specific expectations, and prepared to set examples using public enforcement to achieve general deterrence.

Another substantial cross-industry program of work is the ongoing development of our formal prudential framework for recovery and resolution. We have been working with a group of large and medium insurers to build their recovery planning capability to ensure they are better prepared to recover from a range of stress scenarios. Consultation on the prudential framework that will provide a formal foundation for this work will start over the next year.

Among our general insurance-specific policy priorities for 2019, we are reviewing the implications for the capital framework of the forthcoming accounting standard AASB17 – Insurance Contracts. Our preference is to align capital treatment with accounting standards, unless departure is justified on prudential grounds. Implementation of this standard is expected to be complex, with most or all of the relevant capital standards likely to be amended. We expect to release a discussion paper on these matters towards the end of the year. These are all critical areas of your business and I would encourage you to engage actively with us as we proceed in this work.

Paying the price

Protecting yourself from hazards, whether in business or everyday life, starts with an awareness of what perils you are exposed to. But as every general insurer understands, there is exposure, and there is vulnerability, and they not the same thing. Every house in Cairns is exposed to cyclones, but homeowners who reinforce their roofs, clear their gutters, install shutters on their windows and secure loose objects around their property are less vulnerable.

The evidence that emerged from the Royal Commission showed that in multiple areas of exposure – add-on insurance, unfair contract terms, conflicted commissions and questionable sales practices – insurers left themselves vulnerable by failing to mitigate against risks that, in many instances, were well known. The industry reaped the short-term profits of these decisions through higher premiums charged, more policies sold and fewer claims paid out to policyholders. Now it's counting the costs, and they are almost certainly going to be greater than would have been the case had the industry taken adequate steps to mitigate these risks on its own.

So my challenge to the general insurance industry is to show greater leadership in responding to concerns about products or services, rather than being dragged into action by regulators, politicians or Royal Commissions. This means being prepared to go beyond just legal or regulatory compliance. The ICA and a strengthened Code of Practice can assist, but ultimately individual companies must make conscious decisions to do the right thing, even when not strictly required by law. Companies across the financial sector face this same challenge. Selling policies to customers who are ineligible to claim on them, charging fees for no service, or relying on outdated medical definitions can all deliver higher short-term profits. But as the financial sector cleans up in the wake of the Royal Commission, it should be in no doubt that there's always a price to be paid in the end.