

POLLYANNA DEANE'S INSURANCE COLUMN: DECEMBER 2019

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In her column for December 2019, Pollyanna provides an update on Solvency II and considers the use of artificial intelligence (AI) in the insurance sector.

by *Pollyanna Deane*, Partner, International Insurance Group, Simmons & Simmons LLP

ALL THE FUN[DS] OF SOLVENCY II

It's the festive season and I promised you a present in the form of a Solvency II update, perhaps not quite so welcome and certainly only focusing on a few issues which I've found interesting; I'm thinking that we're all waiting for 2020. Nonetheless, expecting Father Christmas to come up with anything interesting is more in the line of nightmares before Christmas, especially given the exhortations from all quarters to behave at the Christmas party.

So, Solvency II has been left to bed in, remarkably without too much interference – although we are now looking at both the 2018 and the 2020 reviews, the latter promises to be rather more extensive. Looking at what has emerged so far, it is the asset management side of the insurance business which has produced some of the more interesting developments. These include new categories of equity investments, enhancements to investment in infrastructure and changes to securitisation investments where they are simple, transparent and standardised transactions – which wits have decided are never one or more of these things!

Long-term equity investments (LTEI) attract a 22% capital charge and must meet the criteria set out in Article 171a of Delegated Regulation (EU) 2019/981, being EEA-listed or with an HQ in the EEA, held for at least 5 years, forming a clearly identified and distinct sub-portfolio, matching assets with liabilities and with sufficient separation from other parts of the insurer's business.

It is interesting to note that the aim behind Solvency II was to do away with the myriad funds and sub-funds, but it is clear that the need to ring-fence assets, particularly those with specific characteristics that meet the insurer's needs, remains. Here in the LTEI space, we can imagine that a sub-fund will be created, not least to demonstrate separation and also the need to hold something for at least 5 years, which is going to be a question of intention at least for the first 5 years and thereafter easier to demonstrate. Additionally, other investments might be attracted by the 22% capital charge – the favourable capital treatment offered by an LTEI can potentially be applied to ELTIFs and others such as mutual funds. The long-term nature of the investment turns into an advantage and as such may be attractive to life insurers.

Other equity investments which have been brought within a more favourable capital regime include Qualifying Unlisted Equities which, if they can show compliance with the terms of Article 168a of Delegated Regulation (EU) 2019/981, can be treated as if they were listed equities. These should not be companies within the financial sector, their shares should not be volatile, and with a three-year record meeting various requirements. We can see the need to bring diversity into insurance asset portfolios. Not too much though – there can only be an investment which does not exceed 10% of the portfolio and we would surely anticipate much less of the portfolio being devoted to such unlisted equities.

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Qualifying infrastructure has been tinkered around with for almost as long as Solvency II has been in force. The political will to get insurers to invest in the much-needed updating of infrastructure means that favourable conditions are being offered – to extend investment from simply in the project itself to holding companies, bonds and loans. Given this, the idea behind nationalisation of certain of the UK's infrastructure elements seemed hard to justify.

I have seen a word cloud for the 2020 review, which seems to cover the kitchen sink. It will be interesting to see what is actually adopted in the tight time frame we have. Essentially something to consider for Father Christmas next year.

AI – THE ELEPHANT IN THE ROOM

Just to be clear what I'm referring to, AI has been described as:

“the theory and development of computer systems able to perform tasks normally requiring human intelligence, such as visual perception, speech recognition, decision-making, and translation between languages” (Oxford University Press, 2005).

I've long been interested in the InsurTech world and, looking at incumbents and the new tech companies, am surprised to see less use of AI than might have been expected.

In particular, with the advent of driverless cars, discussion has been focused less on the impact on insurance itself and more on items for which insurance can be bought and how they may be covered. Given that insurers are looking to reduce costs and see claims handling as a cost, it is interesting that, so far, insurers have chosen to focus their use of AI on underwriting and pricing, rather than claims handling.

Although simple AI is now being used in claims handling, this is so, less frequently in the complex claims arena than in areas such as motor and personal injury. The insurance industry is considered to be ripe for automation, with researchers at Oxford University ranking claims handlers within the top 20 jobs (across all industries) most suitable for computerisation, in 2017.

Why less engagement with AI is found in the insurance industry has been put down to a number of points:

- Poor historic data and technology practices mean many insurers don't have the breadth or quality of data required to train machine learning AI systems.
- The industry has struggled to attract staff with the necessary digital skills.
- There is a reluctance to invest in the claims function, due to its nature as a cost rather than profit centre.
- Regulatory uncertainty and questions over accountability and legal liability for AI are stifling innovation.

Each of these is a problem, but the reality is that in a short period of time certain players in the market will have overcome these problems and everyone else will be playing catch up.

Insurers are supposed to be skilled managers of data. While they tend to have a lot of it, it's more likely to be defined by the idea of quantity rather than quality, as quality takes time and money to achieve. The key point is that AI needs quality data inputs and data sets to provide the best outcomes. With AI being increasingly able to take over the activities of claims handlers, it is not fanciful to suggest that any fully automated insurance could eventually be able to detect damage, assess quantum and pay a claim, all without any input from the insured.

But AI and a machine are only as good as the input they get and will reflect the assessments of the human programmer, which can lead to issues around bias and assessment. Also with the complexities added through machine learning, the insurer risks losing sight of the reasons behind making claims assessments. How can anyone determine if the insurer has treated its customer fairly if it cannot be sure of the reasoning behind the claims decision and the machine learning algorithm created then strays from the initial inputs and data set?

Regulation in the area has been slow to develop – largely because there is an element of science fiction to all of this, rather than an appreciation of how it might enhance the basic job. Regulators want the insurers to come up with the answers, rather than appreciating that a suitable framework might enable both sides to make life easier for each other. If principles-based regulation has fallen by the wayside, it needs to be revived for the purposes of providing a framework for AI to work within in the highly-regulated world of insurance. Not least, because of the inherent dangers of relying completely on technology, without appreciating the potential for data to lack integrity – thanks to quality issues and potential bias, which has not been considered, as well as the potential for the claims outcomes to be determined without adequate reasoning and, hence, be incapable of appropriate challenge.

Insurers play a significant role in society and need to set a high ethical standard because:

“an uncritical reliance on technology could lead to wrong decisions that threaten human rights and undermine public trust” in the insurance industry (The Law Society, 2019).

To the extent that insurers provide such support, they also need to consider the role that they are playing in managing the future – as risk managers but also data managers. The issues that the financial services world faces because of lack of trust start to become even greater when the data that we give them leads to consequences that have not yet been thought through.

That said, the potential for building a new way of providing insurance through use of AI and improving the quality of data should enhance all our lives and provide a better way of doing business.