ICAEW REPRESENTATION 181/16

Treasury Committee Inquiry into Solvency II

ICAEW welcomes the opportunity to comment on the *Treasury Committee Inquiry into Solvency II* published by House of Commons Select Committee on 13 September 2016, a copy of which is available from this link.

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MAJOR POINTS

Insurance regulation can't be considered in isolation

1. Implementing Solvency II was a major task for insurers in the EU. It is right that there is a review of its implementation and for the Treasury Committee to consider the best way for UK insurers to be regulated in the future in light of the decision for the UK to leave the EU.

2. The decision on whether to continue to apply Solvency II needs to be considered in light of the rest of the negotiations for Brexit. While parts of the insurance sector may operate domestically, or already use country based subsidiaries for cross-border business, passporting is a significant concern for many insurers, notably for Lloyd's market and London market insurers. We also note that a number of large non-UK European insurers have significant UK operations, which bring jobs and other economic benefits to the UK.

3. Decisions on whether the UK remains within the single market, remains part of the system for EU passporting or aims for an equivalence regime are highly relevant to any decision on whether to continue to apply Solvency II in full in the UK. Another factor will be the degree of influence, if any, the UK is able to exert on any future changes to the regulation. Furthermore, there are many other sectors that will be affected by Brexit. Negotiations over what happens in one sector may be affected by those in other ones, so it may not be possible to consider whether to continue to apply Solvency II in the UK in isolation.

The long-term costs of Solvency II are not yet known

4. ICAEW consistently supported the development of Solvency II, although we expressed concerns over aspects of the regime. There are parts of the regulations which we would have preferred to be simpler or less onerous. However, we supported the principles upon which it was based. Notwithstanding any improvements we might suggest, we believe that it provides a sound basis for insurance regulation.

5. Implementing Solvency II was very costly to the insurance industry. Some of these costs related to changes to IT systems or in investment of staff time to change internal control systems or produce new information. Insurers are typically trying to reduce costs at present with capital scarce and there being pressure on prices. However, implementation costs that have been incurred cannot be recovered so are not relevant to any consideration of the future regulation of insurers. What are relevant are the ongoing costs of applying Solvency II and any implementation costs if the UK was to withdraw from Solvency II or introduce its own adaptations to it.

6. Solvency II was only introduced at the start of 2016. We have not yet completed a full year of applying it and have not yet gone through an annual reporting season. The application has not yet settled into mature processes. There are currently significant running costs to produce information for extensive reporting requirements; reviewing this also requires substantial board time. However, we would expect for some of these costs to settle down over time. It is still too early to judge the long term operating costs of Solvency II.

No guarantee that an alternative to Solvency II would be less costly

7. The costs of implementing and applying Solvency II have been increased by a number of factors. Greater use of internal models makes the system more risk focused. There are clear potential benefits to this by better matching capital requirements to risks but the added complexity makes the system more costly to apply. Undoubtedly the process of negotiation and agreement of the framework across Europe led to compromises and various areas where requirements were made more onerous than they might have been. Firms themselves might

also have over-implemented aspects of Solvency II, or implemented it inefficiently. As noted above, this is likely to settle down in time.

8. There is also the possibility that the Prudential Regulation Authority (PRA) has taken a stricter view on how some requirements should be interpreted and implemented than other EU regulators. Some UK insurers are concerned at a lack of supervisory convergence across Europe despite the fact that Solvency II is a maximum harmonisation regulation. In practice, there are areas of the regulation which are subject to supervisory interpretation. National supervisors can take different interpretations such as the approach to model approval. The PRA has arguably had more onerous model approval requirements and asked for greater detail than it was strictly required under Solvency II.

9. If the UK was to withdraw from applying Solvency II, there is no guarantee that the PRA would in fact reduce the regulatory burden for UK insurers. The PRA's primary objectives are to protect the safety and soundness of the firms it regulates and contribute to protecting insurance policyholder interests. Promoting competition is a secondary objective. The PRA does not have an objective, for example, to promote economic growth or to support the allocation of capital for long term infrastructure projects. This creates a natural bias for the PRA towards more robust regulation.

10. Before Solvency II, the UK's Individual Capital Assessments (ICA) regime for insurers was in many ways more complex to apply than the regulatory regimes in other parts of Europe. There are other parallel examples from banking of when the PRA and its predecessor the FSA went beyond EU requirements, sometimes as a result of legislation such as ring-fencing and the Senior Managers Regime and other times to develop pioneering new techniques which were later copied elsewhere, such as recovery and resolution planning. The PRA has made clear that, notwithstanding what happens with regards to Brexit, it is not intent on relaxing its approach.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Competitive implications of Solvency II

11. It is too early to see what effect Solvency II has had on competition. Solvency II is still bedding in. Insurers have yet to feel the full impact on capital of the move to Solvency II. The transitional provisions in practice will allow the increases in capital to be spread over several years, so there has not been an immediate large-scale increase in the capital held across the market under Solvency II.

12. There are some areas where Solvency II is more demanding than other international requirements, for example international capital standards. For example, Solvency II has introduced a risk margin, which increases the valuation of liabilities and therefore capital requirements. The effects of this are felt particularly strongly in the current low interest rate conditions. Like any discount rate for long-term assets and liabilities, the calibration of the risk margin will have a significant effect on valuations so has the potential to impact on competition if it is not consistently applied. Solvency II also has more rigorous disclosure requirements than are required in many non-Solvency II regimes. The measures noted were introduced to increase the safety and soundness of insurers by adding a prudent margin in the case of the former and increasing market discipline in the case of the latter.

13. The way that Solvency II is implemented can potentially impact upon competition. Solvency II has greatly increased the consistency of insurance regulation within Europe compared to the previous patchwork of different regimes in different member states. However, Solvency II includes a number of areas that are subject to supervisory interpretation. Differences in interpretation can have significant effects, for example on technical areas like the treatment of sovereign debt or the volatility adjustment, and on more operational matters like the process

for internal model approval and extent of documentation required. Some insurers consider that the matching adjustment requirements has been implemented inflexibly in the UK.

14. It will also be difficult to isolate Solvency II effects from other matters, including the approach of the Financial Conduct Authority (FCA) to regulation. UK insurers are generally cautious at present about product innovation. This is partly due to the experience of historic problems in financial services that have led to large fines and larger customer redress schemes. Insurers may also be concerned that current decisions may be viewed differently in the future by the regulator or courts. Historically, the FCA and FSA before it were not considered as price regulators but have now suggested that pricing and profitability of individual products can affect whether customers are being fairly treated. Generally, insurers and other regulated financial firms are thinking more carefully about product design.

Q2: Development of Solvency II

15. ICAEW supports Solvency II and does not advocate making fundamental changes to it. However, we recognise that there are areas where there could be improvements in how it is implemented and developed, as set out in this submission.

16. In an ideal world, Solvency II might be simpler, with more straightforward model approval processes for example. The process of negotiation and political compromise undoubtedly added complexities to the regulations. We support the use of internal models as this can allow insurers' capital requirements to more closely match the risks of their businesses. However, some of the complexities around model approval and oversight are a result of the complexity of the models themselves which insurers use. The size and frequency of reporting requirements might also be reduced. Solvency II has increased internal reporting and reporting to the regulators. We note that insurers have not yet published their first full Solvency II pillar 3 disclosures and will not do so until mid-2017. The market has not yet had the chance to consider which public disclosures will be the most important and relevant so it is difficult to say which should be removed.

17. On the other hand, an ideal world would also see consistent regulation of insurers across different jurisdictions, and for those regulations to be consistently applied and interpreted by regulators. This would reduce competitive barriers, avoid potential regulatory arbitrage, increase comparability and reduce the costs of having to comply with multiple sets of regulation.

18. In practical terms, the ability of the UK to implement changes to insurance regulation depends to an extent upon the outcome of Brexit negotiations. The decision on whether the UK remains in the single market; and if not the nature of its relationship between UK and EU markets will affect this. This may include the extent to which the UK can continue to influence the development of EU rules, for example by developing parallel regulations or being part of wider international regulatory accords.

19. Passporting is very important for a number of insurers, particularly for a large number of general insurers operating in the Lloyd's and London markets. Loss of passporting rights could cause these firms significant additional costs and potentially cause major business disruption. Depending on the nature of alternative arrangements, this could well affect London's leading position in global insurance markets, as well as affecting jobs. Many life insurers in particular currently operate under a subsidiarisation model across Europe. For those firms, passporting may be a less significant issue, with equivalence potentially an acceptable alternative, but maintaining equivalence is likely to constrain the extent to which the UK can adapt Solvency II. We also note that a number of European and non-UK insurance groups have substantial UK operations, which bring jobs and related economic benefits as well as greater choice to UK insurance customers. It is important to also consider the impact on non-UK insurers as well as UK ones.

20. In the life insurance industry, there is a trend towards focussing on selling more capital-light products and on investing in capital-efficient assets. The current, low-interest, economic environment squeezes potential margins on savings products which places further pressures on costs. This in turn can lead insurers to seek investments which yield higher returns. Insurance regulation aims to match and offset risks on assets and liabilities to mitigate the effects of this type of issue. However, the economic environment does put pressure on traditional products like annuities.

Q3: Implementation of Solvency II

21. While the costs of implementing Solvency II were significantly higher than they might have been, they are ‘sunk costs’. Having spent significant time and effort on implementing Solvency II there is a strong argument for avoiding the costs of implementing further significant change in the short term.

22. While we support retaining the Solvency II basis of regulation in the UK post-Brexit, there are ways in which its implementation might be softened in the UK without undermining the safety and soundness of insurers. For example, Solvency II has demanding reporting requirements. The volume and frequency of reporting could be reduced and the deadline for reporting to the PRA could be extended.

Q4: Safety and soundness

23. Since only a few months have passed since the introduction of Solvency II, it is hard to judge whether the safety or soundness of insurers has increased. Complexity has increased which arguably makes the regulatory oversight more difficult.

24. Overall, Solvency II is not expected to result in an immediate increase in the amount of capital held by UK insurers. This is in part because the PRA has approved a number of transitional measures, which include taking into account planned management actions, such as greater use of reinsurance, to reduce capital requirements.

25. The Solvency II regime is more risk-based than the previous system. As such it should improve safety and soundness. However, it is also much more complex, particularly where firms use internal models. This means that insurance senior managers and boards need more technical knowledge, for example of actuarial models. Solvency II has led to an increase in the amount of detailed information that insurance boards need to digest. However, it is clearly desirable for boards of complex businesses to properly understand the risks relating to that business. It may take some time to develop the tools to provide boards with sufficient information to understand key risks without providing so much that early warning signs become harder to detect.

Q5: Proportionality

26. In some respects Solvency II is proportionate by allowing alternative approaches to be adopted by firms of different sizes and degrees of complexity. Simpler firms can apply standardised models while those with better data are able to apply more sophisticated modelling techniques and with better developed control environments can apply to apply their internal models. The way that capital requirements are calibrated has the potential, however, to affect competition between complex and simpler firms.

27. The reporting and disclosure requirements may be an area that could be made more proportionate. The Solvency and Financial Condition Report, for example, requires extensive public disclosures. It is debatable whether there is likely to be much interest from the public in all of these disclosures, particularly from smaller insurers which may be privately owned.

28. The Senior Insurance Managers Regime that has been implemented in the UK introduces additional requirements to those imposed under Solvency II. For example, it requires insurers

to hold and maintain up to date responsibility maps. In many respects, however, it mandates measures which insurers should perhaps have been applying anyway.

Q6: Financial reporting

29. It will be desirable to review elements of Solvency II when the new international financial reporting standard for insurance contracts, IFRS 17, is finalised and implemented. Applying two different bases of measurement undoubtedly adds to the costs of running an insurer. This is partly a timing issue as Solvency II was implemented before the new financial reporting standard.

30. Prior to Solvency II, the European Embedded Values project tried to fill the gaps between inconsistent financial reporting across Europe on the one hand and inconsistent regulatory requirements on the other. Despite significant efforts from European insurers, it was not widely accepted by investors.

Q7: Wider implications of Solvency II

31. The PRA's statutory objectives put the safety and soundness of firms it regulates and the protection of insurance policy holders above competition, which is a secondary objective. Balancing these competing objectives is a matter of public policy. Regulating financial institutions including insurers involves the balancing of a number of public policy objectives which, on occasions, will compete against each other. The PRA statutory objectives were agreed after debate in Parliament. Solvency II is consistent with the PRA objectives in primarily being about promoting safety and soundness. If Parliament wanted the PRA or FCA to take a significantly different approach to how they develop, interpret and implement insurance regulation, then it may be necessary to reconsider their statutory objectives, potentially making competition a third primary objective.

32. We note that the PRA has stated that it does not intend to relax its approach to regulation following the vote for the UK to leave the EU. This means that, even if a decision was taken for the UK to develop its own approach to insurance regulation, there is no guarantee that it would be any less onerous than Solvency II, particularly given the PRA's current statutory objectives. The independence of the PRA on technical matters is an important feature of the UK regulatory system.