AFM Response to Treasury Select Committee inquiry into EU insurance regulation

1. I am writing in response to this inquiry, on behalf of the Association of Financial Mutuals.

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of £16.4 billion, and employ nearly 30,000 staff[1].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses[2].

4. In addition, the Bank of England and Financial Services Act 2016 now provides an additional Diversity clause for FiSMA, to require the PRA and FCA to take account of corporate diversity and the mutual business model in all aspects of their work[3].

5. AFM has always sought to offer constructive support to Solvency 2, both in highlighting the benefits of higher standards in the industry, and in amplifying regulatory messages. Regulators have fed back positively about the attitude and co-operative approach exhibited by members of AFM in taking their work forward.

6. The nature of the inquiry, and the questions asked lend themselves to a critical view of the value of Solvency 2. As small insurers, focused only on conducting business in the UK we are keen to see the UK government explore how the Brexit process provides an opportunity to adopt a different regulatory approach for firms for whom international equivalence is not relevant. We firmly believe this will be good for UK consumers and good for the UK economy, and for insurance offers

[1] ICMIF, http://www.icmif.org/global-mutual-market-share-2013
[2] Financial Services Act 2012, section 138 K :http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted
[3] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

the prospect of a more innovative market. But we would stress that we have retained a positive and constructive approach to Solvency 2, and can measure a number of benefits from its approach, even if the final cost-benefit case would be unlikely to be positive.

7. We provide responses to questions on the following pages. We look forward to discussing further the issues raised by our response.

Yours sincerely,

Chief Executive
Association of Financial Mutuals

Questions to the insurance industry and interested parties

1. Competitive implications of Solvency II

a) Lord Turnbull suggested in evidence to this Committee that Solvency II makes it more difficult to expand into non-European markets because a European-based and regulated insurance company is at a disadvantage, relative to a Canadian or an American insurance company. What are the competitive implications of Solvency II for UK insurance firms? Please answer within the context of the UK, European and global markets.

b) What impact is Solvency II having on the development of global regulation? Will we see the development of two-tier regulation as firms attempt to move to less rigorous regulatory frameworks either inside or outside their territories, or reinsure risks to other territories?

c) Could Solvency II create a potential competitive disadvantage for UK insurance firms in relation to firms from outside the insurance industry (including "disrupters" and companies who are not subject to any form of EU or EEA regulation) who may operate substantially in the same market?

d) What effect has Solvency II had on product innovation and the ability for new entrants to join the market?

AFM members have worked hard to achieve compliance with Solvency 2 and have generally received positive feedback from the regulators in relation to their commitment to delivering requirements on time and to a high standard. Where the primary objective of Solvency 2 is to secure effective protection for consumers, this is entirely consistent with the motives and values of organisations that do not have external shareholders.

Members of AFM are not active in overseas markets presently, either in Europe or further afield. Some in the past have developed a small customer base in Ireland; one member retains a customer base of around 600, and continues to sell into Ireland. Some larger mutuals also have or had operations in Dublin and Jersey, though these were back-office operations and focused on servicing the UK customer base.

As a result, we are addressing this question in relation to the UK market only.

Generally, mutuals tend to be well-capitalised: in 2008 for example, where the financial crisis meant that the regulators were assessing capital strength on a monthly, and sometimes daily basis, no mutual was at risk of falling below capital thresholds. Indeed, seven of the ten insurers with the highest free capital ratio were mutuals, and that remains a strength today.

Not only is the capital position strong, but unlike PLC insurers who have tended to hold much of their capital offshore in the past (making it redundant for the purposes of calculating minimum ratios under Solvency 2), mutuals have always held all their capital in the UK.

We would accept that for the wider market, Solvency 2 has stifled product innovation and consumer choice: in the period from 2008 to 2014 the UK insurance market contracted by 20% according to Swiss Re, as large PLC insurers withdrew from more capital intensive products or raised prices. By contrast, during the same period mutual insurers in the UK witnessed premium growth of 40% because they did not suffer the same capital restrictions and did not have to match the cost of capital requirements of PLC insurers.

As a result, the costs of the introduction of Solvency 2 for mutuals have been largely in compliance and not in securing extra capital. We do not suggest that these compliance costs have not been valuable: they have certainly raised standards of governance and internal control and helped improve overall risk management. However, for mutuals with strong capital buffers, the work required to implement Solvency 2 has led to: significant internal costs; highly inflated external actuarial and audit costs; massive commitments of management time; and very large opportunity costs, where mutuals have had to focus on additional compliance work rather than on growing the business.

The minimum capital requirements and technical requirements of the new regime have certainly affected the level of new market entrants in the UK. This was the case before Solvency 2, but has been exacerbated by the Directive. To illustrate, when The Military Mutual opened for business in 2015 it was the first new retail mutual insurer for 20 years, and the regulatory approval process took four years, even though the organisation was and remains non-Directive.

The cost-benefit case for Solvency 2 was never properly proven, and the Bank of England has always stated that, whilst Solvency 2 was first formulated in 2001 in a manner that was consistent with the regime in the UK, and that they are in favour of the overall approach, it would not have developed the regime with the complex technical requirements and complications that are now in place. Indeed, the increased conservatism of regulators following the banking crisis of 2008/ 09 resulted in over-elaboration of the insurance regime, both in the EU and in the UK. That conservatism, and the difficulties in navigating through the needs of so many countries involved in drawing up Solvency 2 standards, has also meant that at times, the UK regulators have been reluctant to show strong leadership in delivering Solvency 2

Solvency 2 has drawn a number of smaller mutuals into the full extent of regulation than was the case under the previous ICAS regime. This is because the thresholds for inclusion in the Directive are low by comparison, as Solvency 2 has impact across countries with a much less developed insurance market than the UK.

We have therefore seen a group of mutuals that were previously non-Directive who have had to spend significant amounts of money in reaching Solvency 2 compliance, including additional actuarial support, the creation of new roles, and additional regulatory scrutiny and reporting. We have also seen a significant amount of merger activity in the mutual (and wider insurance sector) where organisations have not been able or willing to increase the cost base for their policyholders. Inevitably this means consumer choice has been restricted.

2. Development of Solvency II

a) What are the principal developments or adjustments that you would like to see made to Solvency II in an ideal world? Where relevant, please include an indication of timescale, priority, rationale and "real world" constraints.

b) Given the potential increased flexibility that may be available following the UK's exit from the EU, should the UK seek alternatives to Solvency II for insurance regulation (such as a regime similar to the old ICAS regime, or a differentiated regulatory regime which varied according to an insurer's size or customer base)?

c) Lord Turnbull said in evidence to this Committee that "it will actually help insurance companies if we can leave the [Solvency II] arrangement" which "treats insurance companies as though they were banks" . Should the UK Government seek to withdraw from Solvency II?

d) Sam Woods said in evidence to the Committee that there were elements which he would like to change – he said that the calculation of the risk margin (projecting forward insurance and capital grants until they run off and then discounting them back at the risk-free rate, so that the risk margin increases as the risk-free rate drops) "is the most obvious one" and "I would like to have some more macroprudential flexibility in the regime". Should the UK seek to amend, or withdraw from, these, or any other elements of Solvency II?

e) Is Solvency II a price worth paying for the passporting of insurance services across the EEA?

We do not consider that the UK should remove Solvency 2 altogether and certainly do not advocate returning to the old ICAS regime. Insurers have spent too much money matching the requirements of the new regime to write off those costs.

We equally recognise that for multinational insurers, with retail operations in other parts of Europe, having regulatory equivalence is important. However, we do not consider that the whole industry needs to retain equivalence once the UK exits from the EU.

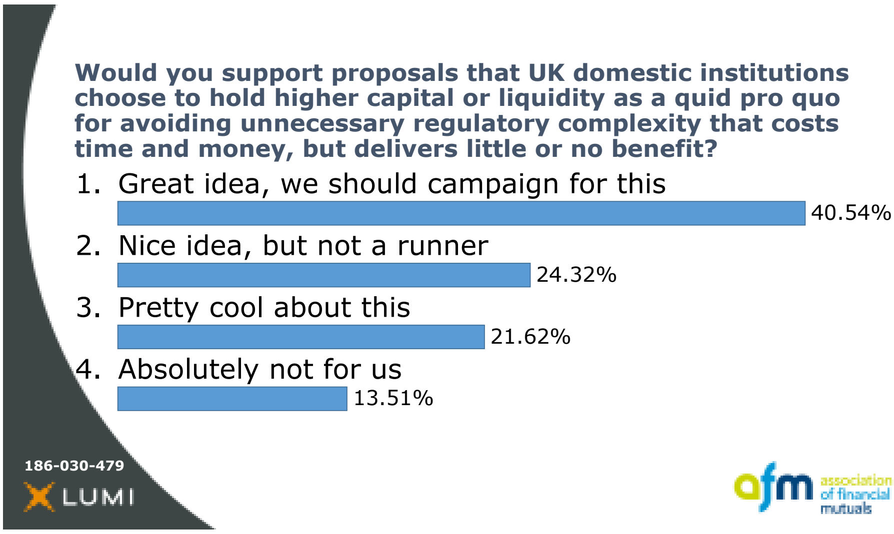
We advocate a two-tier regime in the UK, with those organisations that are focused on the UK market only subject to a separate regime to international insurers. If the government and regulators are only able to manage one regime we consider it should be based on the interests of the UK market rather than the European one:

- Once the UK leaves Europe, our ability to influence EU regulation will be minimal and this creates a significant risk for UK insurers that the Solvency 2 regime (and other Directives focused on insurance) diverge from the interests of an effective UK market;
- Solvency 2 has not facilitated cross-border insurance transactions to any great degree, other than within a small number of multinational insurers and Lloyds of London: organisations that need to operate in other parts of Europe might achieve equivalence by establishing or maintain branch operations;

- There is a real opportunity for the UK to adopt an approach to insurance regulation that offers leadership in standards, which is right-sized for the needs of the UK market, and which continues to attract insurers from other parts of the world.

We consider the regulation of the domestic market should evolve using the existing Solvency 2 as a starting point: there are areas of the Directive that are problematic for UK insurers already, and we agree with the items highlighted in paragraph d) above.

One way of achieving the above is to create more simplification for domestic insurers, by raising the thresholds for Solvency 2. Currently the thresholds are very low: £5 million premium income or £25 million in assets. Raising these to a level where (say) 25% of the market was outside Solvency 2 would create a differentiated regime. We would expect a dialogue with regulators over how those firms below the thresholds maintained adequate protection: one option would be to exchange higher capital thresholds for simplified regulation. We surveyed our members on this idea, and believe it is worth exploring further:



Whilst we agree with Lord Turnbull that the insurance regime 'treats insurance companies as though they were banks', we do not consider that this is entirely caused by Solvency 2: the extension of the Senior Managers and Certification Regime to insurance, or the gold-plating by PRA of the reporting requirements to require Solvency 2 public reports to be externally audited, are UK initiatives.

We also consider that the extent of a two-tier approach should not be limited to Solvency 2: there are a range of other Directives that have or will severely distort the UK market. The Association of British Insurers has identified around 80 pieces of legislation that need to be assessed as part of the exit from the EU[4].

We agree with this analysis, though we would also include the role of the second EU Life Directive of 1990, which originally enabled life assurers to operate across

[4] https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/2016/EU%20exit/EU%20legislation%20mapping.pdf

national borders in the EEC, as it was then, an harmonised insurance regulation[5]. This Directive also harmonised different aspects of UK insurance regulation, such as the previously separate regimes for insurers and friendly societies: Brexit gives the opportunity to diverge these again.

Some of the other aspects of European regulation that we consider should be reviewed as part of a domestic insurance regime are:

- UK GAAP: the Financial Reporting Council has continued to consider whether to remove the UK GAAP accounting rules, in favour of international standards. These result in information to members of UK mutuals that may be difficult to understand, and the sector has been reluctant to abandon UK GAAP.
- Packaged Retail and Insurance-based Investment Products: the Directive produces a range of new disclosure requirements, such as the Key Information Document, which provide less relevant information to consumers than the current Key Features Document and tailored illustrations. The European Parliament recently rejected the detailed PRIIPs proposals which is expected to be implemented in 2018.
- The General Data Protection Regulation is expected to bring sweeping changes to the approach firms take to managing customer data. It will create blocks to data transfer out of the EU, which will hamper UK firms, and from 2018 is expected to provide significant changes to the approach taken to profiling, which is at the heart of an effective insurance market.
- The EU Audit Regulation and Directive defines all UK insurers, regardless of size and complexity as public interest entities. This increases audit costs massively and reduces the range of firms that can support UK mutuals.
- Regulatory reporting is now dominated by EU requirements and this means a significant amount of information that is collected is not necessarily valuable to the UK regulators, but is simply passed on to EIOPA.
- There are differences in tax treatment in the EU: the UK government has resisted the imposition of changes to VAT for insurers (who outsource claims) as a result of the Aspiro case.
- EIOPA has a strong and healthy focus on consumer protection. In seeking to raise standards of protection across Europe it risks undermining the already high standards in place in the UK, including UK law on unfair terms in consumer contracts, the Retail Distribution Review, and Treating Customers Fairly.

3. Implementation of Solvency II

a) What lessons have we learned from the implementation of Solvency II in the UK?

b) With the benefit of hindsight, how well has the implementation of Solvency II met its stated objectives?

c) How did the implementation of Solvency II in the UK compare with other European member states, both in overall approach and specific guidance?

[5] 90/619/EEC; http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:31990L0619&from=EN)

d) Where relevant, please give an indication of the costs of implementation for your firm - both internal (e.g. staff costs) and external (e.g. consultancy costs). [If you would like us to keep this information confidential, producing only aggregated or anonymised data in our Report, please make that clear in the "additional information" box on the website. And if you are content for us to publish the rest of your submission, please send a redacted, publishable, version to treascom@parliament.uk]

e) Solvency II has a number of transitional provisions (for up to 16 years in some circumstances). Are these provisions effective, practical and flexible enough?

The primary lesson to be learned from Solvency 2 is the dangers of mission creep. In its early development Solvency 2 was envisaged as an evolution from the current ICAS regime (at least in the UK). However, the protracted delays in implementation have also resulted in excessive complexity and cost, and the purity of the proposals are affected by the unwarranted overlap of banking standards.

The development of standards across all EU nations has necessitated a compromise of intentions and an ill-fit of some of the requirements. Particular elements which have an adverse impact on UK focused insurers include: the matching process, ring fencing and asset reporting. Products like with-profits, which have a different meaning in the UK from other EU countries, and of which there are still up to 20 million policies in existence, have been difficult to fit in the regime.

Those problems are not isolated to the UK: small French mutuals felt so strongly about the challenges of introducing Solvency 2 that they launched a campaign to "Stop Solvency 2"[6].

We did not share that assessment, though in our view the Directive lacked subtlety in some places, and whilst it promised proportionality, there are few examples of this in practice.

In our view Solvency 2 has met its main objectives, in giving consumers confidence that they had adequate protection. That said, the actions taken in the UK after the failure of Equitable Life ensured there were no significant failings in the UK insurance industry in the worst recession for the financial services industry since the 1930s. In other words, those key protections were already largely in place in the UK.

In the UK therefore, large parts of the supervisory work required to implement Solvency 2 were focused on refinement of the regime, rather than wholesale introduction of new standards. We have though seen a tendency within the UK regulators to overlap additional requirements (such as the Senior Insurance Managers Regime and Approved Persons Regime, as well as the external audit of public reporting), and to forego simplifications (such as many of the transition options).

As a trade association we are not able to provide costs of implementation for Solvency 2, though we agree with the wide industry estimates of £ billions.

6 https://en.wikipedia.org/wiki/ROAM_(Réunion_des_Organismes_d%27Assurance_Mutuelle)

4. Safety and soundness

a) How effective has Solvency II been in increasing the safety and soundness of the UK insurance industry?

b) What are its principal strengths, both technically, and in its influence on Boards?

c) What are its principal limitations?

d) What are your views on the concept of internal and standard models and does the concept work well in practice? If not, what refinements could be made?

e) Is the new regime flexible enough to withstand another financial crisis?

f) Can you think of any circumstances where Solvency II would not operate effectively or could increase the risk to the UK insurance industry?

Solvency 2 suffered a series of delays and is still in the process of being implemented. For example, firms will for the first time be issuing public reports on their solvency position next Spring, and for smaller firms, including all AFM members, their first full regulatory reports under the Solvency 2 regime are due in May 2017.

It is therefore too early to properly assess the contribution of Solvency 2 to 'safety and soundness' of the UK insurance industry. As we covered previously, the actions taken by the UK regulators to bolster the insurance regulatory regime following the failure of Equitable Life were largely responsible for the absence of notable failures during the financial crisis in 2008. The Solvency 1 regime can therefore already be said to have helped ensure proper prudential management of insurers.

Equally, all AFM members voluntarily adopt the UK Corporate Governance Code, Annotated for Mutual Insurers[7]. This means small mutuals adopt the same standards as the largest UK listed companies, and this has led to significant changes in the governance arrangements of mutuals since 2007. Where Solvency 2 and the PRA have developed their own strengthening of corporate governance, it has been very much in the mould of the UK Corporate Governance Code.

It might therefore be argued that for the UK at least, the principal value of Solvency 2 has been in bringing together the various strands of insurance regulation already in place. In doing so it has provided greater structure and consistency, and further attention to risk management: the ORSA is probably the one single new component that Solvency 2 has contributed and which enshrines all risk management, resilience and corporate/ strategic controls in one place.

But it has also added significantly higher costs, and diverted management time from other aspects of developing the business. Inevitably those costs are passed on through the business, and for mutuals at least where there are no external

[7] http://www.financialmutuals.org/mutual-governance/our-governance-code

shareholders, those costs are borne by consumers. Hence the cost-benefit case, were it ever to be properly constructed, would not be likely to show a net gain.

Some smaller mutuals have therefore concluded that customers' interests are better served by sharing those costs over a larger base, so a key limitation of Solvency 2 is that it has restricted provider choice. This is exacerbated by the high barriers to entry that Solvency 2 imposes, which has reduced the creation of new insurers in the UK. And with the removal of some products from the market, and the greater consistency imposed on others, the UK insurance market is less innovative, and hence consumer choice has become more limited.

The UK was at the forefront of encouraging firms to consider Internal Models. At one time more than 50 firms were exploring them in the UK, which was much more than in any other country. Belatedly, PRA recognised that the standard model should meet the needs of the vast majority of insurers. It is not yet clear how Internal Models will develop, but it is safe to say that smaller mutuals are unlikely ever to need or welcome the extra cost and complexity inherent in developing Internal Models. This is even where, inevitably, the standard model, in applying core assumptions provides an imprecise fit for some firms and therefore higher costs or compromises in the operating model.

5. Proportionality

a) Do you consider that the ongoing regulation under Solvency II is cost effective and proportionate with regards to the areas below?

i. Pillars I and II
ii. Pillar III
iii. Solvency II's requirements to identify key function holders as implemented in the UK's new SIMR regime

b) Has the implementation of Solvency II allowed sufficiently for the different sizes and types of firms?

Both EIOPA and the PRA have been at great pains to stress that the implementation of Solvency 2 was designed to be proportionate to the nature, scale and complexity of firms. However practical evidence of proportionality was slow to emerge, and remains limited. The regulatory position has been largely to suggest that where an organisation is simple, then the amount of work is reduced and that therefore the rules are inherently proportionate.

However, in our assessment this is less efficient than making rules that provide a clear and obvious proportionality. One positive example of proportionality is where EIOPA has permitted national supervisors to restrict the requirement for quarterly reporting to the first 80% of the industry- so that small firms can be exempted. PRA has provided a waiver process for firms to take up this simplification, though it does not remove quarterly reporting in entirety.

Elsewhere, EIOPA has responded to lobbying from some countries in relation to the need for insurers to purchase credit rating agency licenses. It has explored whether there are alternatives to the current situation due to the costs of the licenses, and because the licenses duplicate those already held by the asset managers for the same function. EIOPA's expectation is that there is no immediately realisable alternative to paying for licenses, and PRA has not intervened, and merely indicated it is their expectation that insurers obtain licenses. AFM though has provided constructive solutions for its members with some of the main rating agencies to ensure that the data is provided in a cost effective way- though it was disappointing PRA did not itself take up the issue.

Indeed, in some cases PRA has rejected some of the flexibility and proportionality of the requirements, for example in relation to transitions, and in others added extra requirements to all UK insurers that gold-plate the original intentions. The primary example of the latter is in requiring that all Solvency 2 firms are required to undertake an external audit of their public disclosure. This is a very extensive exercise, as the technical nature of the exercise can only be undertaken by a small number of audit firms, and PRA's own estimate is that it will cost in the order of five times the cost of auditing the report and accounts. There is little proportionality in this exercise for small firms, and we have lobbied PRA extensively on the damaging effect this will have on small mutuals.

The generally limited proportionality is compounded by the fact that most small mutuals do not have an in-house actuary or accountant. This means that each incremental demand results in an additional external cost to the business, so that some measures, such as the audit requirement in the previous paragraph become *dis*proportionate.

With regards to the key function holders regime and SIMR, the PRA and FCA used the opportunity of PRA's new SIMR to adopt differentiated approaches. In so doing each has claimed that their new regime is more proportionate and less extensive, though the combined effect of having two authorisation regimes is broadly the same, due to the overlaps in the regime and the more extensive waiting time for authorisations.

In relation to time allocated, our members have tended to exploit 'last mover advantage' with Solvency 2: due to the regular delays in implementing the regime, and with rules constantly evolving until close to implementation, our members have largely resisted acting too quickly to implement some of the Directive requirements. This has saved cost overall and avoided doing work that is undermined by last minute changes, though it does mean that some parts of the regime were implemented to tight timescales.

6. Financial reporting

> *There are a number of international developments (e.g. IFRS and EEV) attempting to clarify and simplify financial reporting and valuation for insurance entities. How does Solvency II factor in to this debate?*

Accounting developments have largely followed a different, but tangential path to Solvency 2. This means there is some helpful correlation in approach, though the priorities of the regimes are different. This is because of the wider, international standards in the IFRS regime.

There is an inevitable risk that public financial reporting via the annual accounts and Solvency 2 public reporting diverge. This runs the risk that users of the two sets of data are unable to assimilate the information and reach the wrong conclusions. For small organisations we see the opportunity to align the data requirements for the report and accounts and Solvency 2, and having proposed this to PRA and are waiting to hear their response.

7. <u>Wider implications of Solvency II.</u>

What are the implications of Solvency II for:

i. UK policyholders;
ii. The wider UK business economy; and
iii. Regulators.

Consumers should gain assurance that insurance companies are being run properly and in their best interests. However, costs of compliance will be passed onto them, raising the prices of insurance or reducing the benefits.

The wider economy benefits from reduced risk of failure of large organisations. There is evidence to suggest that organisations with a focus on serving the best interests of their customers are better run and produce better outcomes for consumers and society as a whole. Our experiences as mutuals support this. This may help to offset the X-inefficiency of higher industry costs.

Regulators benefit from more extensive information from firms, higher standards and competence within firms, and greater use of external actuaries and auditors to undertake verification procedures historically undertaken by regulators. There is a higher onus on regulators to use the data they receive effectively.