Association of British Insurers One America Square, 17 Crosswall, London EC3N 2LB Tel: 020 7600 3333 Fax: 020 7696 8999

Treasury Select Committee Inquiry into Solvency II
Summary response from Association of British Insurers
11 November 2016

The UK insurance and long-term savings market and the ABI
The UK insurance and long-term savings industry is the fourth largest in the world. It plays an essential part in the UK's economic strength, managing investments of over £1.6 trillion (equivalent to 25% of the UK's total net worth) and paying nearly £12 billion in taxes to the Government. It employs around 305,000 individuals, of which around a third are employed directly by providers with the remainder in auxiliary services such as broking.
The ABI is the leading trade association for insurers and providers of long-term savings and the largest financial services trade association in the UK. Founded in 1985, we represent around 250 brands from London Market wholesale general insurance to long-term savings providers and a wide range of specialist providers.

Please find attached a more detailed response to each of the questions outlined in the inquiry's Terms of Reference. We would be happy, and stand ready, to provide further information if this would be helpful to the Committee and this inquiry.

1 Solvency II, the new EU-wide prudential regime for insurers, is now in place

1.1 Solvency II builds on the previous UK prudential regime for insurers, the Individual Capital Adequacy Standards (ICAS), designed by the PRA. Thus, whilst much of the detail of Solvency II was new, the UK industry already had vast experience and expertise in the risk management and modelling concepts at the centre of Solvency II.

1.2 The ABI has been supportive of the overall principles of Solvency II, and with our members we have worked constructively with the UK government and PRA at the EU-level throughout its development to ensure a regime that works for UK regulators, insurers, reinsurers, long-term savings providers and ultimately for their customers. ABI members spent over £3 billion in implementation costs to support this effort – equivalent to over £140 per insured household.

1.3 We also worked closely with the PRA in the run up to implementation at the start of this year. The PRA and those involved from industry are to be commended for the work undertaken to implement Solvency II, including the approval of internal models for 19 firms ahead of Solvency II coming into force. The PRA worked tirelessly and collaboratively with firms to provide clear feedback and took seriously the need to avoid any undue market volatility from this process.

1.4 However, there are a range of outstanding issues with Solvency II that need to be addressed. Some of these relate to the UK implementation; others would require change at the EU level. We outline our position on both below.

1.5 When the UK leaves the EU, there will still be the need for a prudential regime for insurance in the UK. Solvency II is the EU regime and therefore the UK's forthcoming exit raises questions regarding what regime will be most appropriate for the UK market. There are many reasons – including cost of change, lack of time and desire for EU equivalence – why the new UK regime is likely to be close in substance to the EU's Solvency II. Consideration should be given as to how close.

2 The overall principles of Solvency II are sound. After 10 years and over £3 billion, there is no appetite to withdraw from or completely replace Solvency II, and nor do we see strategic value in doing so

2.1 We do not support withdrawing from Solvency II now, whilst the UK is still a member of the EU, and there is legal risk for the UK in doing so. When the UK exits from the EU, doing so will mean it will have effectively withdrawn from Solvency II. This will leave numerous cross-references and gaps in UK legislation and regulation that will need to be addressed. To prevent there being legal and regulatory limbo, the UK should initially adopt the EU-level text directly into UK legislation and regulation and we therefore support the Prime Minister's proposal for a Great Repeal Bill. Similarly, the PRA should follow a process of adopting EU level 2 and level 3 text into the PRA Rulebook and PRA guidance to ensure there are no legal gaps. This would provide short-term certainty for business and allow for the UK to then make future unilateral technical changes to our prudential regulation regime over time, to make it more appropriate for UK firms and their customers.

2.2 Whilst we have concerns regarding the UK implementation of Solvency II, the overall principles of the regime are sound and are similar to the previous UK regime – as a result we view Solvency II as broadly fit for purpose for the UK market. It has built on the previous UK regime and introduced marginal improvements to policyholder protection, more robust risk management and increased Board-level engagement. It allows firms to use PRA-approved internal models to calculate capital requirements, giving larger and more complex firms a more accurate and holistic understanding of their risks which improves risk management. Smaller firms instead use a prescribed standard formula – a proportionate approach and improvement on the ICAS regime which required all firms to use their own model.

2.3 After over 10 years and over £3 billion invested implementing Solvency II – now a sunk cost – there is currently no appetite from the UK industry to spend further significant sums un-implementing it. Change should be avoided for its own sake, hence we do not support a fundamental replacement of Solvency II. Further, there is no current consensus on what would replace it. This would take time to be developed, and both PRA and industry would then require time and incur further substantial cost to implement any replacement regime.

2.4 Unlike the Basel framework in banking, there is no global framework for insurance regulation to adopt instead. There is one under development, the Insurance Capital Standard (ICS), but there is a lack of political support globally and the current proposals are not fit for purpose for the UK market. The proposed ICS lacks key features essential to the UK sector, such as the use of internal models (to ensure a deep understanding of the risks firms are exposed to and their interactions); the Matching Adjustment (which reflects the long-term nature of UK products such as annuities); and recognition of diversification of risk. Without these features, the increase in capital required, above the high level already required for Solvency II, will result in a less affordable and reduced product offering for customers.

2.5 Instead of replacing Solvency II or adopting a different international regime, Brexit is therefore an opportunity to make refinements to the current regime that ensure it is more appropriate for UK insurers and customers. An additional consequence of this would be to safeguard equivalence for the UK with the EU27's Solvency II regime following Brexit.

3 There was a natural desire from the PRA to err on the side of caution during the UK implementation – this should now be reassessed to make it more effective for UK insurers to serve the economy

3.1 The task of implementing such major reform to the prudential regulatory regime in the wake of a financial crisis – and harmonising it across the EU – was a significant undertaking for regulators. It is understandable that in these circumstances, and given the time pressures, there was a natural desire from the PRA to err on the side of caution.

3.2 The regime has now been implemented, the PRA is more familiar with it and the UK industry is facing the added pressures and uncertainties associated with UK exit from the EU. Given the greater

understanding of Solvency II by all parties, and the changed circumstances, we suggest it would now be timely to reassess the UK implementation of Solvency II, to ensure it is sufficiently proportionate and flexible enough to be appropriate for the UK market.

3.3 The ABI supports the objectives of the PRA in maintaining financial stability and protecting consumers in the British market. We recognise the importance of robust supervision and are not calling for a watering down of the PRA's objectives – but we do wish to avoid the 'stability of the graveyard'. The disruption caused by Brexit puts these objectives at a premium.

3.4 The PRA's implementation of Solvency II goes beyond the requirements of Solvency II in a number of important areas, and we would argue goes beyond what is necessary for financial stability. Thus, there is much that should and can already be changed domestically – still within the framework of Solvency II, and without the need to make changes to the EU-level text – to secure the UK's status as a leading place to do insurance business. This could be done now, is not contingent on leaving the EU, or the timing of this, and would not affect the UK's ability to seek equivalence.

3.5 To give a few detailed examples, the high levels of regulatory capital required as a consequence of the UK implementation of Solvency II have in places distorted market behaviour (for example, by driving longevity risk outside the UK) and damaged consumers' interests (for example, by reducing choice in the annuity market). This is partly – but not entirely – driven by the flawed design of the Risk Margin, which the PRA also recognises as an issue; we are working with the PRA to find a solution that can help mitigate this in the short-term but still within the Solvency II framework. Further, the cost and complexity of the PRA's interpretation of Solvency II consumes excessive management time and resources, causing significant inefficiencies. And different interpretations of the rules by the PRA (for example on treatment of a dynamic volatility adjustment, treatment of sovereign risk, the requirement for non-life firms to also model their business on an ultimate basis, and treatment of reinsurance structures) has put UK firms at a competitive disadvantage. Similarly, other national supervisors have made different interpretations of their own meaning the playing field is not completely level.

3.6 We believe there would be merit in a reassessment of the overall impact of the PRA's interpretation of the EU Solvency II requirements, to ensure these are not unnecessarily disadvantaging UK firms from competing in both the EU and global context. Such a reassessment would not require any changes to be made to the EU-level text which, at least until after Brexit, will continue to apply in the UK.

4 Equally, some refinements are needed to Solvency II at the EU level to make it more appropriate for UK insurers and customers; government should address this at the EU level, or when we leave the EU

4.1 Whilst broadly fit for purpose for UK insurers, this does not mean Solvency II is perfect. In addition to the need to reassess the PRA implementation of Solvency II, which can be started now, there are structural elements that require change at the EU-level to make it more appropriate for the UK insurance market and our customers. Such changes should be reflected in the future UK prudential regime, post-Brexit. We are also engaging in the current European Commission led review of Solvency II and will be advocating for such changes.

4.2 **Risk Margin:** Our top concern is the Risk Margin *(an additional liability insurers must hold Solvency II, which is meant to reflect the cost of transferring the business to another insurer)*: Its size and sensitivity to interest rate movements are both significantly higher than expected and reflect unintended consequences of its design. This makes the writing of new business, in particular annuities and other long-term guarantee-based products, unattractive to firms. This concern is shared by the PRA – as Sam Woods said in evidence to the Committee previously. We note the aggregate pension scheme deficit of UK corporates is estimated as £710bn by the accountants PwC. Insurers can and should play an

important role in addressing the challenge this creates for government, companies and their employees. To do this requires a well-functioning and competitive market for longevity insurance – but this is being hindered by the Risk Margin.

4.3 **Macro-economic flexibility**: Solvency II is primarily a micro-prudential regime and therefore has a lack of macro-economic flexibility. There is very little flexibility for regulatory forbearance from the PRA in times of stress and volatility. Such flexibility would help to avoid the unnecessary resolution of an insurer during a period of short-term stress (and the associated disruption to customers). However we do not believe the case has yet been made for broader macro-economic powers, such as counter-cyclical buffers, to extend to the PRA. Solvency II already requires exceptionally high levels of capital to be held as a buffer to ensure firms remains able to meet obligations to customers in all but the most extreme scenarios.

4.4 **Barriers to long-term investments**: Insurers are atypical in holding long-term liabilities which makes them well placed to invest in matching long-term assets. Solvency II should thus be reviewed to better enable insurers' role as long-term investors, ensuring there are not regulatory barriers to the industry's ability to invest in socially useful infrastructure projects. The capital charges associated with these assets should be lowered to be commensurate with their risk; and there must be enough flexibility in the Matching Adjustment *(a mechanism designed to recognise the match between asset and liability cashflows)* to allow it to be used with these assets. There is also the need to address the issue that Solvency II can, in stressed market conditions, incentivise pro-cyclical investment behaviour – even though firms invest long-term.

4.5 **Governance and compliance costs**: There is a need for a significant reduction in governance and compliance costs; excessive complexity and excessive EU-level guidelines, which have resulted in a lack of responsiveness from the PRA. This has made the UK a less attractive place for firms to write insurance business.

4.6 **Reporting requirements**: Solvency II has introduced a step-change to the reporting requirements of firms to regulators, and the PRA requires UK firms to do additional UK-specific reporting over and above the EU-level requirements. The implementation and ongoing costs are excessive and it is unclear there is a commensurate value to the PRA and our customers. This should also be reviewed at the first opportunity.

5 The future UK regulatory regime should have consideration for the competitiveness of the UK, in an EU and global context, and the UK parliament and government should have a degree of control

5.1 It is imperative that changes made to Solvency II and any replacement UK prudential regulatory regime should be supportive of UK competiveness, to ensure the UK retains insurance business and enhances it global position in the insurance sector following Brexit.

5.2 In the short-term, pre-Brexit, the PRA should have a new and explicit remit for UK competitiveness as part of its objectives, in both European and global context, when interpreting and applying Solvency. Longer-term, post-Brexit, this needs to be implemented into the future UK prudential regulatory regime and in primary legislation. It is important that this is balanced with the objective of financial stability and policyholder protection.

5.3 The UK is the largest insurance market in Europe, and it is right that the UK government and parliament have a degree of control over the prudential regulatory regime – although in order to maximise trade it will be in the interest of both the UK and EU to have a broadly common supervisory and capital regulatory framework. Following the UK's exit from the EU and withdrawal from Solvency II, it is

important to ensure there is appropriate political oversight and accountability of the PRA whilst still respecting its status as an independent regulator. Ensuring a regulatory framework that is appropriate for the UK is compatible with our desire to maintain the benefits of passporting, as there is no desire to have fundamentally different regimes in the UK and EU27.

5.4 Solvency II currently acts as a partial constraint on the PRA (for example, by requiring it to justify the use and magnitude of capital add-ons on firms, and to set out a clear course of action that firms can take to remove them). Following Brexit, there should be similar constraints built in to primary legislation.

5.5 The UK insurance sector played a constructive role in the development of Solvency II, through consultation and quantitative studies. It is important that there is a similar open and consultative approach to the development of the UK prudential regulatory regime, involving industry, regulator, parliament and government.

5.6 Finally, following Brexit, a long-term mechanism should be established for regulatory dialogue and cooperation between the PRA and the EU's regulatory authorities. This recognises the interconnected nature of insurance and reinsurance supervision, driven by the global transfer of risk and capital. Similar arrangements already exist between the PRA and other non-EEA jurisdictions, including the US. One of the key cross-border activities is the provision of reinsurance between the UK and EEA countries. The ongoing ability to provide reinsurance will be important, without the imposition of additional constraints, to both UK and EEA insurers.