

Balance of Competences Review – Single Market:  
Financial Services and the Free Movement of Capital  
HM Treasury  
1 Horse Guards Road  
Westminster London  
SW1A 2HQ

16 January 2014

Dear Sirs

**Re Balance of Competences Review – Single Market: Financial Services and the Free Movement of Capital**

ILAG is a trade body representing members from the Life Assurance and Wealth Management Industries.

ILAG members share and develop their practical experiences and expertise, applying this practitioner knowledge to the development of their businesses, both individually and collectively, for the benefit of members and their customers.

A list of ILAG members is at the end of this submission

**Summary**

ILAG welcomes the opportunity to comment on this review.

As an organisation, ILAG is completely neutral on the issue of the UK's membership of the EU and whether regulation is defined at the EU or National level.

We would like to respond to the consultation to share some experiences of the EU legislative process, and make some observations about how the process could be improved

Our concerns centre on the lack of consideration of

- impact assessment
- cost benefit justification
- consumer benefit analysis
- proportionality considerations

These have a significant impact on our members, particularly smaller firms, operating in niche markets which do not exist in all EU territories. EU wide regulation can, therefore, reduce the availability of solutions to consumers unless the impact of the proposals is fully considered.

This is particularly relevant to those who would be classed as vulnerable, or unsophisticated, investors. Such customers often want locally based, simple solutions at low weekly or monthly cost. Increasingly, the level of change and depth of legislation (both from EU

legislators and UK regulators) is impacting the ability of smaller providers to fill this niche requirement.

In our detailed response below we have answered the review questions where applicable to our members, but also sought to provide specific case studies which focus on:

- the implementation of changes to the Gender Directive,
- conduct regulation

ILAG would be happy to discuss this matter in further detail if required.

Yours faithfully,

**Dr Matthew Connell**  
**Chair**  
**ILAG Board - EU Sub Group**

## Response to specific Consultation questions

1. How have EU rules on financial services affected you or your organisation? Are they proportionate in their focus and application? Do they respect the principle of subsidiarity? Do they go too far or not far enough?

Our members will decide individually on whether to comment separately on the firm specific issues. Overall any change has a significant impact on our members and, if a one size fit all approach is used, it can be disproportionate in its impact from small to large firms. Little account is taken of the benefits small firms provide, particularly to vulnerable customers, or the risk a firm represents to the financial system when framing EU/UK regulation and legislation.

2. How might the UK benefit from more or less EU action? Should more legislation be made at the national or EU level? Should there be more non-legislative action, for example, competition enquiries?

ILAG understands the aims of the single market and this has advantages for members who work across the EU directly, or via subsidiaries. ILAG has no view on whether legislation should be made at the EU or National level. The key is that the needs and benefits to all firms and consumers should be considered irrespective of where the legislation is designed.

3. How have EU rules helped or made it harder to achieve objectives such as financial stability, growth, competitiveness and consumer protection?

The issues here are similar, whether legislation is made at EU or National level.

4. Is the volume and detail of EU rule-making in financial services pitched at the right level? Has the use of Regulations or Directives and maximum or minimum harmonisation presented obstacles to national objectives in any cases?

We have no comments on this section.

5. How has the EU's approach to Third Country access affected the ability of UK firms and markets to trade internationally?

We have no comment on this section.

6. Do you think that more or less EU-level regulation in the area of retail financial services would bring benefits to consumers?

We do not consider that it is a question of more or less regulation, but a question of proper consultation and open debate to ensure regulation is hitting the right areas in the right ways and addressing real issues, rather than UK or EU political perceptions.

7. What has been the impact of the shift towards regulation and supervision at the EU level, for instance with the creation of the European Supervisory Authorities? Should the balance of supervisory powers and responsibilities be different?

We have no comment on this section.

**8. Does the UK have an appropriate level of influence on EU legislation in financial services? How different would rules be if the UK was solely responsible for them?**

As a medium sized trade body with limited resources we find it very difficult to get our voice heard. This can apply equally in the UK. The various EU bodies operate opaquely and through a limited number of organisations.

For example, we cannot get access on a timely basis to proposed changes in draft legislation, and key parts of the process eg Trilogue meetings are held privately and debate papers are not published officially (although we find at times materials not in the public domain can be obtained at a cost from political lobby groups).

When speaking to organisations such as Insurance Europe, EU bodies often mistakenly feel they are speaking to the whole industry. Whilst these organisations do represent large numbers of firms and offer invaluable views on the strategic impacts of change, consideration of the day to day practicalities of change can also be vitally important in framing new legislative proposals. The current consultation process does not allow sufficient time for these views to be properly expressed and considered.

What is often missed through this approach is the Practitioner and Consumer view, both of which can add real value and, in our experience, avoid much wasted debate.

**9. How effective and accountable is the EU policy-making process on financial services legislation, for example how effective are EU consultations and impact assessments? Are you satisfied that democratic due process is properly respected?**

See case studies below.

**10. What has been the effect of restrictions placed on Member States' ability to influence capital flows into and out of their economy, for example to achieve national public policy or tax objectives?**

We have no comment on this section.

**11. What may be the impact of future challenges and opportunities for the UK, for example related to non-membership of the euro area or development of the banking union?**

We have no comment on this section.

**12. Do you have any further comments about issues in addition to those mentioned above?**

See case studies below.

## **Case study 1 – Gender Directive and possible changes to Discrimination Directive**

### **1. Gender Directive**

Article 5 of the Gender Directive (Dir. 2004/113/EC), provided that the use of sex as a factor in calculating premiums and other benefits in respect of insurance should not result in differences in premiums or benefits to an individual. However, Article 5(2) contained an exemption to this prohibition which permitted proportional differences in such premiums or benefits where the sex of an individual is a determining factor in the assessment of risk (based on relevant and accurate actuarial and statistical data) for the purposes of determining the level of premium.

Insurance companies in a number of member states relied on this exemption to continue to use gender as a factor in calculating premiums.

The Belgian consumer group Association Belge des Consommateurs Test-Achats challenged Article 5(2) on the basis that it conflicts with the overarching principle of equal treatment of men and women under EU law, and brought the case before the ECJ. The subject matter of the case was a Belgian law enacting, amongst other things, the provisions of Article 5(2) in Belgium.

In September 2010, Advocate-General Juliane Kokott produced an opinion in support of the consumer group's case, advising the ECJ that she unequivocally believed Article 5(2) should be declared invalid as being an infringement of the general prohibition on discrimination on the grounds of gender.

This was upheld in the ECJ on 1.3.2011, albeit with a lead in time for changes to be properly considered and made.

It has long been a concern that other Directives may be challenged in the same way: the Discrimination Directive being the obvious target (see 2 below)

The Test Achats case was successful, in part due to the loose language and clauses of the original Gender Directive.

The ramifications of the ECJ case were enormous and not all outcomes were to the benefit of the consumers the case sought to protect. The cost of change, caused in part by a short lead-in period, potentially outweighed the benefit for consumers as these costs would be eventually recovered from policyholders.

Insufficient notice, or appeals, were made to the industry to get involved in the ECJ case early enough to demonstrate why Article 5(2) should remain unchanged. Had a properly co-ordinated impact and cost benefit analysis been presented the outcome may have been different.

## 2. Discrimination Directive

The insurance industry has been attempting to ensure the wording of any new Discrimination Directive provides legal certainty and no ambiguity which would allow a similar legal challenge to Test Achats post implementation.

It seeks to ensure the principle enshrined in SEC (2008) 2180/1 (ie that the use of age or disability by insurers and banks to assess the risk profile of customers does not necessarily represent discrimination: it depends on the product) is reflected in the Directive's final text.

Specifically, with the support of the forthcoming Polish and Danish presidencies, the industry sought to:

- ensure age and disability are addressed in one single paragraph in both the provisions of Article 2.7 and Recital 15. This ensured it was clear that when assessing risks, insurance companies rely on the combination of several risk factors and do not assess each factor separately. The proposed words thus reflected reality and address both risk factors in one single paragraph.
- enhance legal certainty by excluding phrases which have no legal definition at EU level eg underlying health condition.
- remove the publication of factors used by insurers on account of commercial sensitivity and intellectual property issues.
- remove the limit of resources which could be used (the current draft sought to rely on quantitative proven data whereas the industry proposed that other factors ie expert medical knowledge in the assessment of disability risks can be used even where actuarial principles and statistical data are available).

A hearing held on 20 March 2012 by the European Parliament's Committee on Civil Liberties, Justice and Home Affairs has reiterated support for a proposal to extend the legal protection offered against discrimination based on religion or belief, disability, age or sexual orientation to fields other than employment.

On this occasion, time has allowed for the industry to brief Government Departments leading the UK position on the Directive of the impact of such a decision and the importance of clear, unambiguous, words (see below).

Nevertheless, significant uncertainty still exists as to when this Directive will be considered/implemented. We understand two EU states have specific internal legal barriers enshrined in their country's constitutions which are a barrier to implementation. The industry remains concerned that, despite continual monitoring of current position and progress, there is a risk that political pressures could escalate this Directive up the priority list resulting in a hurried and uncoordinated approach, such as that which resulted in the outcomes on Gender.

### 3. Impact assessment

***Current processes do not allow for full impact assessments to be undertaken at an EU level. For example these are the points which we would expect to be considered should age and disability be removed as risk factors for the UK Life and Longevity insurance industry. Currently there is no forum to make these points directly to EU legislators.***

Loss of either age or disability as an assessment factor would be catastrophic for the UK life and longevity insurance industry and, more importantly, would severely restrict the affordability and availability of cover for consumers

The anticipated impact would be much more severe than the substantial additional risks and costs borne by the industry and consumers from the impending Gender Directive changes.

This is because the degree of rating differential for risks covered between policyholders of different ages and levels of physical impairment (based on physiological differences and backed up by clear evidence) is much more material than that currently applied between genders.

Should these rating factors be disallowed then the UK private voluntary insurance model could not operate as it currently stands. Significant cross subsidies would be introduced through a single rate across all ages and disability making it almost impossible for insurers to protect against anti-selection:

- High risks affect proportionately more cover
- Premiums expensive for lower risks
- Lower risks exit
- Community rated premium increases
- This is known as the 'death spiral' effect as only the higher risks take out the insurance, and the result is an unsustainable model.

#### 3.1 Age related issues

- a) For example, a 60 year old male is 9 times more likely to die in a year than a 30 year old male and this is reflected in current market prices for both protection and annuity products.
- b) For annuities the income payment for a 75 year old (based on £100,000 lump sum) would be typically nearly double that of a 55 year old.
- c) For a 25 year term life insurance policy the premium for a 50 year old would be 4.5 times that due from a 30 year old.
- d) Should age not be a permitted rating factor the death spiral effect would force insurers towards offering terms for annuities on the youngest retirement age.



- e) The age neutral annuity rate would drift towards a 55 year old rate and this would result in the region of a 20% reduction in income for 65 year olds and 40% reduction in income for 75 year olds.
- f) This should be of particular concern in the UK due to the reliance on compulsory annuity purchase in pension legislation.

### 3.2 Disability related issues

- a) There is a wide spectrum of additional risk associated with health factors and assessment of these could be compromised should the definition of disablement creep towards including all health conditions.
- b) Not everybody who applies for protection can be offered terms. Subject to the requirements of the Disability Discrimination Act, cover for approximately 10% of applicants will be postponed or declined because their risk cannot currently be accurately quantified or is so high (eg for the terminally ill) that insurers are unable to provide fair and reasonable terms.
- c) The industry would be open to providing terms for a wider range of more heavily impaired risks on appropriate terms. However, previous attempts have suffered heavily from low consumer take up.
- d) Where insurers are able to offer protection terms after underwriting they will typically provide life cover on graded 'rated' terms to consumers in poor health or with impairments capped at 5 times standard mortality to reflect the increased likelihood of death compared to the equivalent 'standard' healthy/non-impaired lives. Those not offered terms on average would have even higher risk (eg for terminally ill lives, the factor could be as much as 500 times).
- e) Conversely, lives with impaired health or poor lifestyles currently benefit from proportionate enhancements to annuity terms (including those with very heavy impairments).
- f) Removing the ability to underwrite health impairments would result in insurers adjusting protection premium rates upwards to take account of the additional risks, which would fall into the standard pool (including those rated or postponed). This would result in a significant death spiral effect.
- g) Insurers could be compelled to offer protection terms to consumers who are effectively immediate claims. The impact would be to increase all premiums to a point where the insurance model is unsustainable.
- h) Removing the ability to underwrite health impairments could prevent annuity providers from offering fair value to those in poor health and this could have a disproportionate impact on those with low savings, especially where annuitisation has a compulsory element.
- i) In isolation, removal of either age or disability rating would have a significant adverse impact on both the protection and annuity markets. In combination, the impact would be



compounded due to the correlation between increasing age and increased incidence and prevalence of disability.

- j) Unlike general insurance most life and longevity insurance contracts are long term (not cancellable at the option of the insurer but consumers may lapse cover) with the average term of future liabilities typically extending for 5-10 years and a significant proportion being over 30 years. Much of this business is written on guaranteed premium rates – these may be level or increase with age.

The wide range of issues around age and disability increase the potential for poorly designed legislation and transition processes to damage consumer interests. It underlines the importance of clarity and proper consultation at all stages of the process. This is something that is not properly developed under current arrangements.

## Case study 2 – Conduct of Business Regulation

The last twenty years has seen a steady increase in the scope and depth of EU regulation for both prudential and conduct of business regulation for financial services companies.

For insurance companies, the most recent example of prudential regulation has been Solvency II. This has been a complex, and often controversial, piece of regulation, but its progress through the EU legislative process has been helped by an extensive and ongoing process of impact analysis. This took the form of five impact studies, published between 2006 and 2011. These reports acted as a focus for the debate around the legislation, and gave insurance companies an opportunity to show the effect that different proposals would have on the market.

Over the same period, the European institutions have developed a range of proposals to update conduct of business regulation at EU level, including revisions of the Markets in Financial Instruments Directive, the Insurance Mediation Directive and regulations governing the sale of Packaged Retail Investment Products.

It is vital to understand the impact of these measures. This is because conduct of business requirements prescribe and influence written and spoken communications between financial services companies and customers. If the measures produce ineffective communications, consumers will suffer.

For example, a requirement to publish past performance of investment returns may give consumers the impression that a high risk/high return fund always provides high returns.

However, the EU institutions have not implemented the same rigorous approach to cost benefit analysis to Conduct of Business regulation in financial services that they have applied to prudential regulation. For example, the cost benefit analysis for the Insurance Mediation Directive concluded that, 'The current total costs to companies and authorities is estimated to be, in view of the large number of undertakings affected (about 1 million), a relatively moderate cost averaging about €730 per undertaking.'<sup>1</sup>

ILAG members have identified requirements in the IMD proposals, including a potential ban on bundling insurance products together, which would impose costs on UK insurers that have not been considered in the initial cost benefit analysis.

There is no formal, ongoing cost-benefit process into which firms can contribute these insights. It is possible to make representations to the EU institutions and to HM Treasury, but the ad-hoc nature of these representations makes it difficult for smaller companies to make their voices heard at the appropriate time.

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<sup>1</sup> - European Commission, *Revision of the Insurance Mediation Directive - Frequently Asked Questions*, [http://europa.eu/rapid/press-release MEMO-12-516\\_en.htm?locale=en](http://europa.eu/rapid/press-release_MEMO-12-516_en.htm?locale=en)

In addition, some decisions about the scope of different proposals can have a very significant effect on smaller financial services providers. One example is a small insurance company selling insurance-based investment contracts with guaranteed returns on a non-advised basis by post. Some proposals in the current range of EU legislation could provide significant barriers to this form of business. For example, by banning execution-only sales of insurance-based investment products, or by imposing highly onerous demands on providers relating to the amount of product information that has to be provided pre-sale.

Moreover, if the scope of these proposals does not include products with guaranteed returns, the impact of the new measures will be zero. Very often, decisions about the scope of proposals will be fine-tuned right up to the point that a piece of legislation is adopted, and so a firm will be left in a state of uncertainty over the impact of proposed reforms until the end of the process. This leaves firms no real opportunity to speak out if its business model will be compromised by that decision.

ILAG is neutral on the extent to which conduct of business rules for financial services should be developed at EU or national level. However, it is reasonable to expect that any rule-making powers in this area should also be accompanied by a duty to conduct thorough, ongoing studies into the impact of new rules on both customers and financial services companies.

ENDS

## ILAG Membership

### ILAG Membership

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