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Dear Charles

Balance of Competences review: Single Market - Financial Services and the Free Movement of Capital

Thank you for the opportunity to contribute to this consultation. I can confirm that we have contributed to a number of responses submitted independently, most notably the response from the Association of British Insurers (ABI) and an Insurance Industry Roundtable hosted by Aviva. We have reviewed these responses and are supportive of the points they have made.

As the ABI and Roundtable submissions have highlighted, one of the key issues is ensuring coherent legislation that works in the interests of the UK as well as other Member States. It is less important whether it originates from the UK or the EU, so long as it is effective and proportionate. Equally, it is imperative that when the UK Government secures a good outcome at the EU-level, gold plating and over-implementation by UK authorities is avoided. Otherwise it negates the outcome secured by the Government. I've attached a short case study on Solvency II to illustrate both of these points.

Yours sincerely

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Director of Corporate Affairs
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Solvency II Case Study – Balance of Competencies Review

Summary

Solvency II was a decade-long process, involving huge costs for the UK insurance industry and its customers. However, it is debatable if the final package of measures will result in an improvement in the effectiveness of UK prudential regulation beyond what the UK authorities would have delivered, and is unlikely to achieve the original aim of maximum harmonisation. Resources were diverted and investment decisions postponed during the lengthy period of uncertainty, and the competitiveness and ability to serve customers of the European insurance industry at times were called into question. Much of the detail remains unresolved, even 18 months ahead of implementation.

The Industry is a leading contributor to the UK economy with the insurance sector employing approximately 320,000 people, managing £1.8 trillion of investments (about 25% of the UK's total net worth), with insurance and pensions funds contributing about 1.6% to GDP. Yet the insurance industry is now faced with multiple regulatory players, a lack of clarity about implementation and a risk of either UK gold-plating or regulatory over-implementation.

Background to the Solvency II Legislation: Solvency II is a fundamental review of the capital adequacy regime for the European insurance industry. It aims to establish a revised set of EU-wide capital requirements and risk management standards that will replace the current solvency requirements.

The Commission originally presented its Solvency II proposals to Council and Parliament in 2007, as a maximum harmonisation measure to be taken forward under the Lamfalussy Process: the Commission's 2007 press release was headed "*EU to take global lead in insurance regulation*".

The Level 1 Directive was passed in 2009, with a planned implementation date of 2013. The Directive is now scheduled to come into effect from 2016, three years later than intended, and at the time of writing many Level 2 and 3 details remain outstanding. The transitional arrangements also mean that Solvency II won't be fully effective until 16 years after the implementation date.

The legislation has been heavily modified during a series of negotiations and trialogues. This was partly for essentially procedural reasons – a second Omnibus II Directive was required to ensure compliance with the Lisbon Treaty – and partly because the intervening financial crisis demonstrated that the original proposals were in many respects unworkable. Two particular issues related to the treatment of capital for long-dated guaranteed business, and the treatment of third-country equivalence. Whilst we welcomed the review, which was essential, it is the overall process that created the challenges and uncertainty.

Long term guarantees and third-country equivalence: The issue of treatment for long term guarantees rightly necessitated the development of different methodologies (the matching adjustment, the volatility balancer, and yield curve extrapolation) depending on the nature of insurance products in different Member States. As a result, the final legislative approach is in fact far from "maximum harmonised". This is something that was readily identifiable from the outset.

Third country equivalence (i.e. whether an EU firm's non-EU subsidiary is subject to Solvency II or local regulation where that local regulation is deemed equivalent) was also an issue that was addressed by an assumption of equivalence, rather than explicit agreement on the part of the third country.

Both issues created extended uncertainty with detrimental impacts for the EU insurance industry and its consumers. For example:

- Companies were required to "hoard" capital: it is still not clear exactly how much will be required;
- Investment decisions were held back: for example the ability to invest in UK infrastructure was only clarified late in 2013, impacting our investment decisions and therefore yields for our customers; and
- Strategic decisions, for example international expansion, could not be taken against the backdrop of uncertainty.

In total, the direct cost implications of almost a decade of uncertainty for the UK industry is estimated at £3-4bn. Indirect costs to insurers, their customers and the broader economy are higher: for example, UK infrastructure investment could potentially have been started several years earlier, had it not been for the uncertainty around Solvency II.

However, the outcome agreed was the result of effective negotiation, especially by the UK Government, and delivers a more proportionate regime than originally envisaged.

Procedural issues and balance of competencies: The prolonged and complex nature of the legislative process was instructive. While in many ways the financial crisis prolonged the process, without this "real-world stress test" we could have ended up with inappropriate legislation that created uncertain, volatile and procyclical capital requirements.

The Lamfalussy Process for passing financial regulation legislation is intended to provide several benefits over traditional lawmaking, including more-consistent interpretation, convergence in national supervisory practices, and a general boost in the quality of legislation on financial services. This was clearly proved not to be as effective as it could be in this case, as evidenced by, for example, the need to create special groups to address the long-term guarantee issue.

While the second level of legislation, involving advice from EIOPA as well as input from the Council and European Parliament, is complex, it is the third Lamfalussy level, where national regulators work on coordinating new regulations with other nations, and the fourth level which involves compliance and enforcement of the new rules and laws, which brings us to the crux of the balance of competencies issue.

From a firm's perspective, the application of the Directive in the UK presents a risk of gold-plating – the national government effectively makes regulatory requirements tougher in the UK than elsewhere in the EU. This creates competitive disadvantage for the national industry and renders the UK a less attractive place in which to deploy capital. This would be against a backdrop of Solvency II now being deemed as acceptable and proportionate to all Member States and EU Institutions.

The presence of both a national prudential regulator and a pan-EU sector regulator also creates the risk of over-implementation by regulation. This is about a surfeit of competencies as much as a balance of competencies: for example, it is already suggested that the UK regulators will look to impose additional "Early Warning Indicators" with potential capital implications, on top of the Solvency II legislation agreed by HM Government. Again, the potential result is loss of UK competitiveness, reduced investment and poorer outcomes for consumers.

The issue of balance of competencies is not just limited to the potentially overlapping roles of, for example, EIOPA and the UK's PRA. EU institutions are also under pressure to implement G20 agreements, and in the case of the insurance industry the proposals of the IAIS (International Association of Insurance Supervisors) which relate to institutions deemed to pose systemic risks. This again has a potential bearing on capital requirements for some industry participants.

This combination of G20-led regulation, EU-led regulation, and EU and local interpretation and implementation of regulations, creates an over-complex regulatory landscape. It is unclear where the boundaries lie between local and EU regulation: indeed local regulators appear to be able to go beyond common standards, without due regard to competitiveness, customer or broader economic outcomes.

In the Solvency II case, the EU institutions trying to find workable legislative and regulatory solutions were placed in a difficult political situation due to competing Member States' interests and the broader Eurozone agenda. For example, it is axiomatic under Solvency II that euro-denominated sovereign debt is "risk free" for the purposes of calculating capital requirements, even when market spreads on sovereign debt imply quite the reverse. In practical terms, this would have meant that under Solvency II, it would have been more capital-efficient to invest UK pensioners' annuity funds in Greek or Cypriot government debt than in AA or A-rated corporate bonds and certainly more efficient to invest in peripheral Member States' bonds than UK infrastructure, even assuming the latter was possible at all.

This case study illustrates the challenge of a regulatory agenda which does not have the principle of subsidiarity fully embedded within its policy process. Achieving this would help create a more sustainable and proportionate regulatory regime, which in turn would support growth and prosperity in Member States, and therefore ultimately the Union itself.