Institute
and Faculty
of Actuaries

House of Lords EU Financial Affairs Sub-Committee Call for Evidence on Post Brexit Financial Regulation

IFoA response to House of Lords EU Financial Affairs Sub-Committee

29 September 2017

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

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1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the House of Lords EU Financial Affairs Sub-Committee's Call for Evidence on Post Brexit Financial Regulation. This response reflects views from several IFoA practice areas, including Life and General Insurance, Pensions, and Finance and Investment. Our members' varying roles give them both generic and specific insights into financial regulation and how Brexit will affect this.

General observations

2. We would also welcome the opportunity to elaborate on the comments below by providing oral evidence to the Committee. In January 2017 the IFoA gave substantial oral evidence to the Treasury Select Committee on EU Insurance Regulation, including the effects of Solvency II (SII) and the potential for reform of the regulatory system post-Brexit. Our evidence was praised by then-Chair Andrew Tyrie MP as extremely useful, and we would be delighted to offer the same assistance to your committee.
3. The IFoA has commissioned and is currently performing extensive research into various SII topics, and this research may also support the work of the Committee: please let us know if this is of interest. The scope of current ongoing research includes:
   - a retrospective of SII against its original aims;
   - pro-cyclical elements of regulation;
   - the impact of SII (and low interest rates) on consumers;
   - issues relating to the Matching Adjustment; and
   - issues relating to the transitional measures

Key themes of the IFoA's response

Insurance regulation

4. Solvency II is a recently implemented insurance supervisory regime, with extensive rules and guidelines on capital, reserving for policyholder obligations, and governance standards. It is

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generally sound, but this EU wide regime has certain elements that impose disproportionate costs on typical UK insurers (see Question 1).

5. Maintaining equivalence may be useful to parts of the UK industry, but it should be recognised that the industry is a mixture of companies operating more widely than the EU, and UK-focused companies. EU equivalence is thus only part of the concerns of those companies. One would need to weigh the positive refinements that would improve the current Solvency II regime, whilst retaining Solvency II equivalence, against a comparable but not identical UK regime. The industry is quite varied across the EU, so there may be unnecessary constraints from trying to maintain a UK regime nearly identical to that of the EU, by needing to follow uncertain future EU developments that may be inappropriate for the UK industry.

6. We believe that the prevailing appetite in the UK insurance industry is for modest but impactful and well-targeted changes to SII.

Pensions regulation

7. From a pensions investment perspective we are not aware of a negative impact of post-Brexit regulation on the discharge of pension liabilities, although Solvency II (and any UK-tailored version of this) will affect the ability of UK insurers to provide 'bulk annuity' policies offering retirement income to large groups of pensioners.

8. On the assets side, many pension schemes have exposure to EU assets and EU funds. Ideally, there would be minimum disruption to the ability to invest in and hold such assets; failure to achieve this could be quite disruptive to EU capital markets, not only to UK pension schemes. We would want the 'shield' of tax exempt contributions to continue.

9. UK fund managers would want to be able to access and manage (i.e. buy, hold, sell) EU assets and EU funds without undue disruption. They would also want to be able to hedge any foreign currency or other exposures. Fund managers and institutional investors in the EU would also want to be able to manage UK assets. Finally UK fund managers would want to be able to market UK oriented or domiciled funds to EU investors.

Current regulatory regimes

Q1. What is your overall assessment of the EU's financial services regime, in light of its current application to the UK? To what extent is it effective, and for whom?

Solvency II

10. The prudential (solvency) regime of Solvency II is not fundamentally different from the previous regime in the UK. However, the available capital now includes a reduction for an explicit risk margin with a SII defined calculation which can appear large for companies. This risk margin is required to be maintained after the severe shock that the capital is held to

meet, and this need to hold the risk margin at the level prescribed in Solvency II post the shock is potentially cautious.

11. Any prudence within the approach comes with a cost to policyholders. While the stated aim of the regime is to protect policyholders, this should be balanced by an awareness of the costs they face. The cost of implementation, and the cost of holding high capital, is ultimately borne, in part at least, by policyholders.

12. Within the detail of the Solvency II regime are adjustments to valuations of products with long term guarantees, to reduce fluctuations based on volatile market values. However, these adjustments came with stringent conditions, which are excessive for the UK - particularly those for the 'matching adjustment' (the UK is the main user of this measure). Non-life insurers have specific challenges as the matching adjustment is not available to them when reserving for Periodical Payment Orders (PPOs).

13. We believe that with relatively simple refinements the regime could be made more efficient and not noticeably less effective. A UK-designed regime could avoid some of the complexities and costs that seem to go beyond policyholder protection (eg the risk margin for annuity writers and reporting standards). We note that the PRA does not have a primary responsibility for competition matters, and it is therefore for politicians to address whether current regimes meet the needs of policyholders.

14. We believe that there is excessive detail in the implementing standards / delegated acts on capital, governance and reporting requirements combined, which comprise a barrier to entry for smaller, innovative insurance entities. This may lead to consumer detriment as it could be expected that innovation will reduce costs for consumers. We do consider that the level 1 principles are sound and not a barrier to entry. We suggest that there is an over-supply of detail on the implementation of governance requirements (within Delegated Acts and guidelines) that might create too much of a tick box - yet under-implemented - approach.

15. Many companies note that the standard formula used to calculate capital requirements under Solvency II can be more pessimistic than their own view for some asset classes (such as infrastructure debt). This acts to discourage companies from investing in what may otherwise be economically sensible investments.

<u>Financial reporting and IFRS17</u>

16. It is important not to overlook the impact of financial reporting and its potential to be at odds with, or overshadow, behaviours driven by regulatory systems. For general insurers focused on short-term business, IFRS 17 will have limited impact, although it will still require significant implementation costs and effort. Longer term GI business spanning multiple years

faces similar challenges to that of life and pensions products, such as identifying and accounting for onerous contracts and presenting an explicit margin for non-financial risk. Our understanding is that, in the absence of a specific decision to the contrary, the UK will adopt the EU's version of IFRS17.

Q2. Are current EU proposals on banking and financial services in your view positive for financial stability? How do you expect the EU's regulatory framework to evolve in the coming years?

17. We do not have a view on this.

Q3. What are the key differences between financial regulation as agreed at the international, EU and UK levels, and where are the gaps? How important is it to maintain a level playing field for regulation?

18. Given our areas of expertise we can only comment on the second part of the question.

19. More and more the design of insurance regimes is being influenced by global standard setters such as the International Association of Insurance Supervisors (IAIS). The EU regime is one of a number of possible regime designs, and it tends more to a rule-based system than a principles-based system.

20. There are usually advantages in efficiencies, and thus costs to policyholders, when groups are able to operate more seamlessly across jurisdictions. This is very important to the non-life sector of the insurance industry, with considerable cross-border business. It is also important for the life sector, which is a mix of global insurance groups and UK-focused insurers.

21. Such seamlesss operations simplify capital management and allocation of capital for international groups. A level playing field is important to achieve this, however there are country-specific factors which mean that in practice this is not fully achievable. Factors include conduct rules and the precise implementation within countries of these global rules, as well as fiscal constraints and the product differences driven by differing cultures and methods of saving in different countries.

22. Whilst a consistent set of rules assists in delivering a level playing field, the quality of regulation and consistency of regulatory outcomes is more important. This is delivered through regular regulatory communication, via colleges or other media, and we consider that any framework should include clear channels for passing information and opportunities for discussion between regulators.

23. The UK government should note that resolving the detail of Gibraltar insurance companies' continued access to the UK market can be resolved outside the Brexit negotiations, as it is not an EU issue. We consider that this situation can and should be resolved quickly to reduce the uncertainty in at least this one area.

Transition, equivalence and alignment

Q5. What would be the key priorities for a transitional arrangement, and how much continuity would you expect to see under such an arrangement?

24. Transitional arrangements are important to give businesses clarity and to enable them to plan effectively how they will support all their customers, regardless of jurisdiction, fairly. This is important for insurance, where claims can be paid many years after policies expire. In addition, cross-border pension schemes will need to know whether and how they can continue to operate after Brexit.

25. Transitional arrangements need to be put in place to enable existing EU ex UK policyholders of UK policies (and similarly UK policyholders of EU ex UK policies) to continue to have their policies serviced and managed in accordance with their terms and conditions when the policies were taken out. There should be similar consideration of branch business.

Q6. In practical terms, how and when could a transitional arrangement be agreed and put in place? How long would such a transition need to last?

26. A period of transition - describing a post 2019, but pre full exit, mixed UK/EU regulatory regime, would be straightforward for the industry to plan through, and to ensure policyholder obligations were met, provided there was a clear rationale of the purpose of the transitional period and the constraints on changes to the legislation now embedded in UK law.

27. Such a transitional arrangement should be agreed as soon as possible, even though it would only take effect from 30 March 2019, as this will give insurers and their clients comfort that the insurance they are providing or receiving remains legally binding.

Q7. What are the benefits and drawbacks of seeking equivalence? What conditions are likely to be attached by the EU to any equivalence decisions?

28. Maintaining equivalence may make it easier to compete in international markets. Relevant examples of this include the EU cross border business of the non-life insurance industry ('the

London market') and, for pension funds and fund managers, the ability to continue with current (pass-porting) arrangements for funds and assets. It is difficult to predict what conditions the EU may attach to any equivalence decision, but it may mean adhering to much of the EU legislation, and thus the issue is whether UK can amend some of the less well designed (from a UK perspective) parts of current EU legislation whilst remaining equivalent.

29. Other countries, with regimes that are not identical to the EU regime, have achieved permanent, or temporary, recognition of equivalence, but there is necessarily a degree of politics in this - accepting large non EU markets as temporarily equivalent makes good sense. An immediate recognition in March 2019 of UK equivalence, based on its near identical regime to that of the EU, would perhaps, even if described as temporary, be the best and most settled outcome for the UK industry.

Q8. What alternatives may exist for maintaining alignment between the UK's and EU's regimes? What options could be considered for resolving disputes or arbitrating on such matters? What would be the barriers to a more bespoke arrangement?

30. We do not have a view on this.

The Future Environment

Q9. What effect will the loss of the UK have on the development of the EU financial services framework and its capital markets?

31. On the insurance side, the size of the life industry in particular, but also the non-life industry, relative to the rest of Europe, has given the PRA a huge influence on the ultimate shape of European regulation. We should not underestimate the impact of the loss of that influence.

Q10. Where is there scope for the UK to amend its regulatory regime? What precedents exist under current equivalence decisions for divergence to occur?

32. UK occupational pension fund assets comprise nearly half of the EU sector. Without the ability to negotiate new EU legislation, the UK will have little or no say in future EU-level pensions regulation. If there is a need to keep pace with changes in EU rules then it is possible that onerous requirements (including in relation to funding) could be placed on UK pension schemes, with a corresponding price to UK business. While the Solvency II project was quite a painful process for the insurance industry, pension provision across the EU (not just between the UK and the rest of the EU) is much more diverse, and therefore the lack of UK control over UK pensions would be a serious problem.

33. In January 2017 the EU approved a major revision of the EU legislation on workplace pension schemes – the Directive on Institutions for Occupational Retirement Provision, known as IORP II. Member States have until 12 January 2019 to implement it, i.e. before the UK leaves the EU. This could place additional obligations on pension schemes, particularly in the areas of risk management and member disclosures that do not provide better information for scheme members. We hope that government will take a pragmatic view in adopting this and align it with the outcome of the DWP's consultation on defined benefit pension schemes to avoid the need for further rule changes later down the line.
34. Our understanding is that in many EU countries such as Denmark and the Netherlands, pension schemes are regulated much more like insurance companies, and that UK defined benefit schemes could be better served by evolving our current regulatory regime. This could also make it easier for ideas such as defined ambition schemes to be developed in future.
35. Annuity prices currently are punishingly expensive, but Brexit might enable a 'loosening' of insurance reserving standards for annuities, which over time would help pension funds to discharge their very long and substantial tail of liabilities.
36. See also our answer to question 7

Q11. What challenges will expected innovations in financial markets, for instance in the FinTech sector, present in respect of regulation and supervision post-Brexit? How can these challenges be overcome? Can the UK maintain a competitive advantage while adapting to a new regime? If so, how?

37. One serious issue is what constraints may arise over the transfer of data between the UK and the EU and vice versa, as data use and data interrogation is fundamental to FinTech. We note that the UK Government has confirmed that the UK's decision to leave the EU will not affect the commencement of the General Data Protection Regulation (GDPR) in the UK from 25 May 2018. Insurers –among others - will need to establish robust data governance processes and controls, which may be particularly challenging for emerging high-technology Fintech firms entering the insurance market.

Q12. Will leaving the EU affect the way that the UK represents itself in international fora? How can the UK continue to maintain influence when dealing with organisations such as the FSB and IOSCO in setting international standards?

38. The UK will remain a very significant financial services market and UK actuaries will remain with a strong voice in international fora such as the IAA and indeed within the European grouping, the AAE, whose membership is wider than the EU.
39. The UK voice might be heard more clearly in the future, rather than being lost within an EU voice that we often disagree with.

Supervision

Q13. The Commission is currently conducting a review of the European Supervisory Agencies. What, in your view, are the key areas where reform should be pursued and what might be the impact of such reform on UK supervision?

40. From a pensions perspective there is a risk of "mission creep" with the ESAs - in particular, EIOPA may be seen by some as outstepping its bounds – e.g. requiring additional complex information from pension funds for its stress tests, its "own initiative" work on developing a solvency regime and the holistic balance sheet approach. This risk could be amplified were it given the power to set its own budget and impose additional costs on schemes – which presumably UK schemes could be forced to pay as part of the price of an equivalence regime.

41. We would note that wider international developments – such as the protocols developing under the aegis of the IAIS - could have as big an impact on UK supervision as the Commission's review.

Q14. How could an enhanced role for ESMA and the ECB in respect of euro-denominated clearing work? What are the options for the UK to retain euro clearing in the light of the European Commission's recent proposals?

42. We do not have a view on this.

Q15. How would supervisory cooperation (as envisaged for CCPs) work in practice? Are there any precedents? What are the potential risks?

43. We do not have a view on this.