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Insurance Regulation in 2012: Finding Solutions to the "British Dilemma"

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In association with: HM TREASURY

Summary

- Insurance companies face tough challenges, but there are opportunities for the UK insurance sector to build on its world leading strengths.
- As we reform our financial services, we are caught in what the Chancellor described in his Mansion House speech as "the British dilemma": we want a strong, vibrant and successful financial sector to support economic growth; but we cannot afford the sector to pose a risk to the stability and prosperity of the rest of the nation's economy.
- Government is conscious of the inherent and unique characteristics of an insurance business model. The new PRA will bring judgement to the vital task of regulating firms which manage risk - and, recognising the differences between insurance and banks, the Government is proposing to provide the PRA with a specific statutory objective for its insurance responsibilities.
- On the subject of international regulatory reform, the uncertainty surrounding events such as the Eurozone crisis must not undermine the need for integrated financial sector reform. Government believes the new EU regulatory architecture and initiatives like Solvency II will help to promote stability and certainty.
- Finally, we are actively committed to creating a retail savings and investment landscape that creates the incentives for people to address their future needs, not just in retirement but also through life, and are engaging the industry to create adequate solutions.

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CII Introduction: much of the discussion in recent months about the reform to the UK's regulatory architecture, and indeed UK financial services generally, tends to be about banking matters. However this country's dominance in the global insurance markets both retail and wholesale cannot be underestimated, and any regulatory reforms must be reflective of the unique issues in this sector. In this Thinkpiece, Mark Hoban, the Financial Secretary to the Treasury has offered the Government's views on domestic and international insurance regulation.

The UK continues to be one of the leading global centres for insurance: notably, it is the largest insurance centre in Europe. Accounting for almost a third of all financial service jobs in the UK, it also controls over 13% of investments in the London stock market, which is more than that held by pension funds, and significantly more than held by banks.

This flagship position was not developed overnight, nor is it one that the UK is entitled to as a result of past triumphs. Such a position takes constant innovation and adaptation to stay ahead of the game, especially in the light of worthy and rising competitors.

As we grow our economy and we reform our financial services, we are caught in what the Chancellor described in his Mansion House speech as "the British dilemma". On the one hand we want a strong, vibrant and successful financial sector to support economic growth and provide millions of jobs across the country. But on the other hand we cannot afford the sector to pose a risk to the stability and prosperity of the nation's entire economy.

Domestic regulation

The tripartite system failed spectacularly in its responsibility to monitor and mitigate the systemic risks before the crisis. Since entering Government, the focus of our actions has been to address these shortcomings, in concert with EU and international level efforts which will be discussed further below. For instance, we are establishing a permanent Financial Policy Committee inside the Bank of England. Its job will be to monitor overall risks in the financial system, identify bubbles as they develop, spot dangerous inter-connections and stop excessive levels of leverage before it's too late.

The formation of the new Prudential Regulation Authority (PRA) will be a key part of this process. It will replace and focus more closely on the microprudential side of what the Financial Services Authority has done. We think the PRA will bring judgement to the vital task of regulating the soundness of individual firms that manage risk on their balance sheet, particularly banks and insurance companies.

But we recognise, of course, that banks and insurers engage in very different types of business. The inherent characteristics of an insurance business model are different to those within a bank's. This is why we are proposing to provide the PRA with a specific statutory objective for its insurance responsibilities. It is our strong view that insurance regulation will not take a back seat to deposit-taker regulation in the PRA.

In June the FSA published the PRA Insurance Regulation document providing more information on the future regulatory approach in that sector. In particular, and in response to concerns expressed by industry stakeholders, the PRA will have a dedicated mutuals supervisory team in order to develop specialist expertise in the sector.

The PRA will also be responsible for securing appropriate protection of policyholder expectations with respect to with-profit policies - thereby balancing the insurance objectives of policyholder protection and general objective of firm financial soundness.

We are caught in "the British dilemma": on the one hand we want a strong financial services sector to support growth and provide jobs, but we cannot afford the sector to pose a risk to the stability of the rest of the economy.

More widely, the new Financial Conduct Authority (FCA) will play a critical role in consumer protection. Its single strategic objective will be to protect and enhance confidence in the UK financial system. We committed in the June consultation that we will continue to consider the FCA's objectives as part of pre-legislative scrutiny and in light also of the recommendations from the Independent Commission on Banking.

In that role, the FCA will oversee the conduct of financial services firms, the operation of markets and the protection of consumers with new powers to ban the sale of toxic products.

The Government has published three consultation papers on these reforms since July 2010, culminating in the White Paper and draft legislation published in 2011. We are grateful to all those who have responded and the Government is continuing to develop the legislation in light of consultation and pre-legislative scrutiny, which is currently underway. It is absolutely vital that we get these reforms right. We need a financial sector that continues to propel growth but doesn't put our stability at risk.

International regulation

Financial services are a truly international industry, and regulation needs to reflect that fact. Domestic regulatory reforms are taking place amidst the backdrop of work happening at the European and international levels.

Foremost in everyone's mind is, of course, the Eurozone debt crisis. However, there are those who would want to use the current uncertainty to pull the rug from under financial sector reform would be misguided. I do not believe that these events diminish the case for financial sector reform.

The UK government has been a strong supporter of Solvency II, believing that it will help support financial stability in the sector and across the financial system.

The new European Insurance and Occupational Pensions Authority (EIOPA) formed one year ago will play a major role in the shaping and conduct of EU insurance regulation. We are keen to work with EIOPA as it develops, and ensure that it delivers higher and consistent standards of supervision across the EU, and most importantly of all, helps create a level playing field across Europe. By doing so, EIOPA can take a major step in completing a single market in insurance, creating new international opportunities for the UK sector.

We've already seen how constructive engagement between authorities and industry can create opportunities through our parallel reforms to the tax system. In particular, I know many in the insurance sector have keenly followed our reforms to introduce an opt-in exemption from corporate tax for the profits of foreign branches of UK companies. This will make the UK a more attractive location for the headquarters of pan-European insurers. This change is a vital part of a shift to a more territorial system of taxation, reflecting the fact that UK business has become more internationally diverse.

Solvency II

The UK government has been a strong supporter of Solvency II, believing that it will help support financial stability in the sector and across the financial system through better risk-based capital requirements and its focus on strong risk management in firms. It will also provide a harmonised regime across Europe, thereby increasing cross-border competition and creating new opportunities for UK firms within the Single Market. This will in-turn deliver increased efficiencies and reduced compliance costs to the benefit of both firms and consumers across Europe.

Solvency II is also a sign of our success in securing recognition across Europe that helping the industry to maintain its role as a stable long-term investor is critical to long-term economic growth.

We have worked with the industry to identify the top priority issues for the UK, and to broker a sensible deal with the European Commission and other member states on these issues. The Commission recently issued a consolidated Level-2 text, the contents of which reflect a huge amount of constructive engagement by the Treasury, the FSA and industry on a wide range of issues. A priority for the UK was securing an appropriate Matching Premium for annuities: this has been a difficult area of the level two negotiations but one that was absolutely vital to protecting the role of the insurance sector as a long term investor in the UK economy.

It is also a sign of our success in securing recognition across Europe that helping the industry to maintain its role as a stable long-term investor is critical to long-term economic growth. But this debate is not over, and we need to sustain our efforts over the next few months. I strongly encourage you to stay engaged in this debate. It is only through your engagement that we can build the solid evidence to base future regulation. It is only through such evidence that we can ensure that we implement regulation that is credible, effective and proportionate.

Gender-Neutral Insurance Benefits and Premiums

I also want to address the ECJ Test Achats ruling in March 2011, which has had a significant effect on many aspects of the insurance industry.

Of course, nobody should be treated unfairly simple because of their gender, but financial services providers should be allowed to make financial decisions on the basis of sound analysis of risk factors, including gender. However we need to abide by the ECJ ruling which is legally binding.

As I said last summer[1], we were extremely disappointed by this decision: the judgement goes against the grain of a common sense approach to equality. Of course, nobody should be treated unfairly simple because of their gender, but financial services providers should be allowed to make financial decisions on the basis of sound analysis of risk factors, including gender.

We believe this ruling will lead to three main outcomes, all of which fall upon consumers. Firstly, it will result in cross-subsidisation of premiums between the genders. Secondly, adverse selection will operate to increase the cost of insurance generally and incentivise riskier behaviour. Finally, in the field of motor insurance, studies have indicated that gender-neutral pricing would have consequences for road safety. As premiums for (generally higher risk) male drivers fall, then they may purchase higher-powered cars or increase the riskiness of their driving.

That said, we are obliged to abide by the ECJ ruling so we have confirmed that the judgement should only apply to new contracts for insurance and related financial services entered into on or after the 21 December 2012. Our intention therefore will be to implement the ruling by amending the Equality Act 2010 and we have published a consultation paper that sets out our views towards the decision and its potential impact, and consults on how these amendments would be carried out.[2]

Savings and investment

We are all aware of how intertwined the insurance industry is with the country's savings habits. And as a Government we are committed to tackling the chronic lack of savings that preceded the financial crisis. Before the financial crisis, one in four households had no liquid savings and UK household debt was almost 100% of GDP compared to 61% in Germany and 50% in France. And even today, almost 60% of people do not have a pension.

Instead, we want to build an economy more strongly built on the back of savings and investment. We are creating the right conditions to support higher savings across the board. By introducing a duty of automatic-enrolment on employers, more employees will qualify for a minimum quality pension scheme from 2012. That means another 5 to 8 million people can start saving, or can save more into a workplace pension scheme, something that the insurance industry has broadly welcomed.

We want to build an economy more strongly built on the back of savings and investment, and are creating the conditions to support higher savings. This includes the related matter of simplifying products for consumers.

We have also removed the outdated requirement to annuitise by the age of 75, thereby giving people more choice and flexibility over how to use their savings. We are committed to ensuring that a greater and broader spectrum of society have the opportunities, capacity and trust in the system to take personal responsibility for saving. For this reason, we have seen through the development and

[1] Written Ministerial Statement by the Financial Secretary to the Treasury (Mr Mark Hoban) on the European Court of Justice Judgment (Use of Gender by Insurers), 30 June 2011.

[2] HM Treasury consultation, UK Response to the 1 March European Court of Justice ruling that insurance benefits and premiums after 21 December 2012 should be gender-neutral, 8 December 2011. Closing date: 1 March 2012.

launching of the Money Advice Service to ensure consumers have the skills and understanding to engage with the system.

On the related matter of simplifying savings and investments for consumers, we are keen to investigate ways in which the industry could promote better trust and confidence in investments for retail customers. The new steering group announced in October chaired by Carol Sergeant has been tasked with devising a suite of 'simple' financial products. Our goal is a savings landscape that creates the incentives for people to address their security and protection needs and our challenge to industry is to help meet these needs.

Health and protection insurance

Finally, on the subject of health and protection insurance, both government and insurers face significant challenges in society that will require ever closer cooperation and innovation. For instance, the line between public and private sector provision of social insurance and protection has, and always will, shift. This is partly a result of changes in the pattern of state welfare protection, but also as a result of emerging social needs such as long-term care. How far insurers can step up in to this space however, is not always obvious, even when the state's role in such a market is made absolutely clear as a foundation for a viable market.

But these are not insurmountable challenges. In the UK we already have a strong track record of working together to tackle some of the biggest and most difficult insurance risks that we face: from working towards a solution on flood insurance, to our work on managing compensation for those affected by mesothelioma.

Conclusion

We have come a long way in eighteen months – a long way to rebalancing our economy away from debt-fuelled consumption, to more prudent saving. And a long way to reaching a much needed solution to the "British dilemma" and the role of the financial sector in our wider economy, including the insurance sector.

But we still have a long way to go and we are continuing to work tirelessly on domestic and international reform. It is in everyone's interest that we get these reforms right. And it is vital that we continue to work with the industry to do so and I look forward to forging a strong working relationship in the years to come.

If you have any questions or comments about this Thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact us: thinkpiece@cii.co.uk or by telephone: +44 (0)20 7417 4783.

Mark Hoban MP was appointed Financial Secretary to the Treasury following the General Election in May 2010. He held the post of Shadow Financial Secretary to the Treasury since December 2005, and prior to this he was Shadow Minister for Schools and previously Opposition Whip. Between 2001 and 2003 Mark was a member of the Select Committee on Science and Technology. He holds an economics degree from the London School of Economics, then qualified as a Chartered Accountant, and went on to work for PricewaterhouseCoopers between 1985 and 2001. Mark has been the Conservative MP for Fareham since June 2001.

Her Majesty's Treasury (commonly known as HM Treasury) is the United Kingdom's economics and finance ministry.

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Amidst all the commentary on the Jackson reforms, Anthony Hurndall (Chief Executive of the Centre for Justice) describes an alternative model that avoids the aggressive adversarial approach of litigation whilst actually bringing about workable results. At a time when insurers are looking for cost effective and proportionate approaches to settling claims disputes, what is proposed here might just be the fresh approach that is needed.

No.64: **Road to Ruin, Next Exit? Insurance Reflections on Corporate Governance and Risk Management,** by Ian Canham (22 November).

Assesses the implications of a report published earlier this year by Cass Business School in association with AIRMIC and Lockton. In this thinkpiece, Ian Canham (partner in risk solutions at Lockton) provides his personal views towards this study and draws observations and conclusions for the future of corporate governance in the real world.

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In the current economic landscape, Western governments have to make tough choices in balancing a taxation system that promotes economic growth with dwindling resources with which to provide a safety net. Walter Stahel of the Geneva Association calls for a fundamental rethink of taxation policy in favour of supporting the economy's most important asset: its labour.

No.62: **The Role of Professionalism in Securing Consumer Trust and Confidence,** by Adam Phillips (31 August).

Why are regulators and firms suddenly taking staff professional standards so seriously? Will this make a difference for the end consumer? Adam Phillips, Chairman of the FSA's Financial Services Consumer Panel, offers his personal perspective on why professionalism plays a role in improving public trust and confidence.

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The global financial crisis has sparked considerable debate and analysis of its causes and of the lessons to be learned. This paper seeks to make sense of the crisis in terms of its implications for the management of risk. It reflects on the future for the practice of risk management, and provides some recommendations for financial institutions, and their regulators.

No.60: **The Forgotten Hero? The Role of Employer Group Risk Schemes in Closing Protection Gaps,** by Ron Wheatcroft FCII and Keith Williams (5 August).

One of the most important players influencing an individual's personal finances is not the financial services industry or the government but the employers. Ron Wheatcroft FCII and Keith Williams of Swiss Re look at the UK group risk market, emerging trends and the threats and opportunities it faces.

No.59: **A Ten-Point Plan for Improving Reputation and Customer Service,** by Otto Thoresen (15 July).

Chief Executive of the ABI, Otto Thoresen sets out his initial thoughts on the challenge posed by the pressing issue of reputation and service to customers of the insurance industry. In this Thinkpiece, based on a speech delivered at the ABI Biennial Conference, in July, he calls on insurers to act now if the industry is to fulfil its potential and play a central role in the future of the UK economy.

No.58: **Balancing Risk and Return: Encouraging savings and learning to live with financial risk**, by Barry O'Dwyer (14 July).

It may be one challenge getting consumers to save safely and sustainably, but helping them to understand and more importantly live with the concept of financial risk is especially challenging given the setbacks in recent years in the financial markets. In this latest Thinkpiece on pension saving and financial capability, Barry O'Dwyer (Deputy Chief Executive of the Prudential) gives his personal view of some of these challenges.

No.57: **Hack Attacks: Data Breaches and Their Impact in a Changing Legal and Regulatory Environment,** by Ben Beeson (28 June).

The recent high profile hacking attacks on Sony and Google have underscored the fact that large-scale information theft through cyber crime is no longer science fiction but an everyday risk. Ben Beeson, Partner in Lockton's Global Technology and Privacy Risk Practice, looks at the responses to this new threat from a legal, regulatory and insurance risk management perspective.

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On the eve of the Retail Distribution Review rollout, the issue of what to do wiht the mass market "simplified advice" proposition continues to exercise the industry. Is regulating sales process appropriate for this market? Is product intervention needed? Chris Gilchrist (Director of Churchill Investments and contributor to Taxbriefs) provides a view informed by regulatory history

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On the eve of the Retail Distribution Review rollout, the issue of what to do wiht the mass market "simplified advice" proposition continues to exercise the industry. Is regulating sales process appropriate for this market? Is product intervention needed? Chris Gilchrist (Director of Churchill Investments and contributor to Taxbriefs) provides a view informed by regulatory history.

No.54: **Time is Money: The Role of Financial Services in Reducing Re-Offending,** by Chris Bath and Kimmett Edgar (28 April)

Managing post-conviction personal finances is the core to preventing resurgence into crime. Chris Bath of reformed offenders charity UNLOCK returns to our Thinkpiece series and shows that every stage in the criminal justice process contains personal finance elements that can potentially lurch people back into crime when they get out. He identifies specific steps that should be done by both the Government and the industry to stop this, thereby strengthening the pathways to rehabilitation and resettlement.

No.53: **Banned! Underwriting Annuities by Gender: Where Do We Go From Here?** by David Trenner (21 March)

The landscape for retirement is changing. The UK Government is in the process of implementing a number of reforms to pensions to try to incentivise long term savings. Changes are also afoot at the EU level and, on 1 March the European Court of Justice banned underwriting by gender. Trenner considers the potential impacts of this ruling on the UK annuities market and the consumer within the context of the other reforms that are taking place.

No.52: **What Motivates Us to Save? Creating Effective Incentives for Public Engagement in Pensions,** by Nick Hurman (16 March).

One of the great public policy issues is the question of how to get people to save for their retirement, especially when peoples' confidence in financial markets and services has long been eroded. In this article, strategy consultant Nick Hurman returns to our series having led AEGON's latest consumer research on attitudes and preferences when it comes to saving for retirement. His findings offer some timely directions for public policy.

No.51: **A Region in Transition: A Political Risk Analysis of the Middle East and North Africa** by Adrian Lewers (28 February).

With mass political protests sweeping the Middle East and North Africa, predictions on their political and economic implications are changing almost as quickly as the events themselves. Adrian Lewers of specialist insurer Beazley plc provides an analysis of developments from an insurance risk perspective.

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