



Industry and Regulators Committee

Corrected oral evidence: Commercial insurance and reinsurance regulation

Tuesday 1 February 2022

10.30 am

Watch the meeting

Members present: Lord Hollick (The Chair); Lord Allen of Kensington; Lord Blackwell; Baroness Bowles of Berkhamsted; Lord Burns; Lord Cromwell; Baroness Donaghy; Lord Grade of Yarmouth; Lord Reay; Lord Sharkey; Lord Trefgarne.

Evidence Session No. 2

In Person Proceeding

Questions 15 - 27

Witnesses

I: Dr Franziska Arnold-Dwyer, Senior Lecturer in Insurance Law, Queen Mary University of London; Professor James Davey, Professor of Insurance and Commercial Law, University of Bristol Law School.

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Examination of witnesses

Dr Franziska Arnold-Dwyer and Professor James Davey.

Q15 **The Chair:** Good morning, and welcome to the 24th meeting of the Industry and Regulators Committee and our inquiry into the London market on insurance and reinsurance. It gives me great pleasure to welcome our two witnesses today, Franziska Arnold-Dwyer, who is a senior lecturer in insurance law at Queen Mary University in London, and James Davey, professor of insurance and commercial law at the University of Bristol.

I will ask the first question. To what extent has the legal and policy framework, the structure, of the London market developed over time, and who is the main driver now that we are no longer in the EU?

Dr Franziska Arnold-Dwyer: I will go back quite a while and focus on insurance and reinsurance. We have had insurance regulation in England since the 17th century, and there were pieces of legislation in the 18th century. Then we had a century or so when reinsurance was not permitted. That lasted until the 19th century, and in fact gave a head start to our continental colleagues and the likes of Swiss Re and Munich Re, which sprang up in the middle of the 19th century when reinsurance was still not permitted in the UK.

The UK then caught up, and that is attributable mainly to the way Lloyds of London operates—through syndicates, and through slicing and dicing risk and spreading it across different insurers and reinsurers. A particular event, the earthquake in San Francisco in 1906, was where Lloyds of London acquired an international reputation for being an excellent payer of claims.

In the 20th century, from the late 1970s and mid-1980s, our insurance regulatory system was increasingly influenced by the European Union in a drive to harmonise laws. This has carried on, and more recently the most relevant piece of legislation has been the Solvency II directive, which came into force in 2016, and the insurance distribution directive, which came into force a few years later.

Following Brexit, we have inherited the EU's system by onshoring it, so we have stayed pretty much with the same system as the member states of the EU but without the EU issuing further directives for us to implement or giving guidance. So our regulatory system is now, at least in theory, free to go any way we like. There are, of course, international bodies like the International Association of Insurance Supervisors in which the UK is very active, which set global standards that are not binding or enforceable but set out good practice.

Professor James Davey: There has certainly been an intensification, if we look at that timeframe, maybe focusing on the 21st century, and look at the relationship between the insured and their individual clients—the conduct of business, how they run things, rather than the solvency side. In the 21st century, we moved from a largely self-regulatory situation to

a position where it was enshrined in statute and the FSA, and later the FCA and the PRA, was setting standards. So that has been formalised; there has been a move from self-regulation to formalisation.

It has often, as you have said, reflected what has been happening at the EU level, at the federal level, but we should not underestimate just how important the UK was in influencing those standards. When the single market was created, it largely adopted a UK vision of what a single market in insurance would look like, rather than a German vision, which was much more intensively regulatory. There has been a lot of trust in national regulators, and a lot has been set at minimum floor levels so that member states could often take a higher level of regulation if they wished to.

To the extent to which we have always had the power to do more than the EU minimum standards, we have sometimes used that power. We have sometimes been more risk-averse in worrying, particularly about solvency, than some other member states in continental Europe. In terms of the power coming back to us, some of the power was already here, because we could always do more than that standard. The choice will be whether we wish to do less, and generally speaking there is relatively little appetite for doing much less. You might do less in a few small areas. That would be my impression.

The Chair: Do you think the direction of travel is for the EU and the UK to remain pretty well aligned?

Dr Franziska Arnold-Dwyer: There is a concept called regulatory equivalence, which is a principle of comity whereby basically you recognise that the regulation of another country is equally good or robust. For the UK to be given formal recognition of equivalence, one consideration for the direction of travel is that the more we diverge, the less likely it is that the EU will grant that equivalence status to the UK.

The Chair: Your view is that we are likely to remain roughly equivalent. I think James is saying that there is no real appetite for lightening the load of regulation.

Professor James Davey: It is because of the access that we wish to have to risks globally. The UK is not just the centre for UK risk. It is not just our motor insurance. We are a global centre, and a very large one, but if other nations are to allow their risks to be insured in London, they need to be confident that the insurer will pay its claims but also that it will respond appropriately to the demands made on it. Those have to be high enough to meet the standards required elsewhere.

The Chair: Will any other international regulators—the United States and Singapore, for instance—be diverging away from the UK? Will they have any influence on the UK? How do you see that relationship developing? You have explained the relationship with the EU, but how do you see the relationship developing with regulators in other major centres?

Professor James Davey: The point Franziska made was that international association is a meeting place where we would expect the UK regulators, the EU regulators now, Singapore, the US and others to come together. It is that forum that tends to mean that you get broadly similar, but not identical, approaches.

Dr Franziska Arnold-Dwyer: I do not know that much about the Singaporean regulatory system, but I know that in the US it happens at state level. You have different states doing different things and there may be some regulatory arbitrage, but overall it is a fairly homogenous system. Certainly at insurance level US insurers do not deal much globally, which is different from the London market, which has a reputation for being a global market specialising in complex and specialist risks.

Q16 Baroness Bowles of Berkhamsted: We have heard that it is important when assessing the UK's regulatory framework to distinguish between three things. The first is the content of policy. The second is the particular judgments made by regulators where they are given discretion to make them. The third is the speed and efficiency with which they implement their processes. Is that a fruitful framework with which to assess the regulatory framework and the overall policy, and what is your assessment, looking through each of the lenses of policy, judgments and efficiency, of the adequacy of the UK regulatory approach?

Dr Franziska Arnold-Dwyer: The differentiation between content of regulation and application only really comes to the fore for principle-based regulation. There is a theoretical distinction between rule-based regulation, which is very prescriptive and detailed and does not leave much room for discretion, and principle-based regulation, which is often contrasted with it, where you have a wider principle in the sense of a high-level rule that seeks to achieve a particular outcome but there is some discretion as to how you get there.

In that second category, the use of principle-based regulation, there is an amount of discretion: first, in how an insurance company would interpret it to achieve a particular outcome; and, secondly, in how the regulator applies it. There is a trade-off. Principle-based regulation is good, because it gives discretion and more flexibility and allows for proportional application. The downside, of course, is that it creates legal uncertainty, and there may be a sense that, if there is too much discretion, the way a regulator chooses to apply it could be not what insurance companies expect or want.

As for the current system, it is a mix of rules-based and principles-based. There are some very prescriptive rules, as you can see for example in the FCA Handbook, *Insurance: Conduct of Business Sourcebook*—the ICOBS—on the product information that insurers have to provide to customers, especially consumers, before a contract is made. It is an incredibly detailed list of particular pieces of information.

On the principle-based side, you have very broad principles of business. For example, a firm must maintain adequate financial resources. That is quite a wide principle that would then be supplemented with detailed rules to do with technical provisions and solvency capital requirements.

As for enforcement, again the regulatory framework we have has very detailed rules on enforcement, in *The Enforcement Guide*, and there are principles that are relevant and should be guidance for the regulators on how they are enforcing. I cannot speak to specific examples of enforcement gone bad or gone well. There is an appeal process on decisions taken by the regulator, which is via the Upper Tribunal, which is a specialist court. I have looked at the case lists and the decisions over the last few years, and I noticed that there were quite a few appeal decisions against the FCA but none against the PRA or the Bank of England.

Professor James Davey: I think the three criteria are useful. Sometimes you might also want to think about other circumstances. Where we think about making policy and then implementing it, regulators are also, like industry and politicians, subject to circumstance. A substantial number of issues arise for regulation that were not planned for, which land at the feet of the regulator and for which they suddenly have to produce a response.

That tends to pull resource from other planned areas, which is true in almost all organisations. Covid is one example. In the loyalty penalty super-complaint that was brought by Which?, Which? suggested that for financial services generally, although not just financial services, there was a penalty to be paid by being a loyal customer and staying with it. The regulator had almost no indication, very little warning, that that was coming. It landed on their desk, and the FCA became one of the lead point responders across both government and regulators generally. Suddenly it had to become expert in this area and to produce a report on outcomes.

We should also recognise that regulators cannot just plan five years ahead: "This is what we are going to be doing". Sometimes, when it comes to their speed and efficiency, there is, "Well, here are the other things we had to do and we could not plan for them". So that needs to be taken into account.

Baroness Bowles of Berkhamsted: I was hoping you might tell us in each category how well we were doing on responsiveness. I was also thinking about where it is necessary for there to be a permission forthcoming. In an intensively regulated industry, there are lots of approved persons. How quickly do those approvals—approvals of new business and that kind of thing—happen, or are you kept hanging around? How speedily are we doing there?

I would also like to pick up on James's final point about loyalty. If we go back to the financial crisis, one of the criticisms—I remember making it in quite a lot of very public forums—was that the regulators appeared to

have their eyes closed about interest rates and what was going on in the products that were being offered. If they did not understand that there was an issue over loyalty, is that not another example of the regulators having their eyes closed? I certainly had made the point to the FCA, although maybe not to exactly the right people. There were plenty of mutterings going on before Which? came forward with its strong challenge and the CMA stepped in as well. Is that not a blot that they did not see it coming?

Dr Franziska Arnold-Dwyer: Are you asking about the existing expertise within the regulators?

Baroness Bowles of Berkhamsted: I am asking about the responsiveness of the regulators and whether they have their eyes open to the real world, or whether they just have tunnel vision on their rules without looking wider to the real world.

Dr Franziska Arnold-Dwyer: A very good example of where the FCA was incredibly proactive and reacted quickly was in relation to the pandemic insurance business interruption claims that were being rejected initially. The FCA stepped in and said that they should be looked at together, which resulted in the FCA test case and ultimately a positive outcome, first, for the insureds, but it also saved the insurance industry a lot of time and money in litigation because there was a test case for the industry. This is a positive example.

Baroness Bowles of Berkhamsted: I would have thought it was a very negative example if it had not done it, to be honest. They were slower over the longer-running, less high-profile issue of penalising loyal customers. How about the responsiveness over things such as approving personnel and new business models? How long does it take? Is that holding up? We have lost out to Singapore on some of these issues and business has gone there.

Dr Franziska Arnold-Dwyer: I know there is an issue in relation to insurance linked securities to set up ISPVs. They are the transformer vehicle you need to transform insurance risk into the capital markets. My understanding is that it can be quite a lengthy process in the UK. The application form that needs to be submitted to set up this vehicle is 21 pages of questions and document requests. I understand that even once you have made this application, the regulator will follow up on various documents and various pieces of information, which takes a long time. This contrasts with other jurisdictions that are much more agile.

The other point of reference is how this compares to placing insurance and reinsurance in the traditional markets, where even enormously big risks can be placed with traditional reinsurance within days and you do not need regulatory approval for a transaction if the entities are already authorised. I agree that there is a problem with responsiveness, speed and effectiveness on this.

Professor James Davey: To return to the question on the pricing issue, I was doing some research in the area at the time and I was asked to pitch my views of the legal position to the FCA. One of its difficulties at the time of the Which? super-complaint, and even slightly before, was that there was nothing in its ICOBS that described how it would control price in an insurance market. Price was assumed to be something that could be left to the market, because we were all assumed to be effective consumers and able to determine the appropriate price for what we wished to purchase. One of the difficulties is that it had not developed a position. It was not that it had the position.

You ask why it did not see this coming. We might ask whether the insurance industry and other similar industries should have to disclose, rather like with the tax authorities trying to get ahead of the next tax loophole, that they are going to try this new technique because they think it will make consumers more profitable. We do not require that. That would be required in America.

You would have to go with your rates and your policy, and you would have to get pre-approval. We could do that, but most people in this country are not arguing for a US-style, very invasive regulatory system. We largely say, "Here are the rules and there are principles, and you keep to them". The FCA now thinks that it can show—and we have a new duty—that what the insurers were doing was outside the rules. Being just outside the rules, that is what we should expect.

There is an element here of gaming of rules, which is why we tend to have principles-based regulation, which says, "You should be achieving these kinds of objectives for your customers". The more we go to the advanced setting of rules, the more we can expect businesses to try to operate just within the rules or just the other side so that you cannot detect it. It is a normal reaction within markets; people play at the margins.

Dr Franziska Arnold-Dwyer: I would add that there are powers within the regulatory framework that allow the regulator to self-intervene—the product intervention rules. The powers are already there, but I take the point of your question, which is whether they are always exercised or spotted with the expediency you would expect.

Q17 **Lord Allen of Kensington:** Good morning. I am very keen to understand what improvements you think could be made to the current regulatory process. We have heard some positive things from witnesses who say that the UK system is fair and is basically robust. The point you are making, James, is that it can deal with significant complexities. Those are the positives.

On the negative side, we have heard a lot about it being bureaucratic and very slow, and some of that is not just inefficiency or lack of resource but is basically processes they have deliberately put in place to slow things down. I am keen to understand practical things to do. What would we stop doing? What would we start doing? What could we do more or less

of to make us more competitive? As you have heard from other colleagues, the concern is that others, whether it is Bermuda or Singapore, may be getting ahead of us in that marketplace. We may not want to go to the American model, but is there something we can do to make it more efficient?

Dr Franziska Arnold-Dwyer: On the substantive side, on rules content, I understand from the recent call for evidence on Solvency II from the Treasury is that most respondents said Solvency II is more or less a good system and should be retained, and that the costs of disruption or replacing it is not worth it but a number of tweaks are needed.

One of the two most important suggested substantive changes that have been put forward is to the risk margin, which is an additional slice of buffer capital that insurance companies need to retain to make sure that they always have enough funds to deal with all the claims and the liabilities they might encounter. The other major point is the flexibility in the system, the methodologies for calculating these solvency capital requirements.

These are fair points. The risk margin point is of more concern to life insurers, because they have the longer-term exposure, and any fluctuation in the value of assets and interest rates affects them more than general insurers.

I think those are valid points. I also think that improvements could be made to facilitate innovation. You may have heard already that there is a system in place called the regulatory sandbox, which allows not just insurers but actors in the financial services industry more generally to test out a product in controlled circumstances and to make adjustments to it before they bring it to market. Perhaps that scheme could be extended to make it more widely available. It has been particularly successful in the Fintech space, but it could be used much more widely.

I also know that one of the big points under discussion is regulatory remit and whether one of the objectives of the regulator should be to achieve market competitiveness. We will probably talk about this in more detail later on. Again, there are already some points in the existing system that go in this direction.

On the process side, I do not think that the regulator is difficult or slow on purpose. As far as I could comment on it, maybe it is a matter of resourcing, and if the FCA and the PRA had bigger teams, perhaps they could turn things around more quickly. Maybe they could employ more specialists with technical expertise.

Lord Allen of Kensington: Why do they not do it? The industry pays for it, so I do not understand what is stopping that. It seems pretty obvious that if you need more resource, you up your fees to the companies and you have more resource. Can you touch on that, because we have heard it a couple of times?

Dr Franziska Arnold-Dwyer: If the industry was prepared to pay a higher levy to finance better resourcing, maybe that would be a way of improving processes.

Lord Allen of Kensington: They do not have a choice, do they? Do they have a choice?

Professor James Davey: The insurance industry is phenomenally successful in having its voice heard, through a variety of ABI, LMA or whatever else. The idea that it would not seek to influence those who would be involved in setting that figure seems farcical. There will be significant pressure to keep cost down. I am not saying that is inappropriate, but I also recognise that if you want financial services experts in London, that is a highly competitive market to hire and retain those staff in against a very successful private market sector. I think that is realistic.

Lord Allen of Kensington: Are there market improvements that you could think of from a regulatory perspective?

Professor James Davey: If you look globally at conversations about what we should do, the London market is one of the places where people start. The sandbox, the use of a test case, started here. America is desperately in need of a test case process, whether at a state or a federal level. They are absolutely burning money in litigation costs, because it is all dealt with individually. Even the fact-finding part of that litigation is incredibly expensive. We were able to shortcut that entirely.

It is slightly unfair to say that if the regulator gets it right, well, they should be expected to. They should be applauded for this. It was not just them that set up the test case. That was also the legal industry. I think that has worked extremely well. We have had a relatively small cost. The FCA was also able to say, "We don't think you have a claim here, so if you had standard business interruption insurance, we don't think you're covered".

That carried a great deal of weight and it has not been tested in court. That seems to have closed down lots of litigation. If you have the special disease or another kind of government intervention, that gets tested. We got to the Supreme Court in almost record time. We must say that was quick, effective and very cost-effective. We have not had suggestions that consumers were not well-served. We have not heard big complaints from the industry that money was spent unnecessarily on lawyers.

What could we do better? We must recognise that we have chosen to make the process relatively slow. Here, I am talking about the development of interventions. I do not have the experience of authorisations and approvals. From the outside, as an academic, it is very hard to observe that. That is a question for the regulator.

On their development of policy, I have had some concerns post Grenfell about business insurance and the large apartment blocks. It is not really

a private risk, because you sometimes have 100 people together and it gets towards something of a commercial-size risk. The FCA tweeted the other day, "We have written a dear CEO letter". This is pretty light touch regulation. It is a letter out to their CEOs to say, "We have a worry here. You should have a look internally". That is the kind of light touch that a regulator could do.

What is the next step? They will have an evidence-gathering session. They will talk to the insurers concerned, they will talk to some experts, they will start to get evidence together, there will be a proposal. A three-month gap between each of these things is baked into the system, and that is not designed by the FCA; that is in the primary and secondary legislation that set them up, and it is to allow for those consultations.

We could be much quicker, but it would mean that there would be much less time for consultation. The industry may say, "We can live with a month", and if the FCA is sufficiently resourced, maybe they could get quicker responses out, but some of the delay is baked in deliberately to make sure that no one misses the chance to be consulted.

Lord Allen of Kensington: You have touched on innovation. How proactive is the regulator on horizon scanning? I was taken by your example of loyalty or buildings or whatever, and there are a number of things there that seem quite obvious to a lay person that we might want to look at. How proactive are they in trying to get ahead of the game?

Dr Franziska Arnold-Dwyer: One recent example of proactiveness perhaps is cyber risk. Fairly early on, the regulator asked the insurance industry to review their policy wording to see whether it covered cyber risk silently—ie it was baked into their policy in more general terms—so the risk was that they could find themselves liable to cyber risk unexpectedly. Another example of where the UK regulators have been forward looking is on climate risk. Again, fairly early on, the UK regulators were concerned with insurance companies trying to figure out what financial risk climate change poses to their own balance sheet and to consider that in their exposure and processes and to start managing these risks.

Q18 **Baroness Donaghy:** Good morning. I want to ask about proportionality. I imagine that it is a mixture of the nature of the firm, the nature of its activities and the risks they pose, or some combination of all those factors. Could you say a bit more about that? Franziska, you talked earlier about the balance between flexibility and uncertainty, and that there is a trade-off. There are comments that some demands are too high for the new product of maybe a smaller company without the background that is known.

Dr Franziska Arnold-Dwyer: Proportionality is the concept that the means should be proportionate to the end. This has already been expressed in different ways in the regulatory system. Under the Financial Services and Markets Act 2000, for example, which is a key piece of legislation in financial services regulation, the regulator is required to

take into account the principle that the burden or restriction that is imposed on a person or on the carrying on of an activity should be proportionate to the benefits, considered in general terms, that are expected to result from the imposition of that burden or restrictions. This is a test that looks at the burden versus the benefit to be achieved. In the Solvency II Directive, which has been incorporated into UK law, the proportionality test is to look at the nature, scale and complexity of the risk that an insurance company poses, so proportionality is already built into the current system.

To give you some practical examples of this, there is an exemption from authorisation for very small insurers, but the thresholds are so low that it hardly ever applies. Of course, we also have the special authorisation regime for ISPVs, the insurance special purpose vehicles. There is also proportionality in the ongoing supervision of insurance companies, and in that ongoing supervision process, the factors that are relevant are the size of the firm, the types of the business advice, and the risk it poses to consumers and the financial system as a whole.

Again, there are examples in the current system, so for ICOBS—the FCA Handbook, *Insurance: Conduct of Business Sourcebook*—none of the provisions that have to do with how you promote a product, what information you must give to the customer and how claims are being paid applies to reinsurance companies. Even within that part of ICOBS, different rules apply to different types of insurance companies—for example, there is a distinction between consumer insurance and business insurance; and there are distinctions between general insurance contracts, such as your motor insurance and home insurance, and long-term life products. Again, the system is already making distinctions.

On the solvency capital requirement side, the rules relating to the capital requirements of insurance companies are risk-based, so they will by definition be particular and specific to an insurance company and the business it does. The insurance company also has a choice between using the standard formula for calculating capital requirements or coming up with its own internal model, which is shaped to its own circumstances, so there is already proportionality in the system.

Baroness Donaghy: You mentioned Solvency II. It is said that the regulators chose not to utilise the option of exercising proportionality. However, what you just said would not agree with that statement. How do you think the regulators interpreted this?

Dr Franziska Arnold-Dwyer: I would disagree with stating so categorically that there is no proportionality in Solvency II.

Professor James Davey: Can I take an example? If we are thinking about this as a cost-benefit analysis and we are saying that the cost must reflect the potential benefits, one of the things we sometimes find is that people are measuring different things. If we think about solvency, there are two possible outcomes that you might think are acceptable. You might run a lower level of solvency so that you expect insurance

companies to fail, but that will be relatively infrequent, only the customers of that insurer will be affected, and you would not get a run through the market, so you would not expect a contagion issue.

That does not happen very much in insurance, but you would not get a significant loss of confidence in the market. Some people would say that is an acceptable outcome, and there would be others who would say, "No, we want a system in which, if an insurer fails, it will fail by slowly going out of business, but it will meet all its obligations". It will not be able to continue trading, but it will not leave behind a large unpaid series of claims.

Those are two different legitimate outcomes, and there is a political choice between those two. Even before Solvency II, my understanding is that we took a fairly risk-averse approach as a country. We were not looking to have the lowest possible levels of capital permitted. We were saying that we do not want insurers to fail. We have had insurer failures and we thought it harmed our reputation; it did us long-term economic harm, so the costs were worth it because of our long-term reputational basis. That is what we are doing here that some other European countries are not doing. We are looking to sell insurance globally, so it is about protecting global reputation in that respect. Sometimes that means that we do not operate quite as close to the margins as some other countries that are just looking at a domestic reputation may do.

Baroness Donaghy: Do you think that, on balance, that conservative approach has an attractiveness, in that we are a reliable ecosystem, or do you think that the margin of risk averse is on the wrong side of that balance?

Professor James Davey: My impression is that we probably have it just about right. That means that if you are trying to be cautious, you will have passed up other opportunities but you will have sought to avoid a catastrophic loss or failure in the market. I would say that on balance we have that probably just about right, but that may reflect my own vision of how we should seek to sell ourselves in the world. There are legitimate arguments to say that we could have taken a riskier position, but they are not ones that I would adopt.

Q19 **Lord Cromwell:** Good morning to you both. We have touched on innovation and I would like to ask a bit more about that, in particular whether the regulators or the regulation welcome and encourage innovation in our system, or discourage it. We have heard both sides of that argument. For example, we have been told that in respect of the captives and the creation of the insurance and securities market, which Franziska touched on earlier, the regulators have been obstacles rather than facilitators.

Is that a fair assessment and, if so, why? Is it a cultural thing? Is it the regulation? Please feel free to draw on other examples, positive and negative. It is about the extent to which innovation is welcomed and encouraged within our system, because that will determine our ability to

remain competitive and, frankly, not to have other jurisdictions eat our lunch.

Dr Franziska Arnold-Dwyer: I think the London market is starting from a strong position in innovation. It has long had a reputation for being innovative and being capable of dealing with risk, especially complex and specialist risks. We have already mentioned the regulatory sandbox, which was first introduced by the UK regulator and has now been copied all over the world. There are quite detailed and technical rules even for standard products requiring insurance companies to do their own testing before offering a new product to market, to look at what the potential customer base would be and how it would play out and so on. These rules are in the FCA Handbook and in the part on Product Regulations.

When I read through them before this meeting, I thought that there were quite onerous rules for standard products. We have them, because for insurance they are reinforced by, and to some extent derived from, the Insurance Distribution Directive, which is an EU instrument. Also, on innovation, there are thriving captives markets in other jurisdictions for reasons that are not solely and necessarily related to regulation, but for historic reasons and because of local market conditions. For example, the Bermuda captives market was largely a product of risk overspill from the United States. Of course, there are all sorts of tax reasons and general operational costs of setting up a business, employment costs and so on.

Overall, I would like to pinpoint the precise obstacles a bit more, apart from the insurance linked securities example, which the industry sees and what changes they have in mind.

Lord Cromwell: Partly you have the industry saying that it takes for ever to get things approved, you cannot get decisions and it has to go so far up the food chain, and they contrast that with other jurisdictions. There is the thing about maintaining a robust reputation, which I agree is very important, but equally there is a cultural approach as to whether innovators are welcomed or whether it is a very risk-averse culture that encourages them, frankly, to go elsewhere.

I am trying to tease out that, on the one hand, of course the industry would say that; approvals will never be fast enough. On the other hand, if it is to the extent that people say, "This is just not worth trying"—.

I am trying to get a flavour of where we are with that, and whether it is the regulation or the regulator that is the problem.

Dr Franziska Arnold-Dwyer: Coming back to Bermuda, the Bermuda regulator has a two-tier system. They have one strict regulatory system that is for normal commercial insurance and reinsurance, and a separate track for captives, which has a much lower level of regulation. The commercial side, the more highly regulated side, has equivalent status with the European Union, so that regulation is regarded as equally robust and as good a system as we have here at the moment, whereas the captives side is more lightly regulated and has no equivalent status.

Captives are very different; they often only have one customer, and if the captive fails, the knock-on effect is relatively small. In Bermuda you have these two very distinct markets of sufficient size.

Thinking about tiered regulation, in the UK, one of the issues is that many insurance companies operate as group structures, and authorisations and supervision and the capital requirements are done on a group structure. It would require more work and more regulatory effort to split all this out and have it done separately for different business streams or for different subsidiaries within that group of companies.

Professor James Davey: On your question about innovation, the regulator has been fairly proactive in seeking what it describes as regtech, so like fintech in how you make insurance technologically driven. It has this vision of how as a regulator it can use big data and whatever else to highlight issues in the market. We heard some questions earlier about whether it was working with its eyes closed. It has been talking quite a lot about how we can use data in real time to see issues emerging within the market.

I think its culture is reasonably in favour of the use of those kinds of innovatory techniques, because it seeks to adopt them itself. Maybe there is a bit of pathway dependence here. We set up the sandbox and were seen as fabulous for having done that, but maybe there is an expectation that if you are an innovator you sit in the sandbox for a while and that is where you write up your application. That gives you the time, but it also gets you the time to get support from markets; you might want to attract further capital and you can do a proof of concept within that. Is there an expectation that innovators sit in the sandbox first and then come to market that way? That is possible. But in some ways maybe we have become a victim of our own success. We think the sandbox is the way to market rather than coming immediately to market, and maybe that is why it looks slower if you just want to come straight to market. That is possible.

Thinking about the captives, I do not think there is a clear definition of captive that we all agree on. We may wonder whether the UK has any captives. We have still a fairly substantial role in protection indemnity clubs, which are in the marine insurance market. Ship owners will come together, there is a large fund that they use for the kinds of risks that they do not use commercial insurers for. They are not all still mutuals now, but certainly they were and some still remain as mutuals.

Those are captives, because they are representing an industry. Do they work within the UK system? Yes. Why are they here? Because they were here in the 19th century and they have stayed. Insurers tend not to move very much for minor advantage. Moving from one regulatory system to another is very expensive, and I think Brexit has shown that. Uprooting a lot of assets from the UK and into Brussels and other places has been incredibly costly. Your point is absolutely right. It is tax and other things, or big differences in regulatory systems. Probably small differences do not steer those kinds of decisions.

Lord Cromwell: That is really interesting, and anyway the world will possibly become more uniform in how it regulates these things, rather than less. To my colleague's question, is it a matter of resources, or is it a matter of culture, that we hear a lot of complaint about how slow and treacly the whole process is?

Professor James Davey: It is not as quick as people would like—they would like to have forms with nothing to fill out or to be very quick—but some of it is probably necessary, because these authorisations are significant; they give you the power to operate within what was until recently, because of passporting, the whole of the EU. Maybe that culture has not quite changed yet. Maybe we have not quite adapted to "This is the jurisdiction that we are giving you permission for", rather than necessarily anything wider than that. Wait and see. I do not know, but these are probably questions you will have to put to the regulator and its internal processes. It is not what we are seeing in the literature.

Dr Franziska Arnold-Dwyer: I would add that there is a trade-off between transparency and agility. The regulatory processes, especially with authorisation, are very transparent. There is an application form for everything, and once you have the form, if you are the person at the FCA or the PRA responsible for looking at the application, you have to go through the form and tick off the boxes. That may look like it is a slow process and perhaps a bit bureaucratic, but it means that every new entrant has the same process and there is an equal chance for everyone. So there is a trade-off between having these very regulated processes and perhaps just slowing matters down in some instances.

Q20 **Lord Blackwell:** You both paint a fairly benign picture of UK regulation and the interpretation of regulations. You think that the regulator has it broadly right and that Solvency II is being interpreted sensibly. That does not match what we are hearing from those being regulated in the London market, who have told us that there is a tendency for a one-size-fits-all approach by the regulators that is inappropriate and constraining for this very specialist market with very sophisticated players and customers who may not need the same level of consumer protection or risk management that may be needed in other areas of the insurance sector.

I want to push you a bit on reinsurance. Franziska explained why historically there had not been a Munich Re or a Swiss Re in the UK, but it is still true that there are not any pure reinsurers in the UK market. We have been told that that is in part because the regulations here do not differentiate between a reinsurer and the requirements they might have in other insurance. Is there any merit in that argument?

Dr Franziska Arnold-Dwyer: First, perhaps I should say that there are very few pure reinsurers in the world. Even Swiss Re and Munich Re are huge conglomerates that have a reinsurance business and insurance business, so they will be mixed. I do not know whether James would like to comment, but two examples given in the question were Flood Re and Pool Re. They are not the traditional reinsurers that you would expect. In the UK, the reinsurance landscape consists of companies in the

companies markets, some of which are subsidiaries of groups that have their headquarters outside the UK, and reinsurers in the Lloyds market.

Is there a case for differentiating the level or intensity of regulation between direct insurance and reinsurance? The argument is, of course, that reinsurance is insurance for grown-ups. It is insurance between two market players that are roughly of equal bargaining power, sophisticated and so on, so they do not need all these extra protections. The counterargument is that if you look at it systemically, at the security and the solvency of a reinsurance company, you would say that it is very important that they are equally well-regulated in terms of capital adequacy, because there will be a direct consequence of a reinsurance company failing to pay a big claim to an insurance company as that will have a direct effect on that insurance company possibly not being able to pay claims or having financial difficulties vis-à-vis its direct customers, consumers and businesses.

It is absolutely right that, at the conduct of business level, that insurance and reinsurance do not need the same protection, and this is already recognised in the regulations, so the FCA ICOBS part of the Handbook does not apply to reinsurance. On the capital adequacy and on the solvency side, they are the same rules but, as I said earlier, in each case the application of the formula is tailored to a specific business and of the risk it assumes, the risk it transfers and the various operational market risks it faces.

Lord Blackwell: Do you think the regulator has this right?

Dr Franziska Arnold-Dwyer: By and large, yes.

Professor James Davey: The last great insurance financial crisis, Lloyds and the LMX spiral, was reinsurers and retrocession, so it was not because of the failure; it was because of the inadvertent concentration. We had risks coming into the market and getting paid. It had not been sufficiently appreciated that it was essentially all the reinsurers looking to each other to meet these claims, and you ended up with a concentration of large losses within the market insufficiently spread across assets.

That was the 1980s. For some people, that is ancient history, but insurance regulation changes fairly slowly. It was a significant part of our economic memory that we almost lost our market at that moment. It is the closest we have come, I think, to losing international reputation and to very serious problems. Reinsurance is systemically significant in this way.

Lord Blackwell: Anyone can understand on the solvency side. It is what it is like for business.

Professor James Davey: You say that it is insurance for grown-ups. There is an assumption at the high level that the reinsurance contracts are well drafted, are sharp, and everyone knows what they are doing. Historically, that has certainly not been the case. My understanding is

that getting the wording to be tight is improving, but from a fairly low base.

The problem is often matching a Spanish, Colombian or whatever insurance contract to reinsurance cover in London. The idea is that they should both trigger perfectly in sync. That has not always worked very well. There have been circumstances in which the courts have felt obliged to say, "This is a bit of a mess. We'll have to try to make the contracts work together". The regulation has also been a response to that. If you are a large insurer in Colombia or Spain and you do not get paid, you might say "Fine", but I do not think that is good for our market reputation.

Lord Blackwell: Franziska mentioned on captives that Bermuda has a dual track. Captives are different; there is not the same systematic risk, because they are within a single customer. Is there any reason why the UK regulator could not have a similar dual track to treat captives differently?

Professor James Davey: There are two things, and again the definition of captives is a bit flabby here, because there are captives that work across several industry players, not just one customer. You could imagine a circumstance in which you have a P&I club with maybe 100 ship owners and they come together, so we need to be very careful about saying, "Is it only a single captive for a single entity?"

Could we be different? Yes. Then the question is: what is the relative regulatory cost of having a two-tier system? If it is going to be an entirely separate entity, it falls under that system. What if it is part of a wider system? Those, as ever, are questions of regulation. Is there a benefit? If so, we should do it. People often assume that a second tier will necessarily generate regulatory savings. I would want to see that shown.

Dr Franziska Arnold-Dwyer: If the committee is interested in more detail on the Bermuda regulatory system, I refer you to O'Neill and Woloniecki's *The Law of Reinsurance in England and Bermuda*, which has a very good chapter on this. I can leave a copy, if you wish.

Lord Blackwell: I am sure you both act as consultants outside your academic work. Do you never get large insurance companies or reinsurers coming to you with issues about the regulation that you have to deal with?

Dr Franziska Arnold-Dwyer: When I was a practising lawyer I had that kind of query, but as an academic, no.

Professor James Davey: I have undertaken some consultancy. It tends to be more on the litigation side, so that tends to be when insurers approach you to say, "Here's a piece of litigation and we'd like some advice". We obviously also speak to people in the market quite often.

My impression, certainly as a watcher of the market, is that there are several phases. When regulation is being drafted, "It's terrible, it's

impossible, we can't live with it, Chicken Licken, end of the world, couldn't possibly work under this system". The day it gets launched, "We welcome these. We've always wanted something like this". The lobbying game is also part of massaging regulation to the way that fits industry. But I do not criticise them for that. That is what they are supposed to do. I think the costs are often overstated.

Dr Franziska Arnold-Dwyer: Coming back to the regulatory intensity, we do not have many pure reinsurers. They tend to be part of bigger groups, and a lot of the ongoing supervision in terms of submitting reports and data to the regulator will be at group level, so that is information that they would have to provide in any event. It is not specific to the reinsurance entity.

Professor James Davey: Can I just add one point, because it is important, given the questions? We were asked about Flood Re and Pool Re as reinsurers. They are in no way market-generated reinsurers. They are statutory interventions designed to stop market rates. They are vehicles by which we subsidise reinsurance as a way of subsidising primary insurance. They are statutory vehicles for us not paying appropriate market rates for our flood or domestic terrorism property risks. I am not sure that it is appropriate to reference them here.

The Chair: After Franziska's brief commercial break, could we come to Lord Grade?

Q21 **Lord Grade of Yarmouth:** I have been surprised at the measured support for the regulatory regime. If you look internationally, all the growth is in Singapore, Bermuda and one or two other markets, and the London market is absolutely flat. The regulator has presided over this. This is the beginning of a decline in the London market if you extrapolate that forward. Do you think that is fair? If it is fair, do you think that Brexit provides an opportunity for us to introduce regulatory changes that are more attractive to the market and that will get our share of the market growing?

Dr Franziska Arnold-Dwyer: In the reinsurance space, what has been noticeable is the growth of Asian companies—Korea and China. I think this has meant that market share has shifted and has been reallocated to some extent.

I heard in the evidence given here last week that the reinsurance market share has shrunk by a very small amount. I do not have any direct knowledge on this. I would query, however, whether that is a result of other companies coming to prominence rather than the direct effect of the regulatory regime in the UK.

Lord Grade of Yarmouth: Do you see any opportunities in the post-Brexit world to make the London market the most attractive?

Dr Franziska Arnold-Dwyer: Yes and no. Making our regulatory system more attractive and making it easier for new entrants, for companies that set up business here, would obviously help. On the other hand, if our

regulatory regime is going to diverge from the existing EU regime to the degree that we will not be given equivalent status, this could also negatively impact the attractiveness of UK reinsurers, because then, in the eyes of EIOPA and the domestic regulators and EU member states, they might give less weight to reinsurance from the UK as a credit risk mitigant, as a component that allows local insurance companies to reduce their capital requirements because they have mitigated their risk by obtaining reinsurance.

Reinsurance is one of the key parts of the equivalence regime. Why is that? The rationale behind it is that if you are dealing with a reinsurance company from a jurisdiction that does not have equivalent status, then, in the methodology, the formula, for calculating capital requirements, the counterparty risk is deemed to be bigger so less credit can be given.

Lord Grade of Yarmouth: James, do you see any evidence of the regulatory regime in the UK having a concern about our international market share? If not, should they be concerned and should they have a statutory responsibility to look beyond the domestic market?

Professor James Davey: If we look at the UK's statutory duties—these are obviously baked in, so we would need primary legislation to change these—competitiveness is there. Competitiveness, as I read them, is the primary one; you achieve competitiveness if it is not inconsistent with the integrity of the market and protection of consumers. They seem to be given equal ranking in the introduction, but competitiveness seems to be the top one in the statutory framework. However, it is competitiveness for the consumer. The assumption is that a competitive market generates innovation, that it will generate lower prices, that that is the effect of competition.

What I do not think is there, and I can understand from the FCA's perspective why it probably should not be there, is any sense of us needing to get UK plc to do better in that international market. The FCA is there, as a regulator, to think about the extent to which the customer has less power in the negotiation. That is its primary task. It is what it has been told to do. I do not think we can criticise it for what it has done, because it has been following the lead set by Parliament.

If you ask whether it should then make us more attractive, in the wider sense of making us more attractive internationally, I would want to know how you would rank that alongside the others. Again, this comes back to our risk appetite. I take the view that we have a well-established, long-standing market that has taken us a very long time to build and which we could lose fairly quickly with one or two large failures. How you behave if you are a market leader is different from how you behave if you are some little, light, agile start-up where, if you try and fail, no one will notice.

Do we tend to reflect our sense as one of the big players in the market? Does it make us a little slower, a bit more conservative? Yes. But risking all or going all-in, if you are the market player, is not a particularly effective way of looking at where we are going to be in 100 years.

How do we transition to fintech? We have used the sandbox, we have tried to get the kind of world where, "You can come in and play, and when you've shown that you're safe we'll let you go loose". I think we have had a bigger market to gamble with, so we have been more cautious. That is probably what I would want both government and governance more widely to do if you are a market leader.

Q22 Lord Burns: It has been pointed out to us that, compared to other regulated sectors, the financial services sector rarely applies for judicial review of regulatory decisions. I would like to test you on whether this is because the alternative arrangements with the Upper Tribunal and so on work very well, or whether it indicates that it is just too difficult to challenge the regulators because there is too much at stake to fall out with the regulators.

I have been on both sides of this fence at different stages in my life, and it is a noticeable feature in many other regulated markets that judicial review is almost the first weapon that is called for when there is a problem. That has turned out not to be the case with financial services regulation, although I recall, when I was involved with that back in 2000, that it was set up in a way to try to avoid that nuclear weapon being used.

Dr Franziska Arnold-Dwyer: There are probably a number of reasons why we do not hear about many JR cases against the regulator. One is that many of the rules are principles-based, and we have these statutory objectives for both the PRA and the FCA, which are very widely phrased. From a purely technical perspective, it would be very hard to pin down whether the regulator acted outside its powers because it has very wide powers.

Secondly, the regulatory processes which the regulation provides for in the FCA Handbook and the PRA Rule Book are quite detailed and—not quite consensual—but there are lots of opportunities for different parties and stakeholders to make representations before the ultimate enforcement notice to come into effect. Then we have the Upper Tribunal, which will be the first place to go if the decision is to be appealed. So you would not go directly to having a decision judicially reviewed.

Another important structural point to understand here is that the authorised person, the insurance company, is under a duty to co-operate, to provide information and to be helpful. That sets the tone. You know that you have a continuing relationship with the regulator, and you want to make it work. Having this duty, which continues even if you have an argument with them, makes it very difficult to take an adversarial position and say, "I'm going to have it judicially reviewed".

Professor James Davey: First, there have been some successful JR cases against other parts of the ecosystem. The Financial Ombudsman Service, for example, took a view on its jurisdiction, which was successfully challenged, and there are other kinds of technical issues that have arisen around it. So I think it has been used.

I do not get the impression that there has been the issue of what you might think of as reputational cost—"If I take you to a JR, will you regulate me more strictly or something in the future?"—mostly because I do not think there is much heat in that relationship. It has been described as a regulatory conversation. If you are a big insurer, you talk to the FCA fairly often as part of the duties of co-operation, but also because it is doing things in your space.

Lord Burns: I think it is called closely continuous, is it not?

Professor James Davey: I do not think that if we had a dispute over a technical judicial review point, either a win or a loss would make a difference, in the same way that I think the test case was seen as, "We recognise this, as there is an uncertainty here that needs to be tested". As long as it was an arguable JR case rather than simply an obstructive one, I would not see that changing the relationship.

I take Franziska's point that the slow deliberative nature of the process where everything is three months makes it quite hard to show that you did not follow a proper process of deliberation.

Dr Franziska Arnold-Dwyer: Sometimes there is a sense that, once there has been a breach or non-compliance by an authorised person, it is often a case of just limiting the reputational damage, and you just go ahead, pay the fine quietly, put a stop to it and that is it, rather than making it worse by taking it to the next level.

Q23 **Lord Reay:** I would like to talk about accountability of the regulator post Brexit. How accountable are the regulators for their activities, and how could scrutiny of their activity and their accountability be improved now that they are gaining more powers?

Professor James Davey: We probably have a standard expectation of regulators in this field in that there is normally some oversight by a government department, as I understand it, and here we would be looking at the Treasury. You obviously have that relationship. That is often a two-way conversation about priorities and about issues that have arisen, but also maybe about some opportunity to influence the severity, the level, of intervention. There is a kind of tighten up, ease off a little bit that operates through that process. As I understand, they will also give evidence to this committee and others fairly regularly. So there are those kinds of reporting processes.

We would normally expect regulators to be operationally independent, and what matters when it comes to having an internationally reputable process is for it to be sufficiently separated from immediate political influence—so certainly on an individual decision-making basis.

Certainly with the FSA/FCA, we have seen the appointment of senior figures maybe thought not to quite match the prevailing mood and then other figures coming in to replace them. There has been an accountability, but probably more about who is leading the organisation. That is probably what we would expect with regulators, and not the

down-in-the-weeds “What are we going to do on this particular dispute?” and certainly not when we get to a particular application to a particular insurer. That needs to be absolutely arm’s length from government and probably from wider branches.

Lord Reay: You do not think there has been a lessening of accountability since Brexit.

Professor James Davey: I think there is an increase in power, so if you said that that might mean that we need to look again at accountability to reflect that, I would agree. But I do not think that they were out of line with what we would expect to see from a regulator with the powers that they had. I agree that as they get more powers, you would probably look to have a greater degree of accountability, but that is about transparency and accounting for the decisions rather than control. That is where I would separate it out. I still would not go into control. It is important that they be absolutely transparent and arm’s length.

Dr Franziska Arnold-Dwyer: Echoing what James said, accountability can be looked at in different ways. It can be ex-ante—which means that consents or having permission to take certain decisions are required in advance—here we have Parliament giving the regulators the powers to regulate within the objectives they have been give. Then we have ex-post accountability where you are basically required to report what you have done and, to some extent, to have your outcomes measured.

On that side, we have the regulators reporting to the committees of Parliament, and there is also some sense of output audit, because, as I understand it, the regulators have to report to the National Audit Office. This is not a substantive review of whether they have taken the right decisions. It is a review of whether what they are doing is effective and good value for money, basically.

There is also a lot of softer accountability, which is also enshrined in the statute, which is that the regulators have to follow consultation processes and to engage with stakeholders. There are three particular groups of stakeholders they have to consult in areas of policy-making: the FCA Practitioner Panel, the Smaller Business Practitioner Panel and the Consumer Panel. There is also soft accountability in the sense that the regulators issue reports—almost like annual reports—of what they have done.

As James said, post Brexit the regulator has more powers. There is not the EU level of scrutiny: “Have you implemented what we want correctly?” So I would agree that there is a case for reviewing whether there should be more formal processes of the regulator having to account. In the Treasury’s published Framework document, some of the suggestions are that the regulator should be reporting more regularly to committees in Parliament, but there should also be a more formal process of communications between the Treasury and any regulators.

There should be more scrutiny, but ultimately there must also be a sense of operational independence: the Treasury should not be saying to the regulator, "You must do this and you should not be doing that". There must be some kind of balance. The test proposed in that paper is whether it is in the 'public interest' for government to give directions. These public interest tests have been used in different contexts and for different areas of law. It would depend on how this public interest test was shaped. It should probably be tied to considering public interest in terms of the regulatory objectives.

These are views for discussion, but there should also be limits to accountability—let the regulators get on with their day-to-day business.

Q24 Lord Sharkey: I would like to come back to the issue of promoting the competitiveness of the UK. The Government are considering re-adding that objective to the list of regulators' objectives. I wonder whether there are any issues the industry has with regulators that would be addressed by the re-inclusion of this objective in the regulators' list.

Dr Franziska Arnold-Dwyer: I can only speculate here. I do not have any direct knowledge on this, but it is tied to the point that the regulators' approach to authorisation and supervision should be helpful in making things happen. If you had this regulatory objective of promoting growth, that would be the hook to tie it on to say, "Come on, speed up your processes, be more efficient and make it happen".

Professor James Davey: I will come back to the kind of duties that financial services regulation/insurance regulation tends to put on insurers. If we have to cut back, what are we losing?

The first thing a regulator tends to do when it sees an issue is, as I said, to send those "Dear CEO" letters: "This has come across our radar. We're a bit worried. We need to talk to you about it". If intervention takes place, the next step tends to be an information approach. There is a general assumption that we correct problems in the market by requiring insurers to explain better. I think there has been a sense that maybe that goes too far up the food chain. Consumers need it. Whether they use it is another matter. Small businesses almost certainly need it, and maybe medium-sized businesses too, but there will be large organisations for which the production of these documents and the delivery as part of the negotiation process perhaps is just an unnecessary burden.

The counterpoint is that it is probably not that expensive to do. That is one reason why we use information as a corrective in markets. We are not giving extra substantive rights. No one will get to sue on the basis of this. It is a regulatory request to provide some information. When you design your product, you should be able to explain what it does.

If we are going to talk about cutting back insurance regulation on the conduct of business side, there is not a lot there. It is fairly light touch. When we start to get into real enforcement, that tends to be the kind of

practice where we have real worries about whether there has been fairness in behaviour.

To give an example of an enforcement action that I spent some time looking at, an insurer came into the market that was not familiar with the UK market. They looked at the status—this is mobile phone insurance, so I know this is a consumer risk—and decided to use a nice innovative technique: “We’re going to use some software that looks to see how stressed you are when you report your claim to us, and if you sound a bit too stressed we think you are fraudulent and we will notify the IFR, the fraud register, whatever else”. The regulator found out about this and there was not enough scientific evidence to back up the use of this. It seemed to be massive overreporting of fraud, so there was a multi-million pound fine on the basis of that.

So the regulatory actions, the enforcement actions, involve a good amount of money, but in the US that would be a bad faith denial of insurance claim and you would be in court and there would be huge amounts of money. We trust our regulators rather than using enforceable private rights to steer market behaviour. When we say, “There is lots of regulation there”, there is lots of detail but it is fairly light touch. What it requires insurers to do is relatively at the gentle end. Even in the consumer market we are not currently proposing that there be an individual right of action for breach of the new consumer duty. It will be the regulators that do it.

Compared to other places, our costs are less and are generally at the lower end of the pool. We are in the shallow end mostly.

Lord Sharkey: I think you might be saying no.

Professor James Davey: There are things that we can do with the margins, but I do not see huge savings to be made.

Lord Sharkey: How do you assess competitiveness?

Dr Franziska Arnold-Dwyer: I am sure that lots of books have been written about this.

Lord Sharkey: Almost certainly.

Dr Franziska Arnold-Dwyer: How do you assess competitiveness? You would probably look at the ability and ease of doing business. You would look at statistics, the degree of competition within the industry, the ease for new entrants, how easy it is to commercialise innovation. But you would also look at the wider political landscape. That would include whether it is a jurisdiction of legal certainty, what the tax system is like, how easy it is to hire and fire people—all those factors.

Coming back to competitiveness and regulation, a report by one of the accountancy firms mentioned in the news last week said that the UK had regained some of its attractiveness as a place of business for financial services firms because of its strengths in ESG—the G standing for

governance, having a robust and good system of regulation and of well-governed corporates.

Lord Sharkey: Do you know of any other reputable regulators that have a promotion and competition competitiveness objective in their remit?

Dr Franziska Arnold-Dwyer: I think the Swiss regulator does.

Lord Sharkey: You do not happen to know offhand how they measure it.

Dr Franziska Arnold-Dwyer: No.

Professor James Davey: I think that market concentration should also be a factor. We should look at how many players there are in these particular markets.

Just one other thing; we also need to recognise that there is often—not always—a requirement that the assets be in the jurisdiction where the risk is. So we should expect to see some UK loss of market share simply because things that were being done here will now need to be done by Lloyd's Brussels, or wherever else. So that may appear through a different system, through a different location, but that is the choice we made. It is not a result of the regulatory system—other regulatory systems, not ours.

Q25 **Lord Trefgarne:** I would like to ask about the competitive status of some of the UK's rivals, such as Switzerland, Singapore or Bermuda. You mentioned Bermuda earlier, which I think you said was taking over from the United States market. Is this a matter of insurance regulation itself, or is it tax policy or something of that nature? To what extent does international business come to the UK because of the attractions of our legal and regulatory regimes?

Dr Franziska Arnold-Dwyer: We have talked about Bermuda. With Switzerland, I think the position there is driven by the insurance industry as one of its top industries, with Swiss Re and Zurich being some very large companies.

The industry is being driven by key players that carry a lot of weight, and I understand that the Swiss regulator is also currently reviewing its regulatory system; it is looking at two things, which have not been implemented yet. The first is making the calculation of the capital requirements more sensitive. Rather than having one standard model, they would have different standard models which could be more tailored to specific types of risk. Secondly, it is looking at lighter regulation for very small domestic companies. I do not think that regulating very small domestic companies more lightly will increase the UK's reinsurance market, but that is what it is looking at.

For the UK, I think having a robust regulatory system is a competitive advantage. I would also see the Lloyds market and how it operates, its reputation for being agile and being able to transfer risk in different ways,

slicing and dicing it, facilitated by the UK broker industry, as an advantage.

I also think that the UK legal system, the body of insurance law that we have, and the fact that we have a judiciary that has specialist judges who know about insurance law and market issues and would be the judges in disputes or would act as arbitrators, especially in reinsurance, a reinsurance law that is driven by market practice and commercial considerations, would be an advantage. This is where the legal system, not the regulatory system, gives us an advantage.

Professor James Davey: I would echo that. If we look at the high-value commercial risks—marine insurance, for example—we remain a significant sector. It has become more competitive. There are two things I would say about that. First, some of that competition comes from non-market providers, the Chinese kind of insurance industry that has a large amount of state capital flowing through it. I think you have to say that it is not playing the same game.

Secondly, and I do not mean this as a deep criticism, some of our large institutions have been a little slow, and not because of regulatory pressures. Lloyd's is a very significant provider, and its adoption of technology looks to me to be quite slow. It has now gone through a series of quite self-critical reports about where it needs to go to maintain market share. I do not see in its discussion a huge amount of, "Well, it was regulators that stopped us". I think there was also a bit of, "We'll do it the way we've always done it". It did not push itself to change. It certainly was not pushing the envelope in terms of what regulators would allow it to do.

Lord Trefgarne: Am I right in thinking that we are major players in the aviation industry?

Professor James Davey: Yes. I would put marine, aviation and transport together as those kinds of very significant global risks. That will be both reinsurance and primary insurance.

Q26 **The Chair:** Franziska, I cut you off earlier on when you were discussing Baroness Donaghy's question in connection with solvency. Is there anything you wanted to add on whether the proportionality on solvency was about right?

Dr Franziska Arnold-Dwyer: On solvency, the Treasury called for evidence and the responses received indicated that it is working reasonably well. Very specific, very technical areas were identified—to do with risk margins and modelling—as areas to be looked at. It is important to understand that these were calls from particular segments from the industry for making tweaks. They were not calls for change and reform on a large scale from across the industry.

The Chair: If I can just summarise, you have painted a picture where both of you feel that the proportionality between prudential regulation and risk is well judged. If we come back to the issue of treacle, the

processes have come under quite a lot of criticism in what we have heard. You just mentioned IT systems, which often lie at the heart of the treacle problem. Would you agree that that is an area where, in order to remain competitive, rather than making it a laxer prudential regime considerable attention needs to be given to getting things moving rather swiftly?

We had a particular example—you may have seen it earlier in our inquiry—about how Singapore, using the same rules as the UK for ICS, had managed to authorise half a dozen, or even more, in the space of time when we had possibly done two. Do you think that is a legitimate concern and criticism?

Dr Franziska Arnold-Dwyer: I agree, but it applies to the insurers and the regulator. To give an example, Lloyd's has recognised that one way to make cost savings is to make more use of technology. So it is looking at electronic placement platforms and stream-lining their processes using technology. This is set out in their Blueprint documents, Blueprint One and Blueprint Two.

On the regulatory side, there is a lot of discussion in academia about the extent to which regulatory processes can be made more efficient with the use of technology. But I think machine-led enforcement and AI in regulation are probably a long way off, which is not to say that at a more low-key level technology could not be used. Especially for smaller matters, I am sure there is scope for having a machine pre-assessment before it goes to a person making a decision.

Professor James Davey: I take a slightly different view. I think it will come more quickly than that. The FCA in particular is real-time monitoring. One of the things that insurers often complain about is, "We suddenly get asked for huge amounts of data and we have to find it and deliver it", and whatever else. What it would like to achieve in the medium term is a sense of it having access to data in real time and being able to see issues such as a concern about the number of unsuccessful claims or claims rejected as fraudulent, or whatever, in a particular part of the product line—flagging it automatically so that rather than waiting for customers to complain it hits a red light somewhere in the system and the regulator comes in and has a look.

The processes will be able to continue in the insurer, and the regulator will be able to observe it because it will have access to the data. I think that regulators are quite keen on better data sharing in real time. That should make things quicker. It will not help the application process; I am talking about once you are a regulated person. They probably want to move away from the kind of, "Everybody has to stop today, because we're going to be investigated", so that it is monitored much more consistently.

Q27 **Lord Grade of Yarmouth:** My takeaway from this session is that everything in the garden is rosy and that we are wasting our time with this inquiry, that everything is fine. I was wondering if we had missed

something that you would like to see us recommend that might help to improve the system.

Dr Franziska Arnold-Dwyer: There are lots of things that can be improved, not so much on the basic building blocks but around the edges. I would like to see Parliament considering amending the statutory objectives of the regulators, looking at competitiveness not just in terms of promoting growth to make the UK the biggest and the best, but in terms of sustainable growth, and to give more room to play with to the regulators when they discharge their functions by putting more weight on whether it helps our economy to transition to a net-zero economy.

Professor James Davey: I am not saying that everything in the garden is rosy. There have been mistakes, on both sides. What I feel I have been asked is: could we change the system in such a way to make a significant change to the number of errors? That is where my suggestion is "Not much". There is tinkering. We could look at reducing regulatory burdens for the high level, but equally I would not make reinsurers unregulated. That would be really dangerous.

The point about net zero is significant. I think that insurers—and this would help industry—would like the ability to say, "We now have this regulatory pressure", because there is a risk in being the first mover and saying, "We're not going to insure coal". This has been a big issue in the UK and the US: do we insure new coal seams? I think they would find it easier to have regulatory pressure, so that they can say to shareholders, "This is limiting our ability to invest in this", rather than having to make their own political decisions. There are a number of significant global risks: coal in Australia, several oil pipelines and the like, which UK insurers—Lloyd's and others—have declared they are nervous about getting involved in.

A regulatory steer is needed on that, and you probably need to bake that into the regulatory objectives. It is difficult for the regulator to do it.

Dr Franziska Arnold-Dwyer: There have been calls to incentivise insurers taking greener actions and for this to be incentivised, for them to be rewarded in their capital requirements. The counterargument has always been that the solvency capital requirements state they have to be risk-based. Just because you are doing something green does not mean you are taking on less risk. In fact, it can be higher risk if it is a new technology. There may not be any track record, any data, so it may be riskier to underwrite a risk or to invest in such an asset.

This is, of course, correct when you look at the regulatory objectives as they are but, as James said, an additional regulatory objective that was focused on sustainability would give more ammunition to the regulator to revisit that.

Lord Cromwell: Could I just take us back to competitiveness globally and something I wanted to clarify? James will correct me if I am misrepresenting him, but I think he was making the case that it is not

appropriate for the FCA to be involved formally in promoting the UK globally and its competitiveness against other nations. If that is the case, and correct me if I have misrepresented it, whose job is it to do that?

Professor James Davey: I am saying that, under the current statutory requirements, it is about the creation of competitive markets for the benefit that brings to consumers or customers more widely. The creation of competitive markets is absolutely one of their current targets, and should remain so.

The question, it seems to me, is how we treat that as part of attracting a global market and competition with other regulators. One way you could read the sense that you must chase global competitiveness is a race to the bottom. But we need to be undercutting the regulatory demands of others, and that is how we will seek an advantage.

There has been some suggestion of this, such as when Huw Evans left the ABI and gave a talk on Solvency II. It was quite interesting, because he said, "It's essentially the job of the UK regulator to provide us at least with what the EU has done, but more so to get us a competitive advantage". If we undercut them, they will undercut us and so on. You can end up with a situation where you forget the other objectives.

All I said was that I would want to understand, and it has not been explained to me, how you would fit that with the other requirements to make sure that we have a market that is likely to be sustainable in the long term. Insurance is not something I would want to make a fast buck in. It seems to me that these are markets that we should expect to be enduring. That is what I would plan them for.

The Chair: Thank you very much, Franziska and James. It was a very good session. Thank you for answering all our questions and raising some interesting issues. As to whether everything in the garden is rosy, we will hear from other people in the garden shortly. Thank you very much.