Treasury Committee

Oral evidence: EU Insurance Regulation, HC 852

Wednesday 22 February 2017

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Watch the meeting

Members present: Mr Andrew Tyrie (Chair); Mr Steve Baker; Kit Malthouse; Mr Jacob Rees-Mogg; Rachel Reeves.

Questions 152 – 226

Witnesses

I: Sam Woods, Deputy Governor for Prudential Regulation and Chief Executive Officer, Prudential Regulation Authority; Victoria Saporta, Executive Director, Prudential Policy, Bank of England; David Belsham, External Member, Prudential Regulation Authority Board.

Examination of Witnesses

Witnesses: Sam Woods, Victoria Saporta and David Belsham.

Q152 **Chair:** Thank you very much for coming to give evidence to us this afternoon. It is possible that we will be interrupted by a vote. I hope not; it should not come until 4.00. Can I begin by asking you about your competition objective? What progress are you making towards implementing the recommendations of the Bank of England's Independent Evaluation Office review of your approach to the secondary competition objective?

Sam Woods**:** The IEO, as we call it, made a very thoughtful report on how the PRA is doing on the competition side, which is relevant to both banking and insurance. Obviously we have talked a lot previously here about the banking side. They made 11 recommendations, really targeted at three things. One was the identification of issues. As issues are coming up within the PRA to the PRA board, which David and I sit on, or to the committee beneath it, which Vicky sits on, how do we identify those issues? That was one set of recommendations. A second set of recommendations was around the infrastructure that we have in order to make sure that we are across the competition issues. A third was around how we talk about that publicly and what we do in our competition report.

Across those 11 recommendations, we have completed four. There are six that we have implemented but are, by their nature, ongoing. There is one that is currently still in train, and that is one that relates to how we use a database and how the secretariat, which covers both the PRA board and the committee that sits beneath it, does its work. I think we are pretty well on track.

The one other comment I would make is that that was a very important report for us. We are shortly going to have an insurance report from the IEO, but there is a lot we are doing on competition that is not covered by what I just said, including on insurance. If we wanted to go broader, I would be happy to add more.

Q153 **Chair:** What we really want to know is what you are doing to make sure this market is competitive. You are a competition regulator for this sector and we want to know what you are doing.

Sam Woods**:** I can certainly come to that broader question. One fact that is useful to have in everyone's mind and perhaps very little known is that we have had 17 new insurance companies authorised by the PRA during the first three years of the PRA's existence. Again, that is probably more than most people think. We have done a number of other things that we consider to be pro-competitive, and I think they are. One example is the work that we have done on non-directive firms. In our submission, we tell you that we have 600 firms. That is the number of authorised entities. I like to use the number of 469, which is if you clump together those entities that are really just one company. Of those

469 companies, 40% or 188 are taken out of Solvency II. That is not something that we have done; that is something that regulation does if you are south of certain parameters. It is €5 million of income and €25 million of balance sheet when you are taken out. That left us the question of what to do as a regime for those very small firms, which are not firms you have heard from directly. We have done a sensible but very proportionate job there and we can talk about that in more detail, if Vicky wants to come in on that. That is one thing.

We have also been very mindful of our competition objective when it comes to reporting. You have heard from all of your witnesses that the reporting load of Solvency II is high, and we may want to come to that more generally.

Chair: Just to be clear, they are saying that it is not only unacceptably high, but a lot of it is a waste of time and pointless, or worse. We will come on to it maybe.

Sam Woods**:** Shall we come on to it? I can do it now, if you prefer. You are laying the ground for it.

Chair: Go back to the competition.

Sam Woods**:** We are sticking on competition. There is not very much we can do under the directive about the annual load of reporting. That is pretty much locked down in the directive. We should come to whether it is sensible or not, but that is a fact. When it comes to the quarterly reporting, we do have some discretion, considerable discretion under the directive, which we choose to interpret as relieving the burden largely on smaller firms. We have taken a decision that, for 85% of the firms covered by the directive, which are categories three to five in our world, we have allowed them to apply for a waiver that takes them out of about 70% of the quarterly reporting burden. Again, we have done that for competition reasons and for proportionality reasons, because we think it makes sense.

The one last example I will offer—I am sorry for the long answer—is in a different space, which is the London market. Now, the London market has complained to us that Solvency II is not well fitted for some of the funkier things that go on in that market. The particular example that was causing a problem was something called catastrophe bonds, which is a very different type of insurance product. The plain fact is that Solvency II does not work very well for that product, so we have worked very closely with the Treasury, HMRC and the industry to come forward with a proposal that allows them to work as well here in the UK as they do elsewhere. We are consulting on that currently. I offer that as an example of where we are also mindful of the need, while consistent with safety and soundness, to promote innovation.

Q154 **Chair:** Unlike banking, modern technology has opened up insurance to a high level of switching and the exercise of consumer choice in a number of ways, less so in the life market than the traditional insurance market. What is the argument for maintaining such a high level of prudential supervision, when you should be able to allow a firm to go bust and consumers to migrate to new suppliers?

Sam Woods**:** The question is, "How high is it?" You have heard from previous witnesses that it is very, very high. I do not believe that to be the case; I think it is proportionately high. To answer the question directly, the reason in my mind is that people can obviously suffer a very significant detriment if their insurance company goes bust. We can look back to the Equitable as the most obvious example of that. If someone is particularly an annuitant, who has put what might be their life savings into a company, and that company goes bust, there is FSCS coverage, but may they experience some very significant detriment? I think they may. That is why we had the objective that was given to us by Parliament of policyholder protection, and safety and soundness.

I do agree with what I took to be the premise of your question, though. The competition problems that we have, in my view, are more obvious and pronounced on the banking side than on the insurance side. Our objective applies to both, but we have talked much more about banking in this Committee. In my view, that is because the problems there are more serious.

Q155 **Chair:** I agree that there are conduct risks with firms going down and that there will be consumer detriment when one does, and Equitable is an example of that. That is a world away from what you get when the banks go down and bring the whole financial system down, is it not?

Sam Woods**:** I would agree with that, with one caveat, which is that we cannot ignore the AIG issue.

Chair: AIG was not doing insurance. Is that not a fairly important point?

Sam Woods**:** It is an important point. Let me put it another way.

Chair: They were in derivatives trading on a gigantic scale, in direct competition with banks.

Sam Woods**:** Of course, but I think it is reasonable that people should expect us in the regulatory community to have an answer to the question on the AIG issue. Vicky may wish to come in, because she is the chair of the International Association of Insurance Supervisors, which is progressing the whole international agenda, if we want to touch on that. I do agree with you that, in general, insurers do not present anything like the same kind of financial stability risk. The view that you have heard in this Committee that insurance regulation and Solvency II is something dreamed up by banking regulators and banking supervisors, honestly, I think is baloney. I do not know what the basis for that is, so you are right to see them as very different. This idea that we have cooked it up on that side is just not right.

Q156 **Chair:** When you say the same kind of stability risk, what you mean is as much stability risk. You are saying that they do not present as much stability risk. I am just trying to be clear what you are saying.

Sam Woods**:** Sorry, to be more precise that is exactly what I mean.

Q157 **Chair:** Are you happy with that sentence with that slight change?

***Sam Woods*:** I am happy with that. That is indeed an improvement.

Q158 **Chair:** You used the word "remotely". We are talking about a gulf. What is the case in insurance, then, for subordinating your competition objective to the objective of stability? Why do we not turn this into a primary objective?

***Sam Woods*:** I watched with interest your earlier hearings where some of your witnesses, though no members of the Committee, seemed to me to get quite jumbled up between a competition objective and a competitiveness objective, which, as we all very well know, are extremely different things. In my view, it is extremely helpful in our line of work, which is quite a complicated line of work, to have the strong focus that we get from having those two primary objectives, which tell us that our job is to make sure that insurance companies have enough money to pay out policyholders when their risks go wrong. That is a very helpful clarifying thing. The more you add other things on a similar level to that, the more complex that becomes. The secondary status of the competition objective is correct and adequate, but it obviously then depends to some extent on what all of our stakeholders think about what we are doing on the competition side. If people think we are not taking that competition objective seriously because of its secondary nature, then that would be a source of great concern.

Q159 **Chair:** Why did the regulator fight like an alley cat to have this competition objective subordinated to its primary stability objective?

***Sam Woods*:** As I say, it is a benefit of clarity. Now, you can prise apart whether, with the lower financial stability implication of insurance companies, that calculus would change. Logically, you can see that the calculus might be slightly different, but I would absolutely not maintain that the insurance sector, which in this country has £2.4 trillion of assets, does not have any kind of financial stability importance. I think it does.

Q160 **Chair:** Lots of things have stability risk. However, you have just agreed with me that it is not of the same order, but of a dramatically smaller order of risk than is provided by banking. If I may say so, I have not really heard an argument. Have one more go for saying why this should not be elevated to a primary objective.

***Sam Woods*:** You added "dramatically".

Chair: "Remotely" was the word you used.

***Sam Woods*:** I would say significantly less.

Chair: We are moving down quite a lot. We have moved from remotely down to significantly.

***Sam Woods*:** I would say significantly. It would be unwise to contend that a sector of the importance of this one, which is why we are debating it here today, I guess, does not have any financial stability risk. It is significant, but I readily accept that, because you do not have the same liquidity transformation going on, you do not have the same degree.

Does it make sense for us to elevate the competition objective for insurers only? I do not think it does. I think that would be thoroughly confusing.

Q161 **Chair:** The regulators did not want to touch this stuff with a bargepole. They did not want to go near to competition. We had terrible trouble getting either of the regulators seriously to consider the possibility that they should have a competition objective. Why? It might interfere with them being able to do exactly what they wanted on their respective other statutory responsibilities. It might lead them to have to think about that complex set of trade-offs, which a good regulator should be thinking about in practice, on behalf of the consumer. It would also force regulators to focus on the extent to which regulation itself could be an impediment to competition.

Sam Woods**:** Actions speak louder than words, and you should judge us on what we are doing. The competition objective is taken extremely seriously within the PRA. We have done lots of things, on both sides of the house, which are driven by competition. We have more to come. As I say, we have done a bit more on the banking side, because the problems there are worse, but we have done plenty on both.

Chair: We are here to do our best to ensure that, in the long run, millions of consumers, only a small proportion of whom will be watching this hearing, are nonetheless going to get a very good deal when they go and buy their insurance. The competition objective should be central to that. I have been told, by the way, that we may have a division in 10 to 15 minutes. I am going to pass the cross-examination to Rachel Reeves but, if there is one, we will adjourn for 15 minutes.

Q162 **Rachel Reeves:** Thank you very much for coming to give evidence to our Committee today. Solvency II requires that a large amount of capital be put aside for insurers' infrastructure assets. Others who have given evidence to this Committee have suggested that that is a problem. Do you regard it as a problem, Mr Woods?

Sam Woods**:** In short, I do not, but let me explain why that is. There is an area of legitimate and genuine debate between us and the industry about this. Our view is that insurers are natural holders of long-term assets and we want to encourage that. The main way that that is encouraged under Solvency II is through this device called the matching adjustment. In short, the way that works is, if an insurer can show that it will be able to hold to maturity the thing it is investing in, it can take all of the spread on that asset above expected losses over at an extra discount rate on to the other side of its balance sheet, thereby reducing its liabilities and adding to its capital. That is the main device that we use to encourage it.

The reason I say no in response to your question is that you could reasonably have concluded, from the evidence of earlier sessions, that the PRA was being extremely niggardly with handing out this benefit. I put it to you that the numbers just do not support that. We have handed out £60 billion of benefit. That is £59 billion of matching adjustment and £1 billion of volatility adjustment. To put it in context, the whole capital requirement for the insurance industry is around £126 billion, so there is a very powerful mechanism to encourage it. I am sorry; I will stop and let you come back in. The debate is whether we are being too tough around what types of assets we allow to qualify for that benefit. I would be happy to come on to that, if you want me to.

Q163 **Rachel Reeves:** It is interesting that you say there is a difference of view with the industry and the insurers on this, because in the end it will be them who decide what assets to hold. What quantification have you done of the impact on infrastructure investment?

***Sam Woods*:** The best way to look at that question is what the firms are planning to do. This is particularly relevant to annuity business, because it is really through annuity business that you would naturally invest in this stuff. Currently, looking across firms' business plans, annuity business is about 25% invested in illiquid assets of the sort that we are now describing. The rough average of the intentions of those firms across the next four years is to raise that 25% to 40% of illiquid assets backing annuities, so they are all planning to do more of this stuff. The regime encourages it.

There is an argument at the margin about whether we are being too tough about certain types of assets, which we could come to. Honestly, when I talk to insurance executives about this, I of course hear some of the things that you have heard in these hearings, but what I hear much more often is, "We are finding it very difficult to find assets at a decent price". The search for yield is pushing up the prices of these things, and often they decide that it is just not very appetising. My personal view is that that is a bigger block, and I intend to meet the people who are raising finance for these infrastructure assets to ask them that question.

Q164 **Rachel Reeves:** You would say to L&G, Aviva and others that have given evidence to this Committee that the reason they are not investing more in infrastructure is because they are struggling to find the assets in which to invest, rather than because of Solvency II. Is that what you are contending?

***Sam Woods*:** That is the primary reason, yes. That is my belief.

Q165 **Rachel Reeves:** So when Nigel Wilson of L&G told us that he could "readily invest in German Government bonds, Greek bonds, or US corporate bonds, and sail through the matching adjustment test"; and then when Mark Wilson of Aviva said that "Solvency II penalises long-term investment like infrastructure" and added that this was unacceptable and unsustainable, you think that both of them were wrong.

***Sam Woods*:** In my view, and with the greatest respect to both of them, they put their case much too strongly.

Q166 **Rachel Reeves:** Why would they do that?

***Sam Woods*:** I think it is because of this debate we are having at the margin on what types of assets come in for matching adjustment. That is what you are seeing. Would it help if I spent a minute on that, because that is what this is really about? It is also about the risk margin, by the way. I agree with them that the risk margin is a problem. Perhaps we will come on to that but, just on the matching adjustment, because that is much more narrowly to do with these sorts of assets, if you imagine what we are doing with the matching adjustment, we are doing what I have just described. It allows them, in effect, to bank as capital upfront any part of the spread that is not deemed to be expected to be lost through defaults further down the track. Now, that is quite a racy thing to do, but we think it is the right thing to do, because it creates incentives to invest long term, which is what we want insurers to be doing.

The Solvency II directive says that, in order to qualify for that matching adjustment, which as I say is £60 billion worth of capital at the moment, the cash flows must be fixed. Now, the word is "fixed"; it is not "predictable" or "almost certain". It is fixed, both in timing and in nature. That is not a stupid thing for the directive to say. If I was buying an annuity from you and giving you 100 grand, you would not want to toss it all into equities. You would want some kind of fixed nature to the thing. Where that has led to a debate is that some assets are at the margin. We have therefore taken, we think, a reasonably flexible view of how to deal with "fixed".

To give you a really obvious example, clearly a floating rate bond is not fixed. That is going to move around, depending on what interest rates do. Now, where a firm pairs that with an interest rate swap—there is nothing about this in the directive, by the way—we have said, "Fine, let us do pairing. You bring them together and we will regard that as fixed". We have done a similar sort of thing with callable bonds. There is a consultation going on at the moment about equity release.

Our view of it is that we have to meet the law. Of course we have to meet the law. It is not us who sets the law, but then we need to be sensible and find ways in which we can allow in the sorts of assets, like ERMs, that we think should get it. What you are seeing is a bit of back and forth between us and the industry about whether we are doing the right thing there. That is a developing picture, and I think that is what you are seeing.

***David Belsham*: **The Solvency II rules are very clear that the matching adjustment is only allowed on assets with fixed cash flows. They emphasise it more by saying that the cash flows cannot be changed. It is absolutely clear which assets are being limited, and that is because the matching adjustment is such a big benefit. Firms are capitalising the full liquidity premium on their fixed-interest assets at point of sale, so they are getting maybe a 10% uplift over and above the market value of the asset. It is a correcteconomic benefit for annuity writers with illiquid liabilities, but it is very substantial financially.

Because of this rule, some infrastructure for example might not have fixed cash flows throughout its term, but the PRA is allowing the firms to carry out a restructuring to get a senior tranche of that asset, which could be 80-90% of the cash flows, to be eligible. In a way, we are stuck with the rules as they are written, but the PRA is trying to operate them in as flexible a way as possible. The matching adjustment is being achieved by firms but, compared to the old ICAS regime, they are having to go through a more complicated process on some assets to achieve the benefit.

Q167 **Rachel Reeves:** Mr Belsham, you are saying, as I think you are too, Mr Woods, that the rules are the rules, and we are interpreting them in as flexible a way as possible. Do you think the rules are right?

David Belsham**:** I would prefer principles-based regulation in this sort of area, and that was the approach under the ICAS regime. You can understand that the Solvency II regime is far more rigorous than ICAS in many ways, which is good, but one of those rigorous ways is to question the circumstances in which it is appropriate to capitalise a liquidity premium. Although I think principles-based is better, I can understand why the Solvency II rules are as they are.

Sam Woods**:** I am glad you asked that, because I am worried, given the nature of the evidence you have had, that we will come across as cheerleaders for Solvency II. My view of it is that the fundamental regime is pretty sensible. By the way, it is very largely built on the regime that we had here in the UK before, which has basically been exported to the rest of Europe. But there are some bugs that need to be ironed out and there are some design features that I don't like. On the matching adjustment specifically, if I had complete control of it, I would probably do something slightly different. I would want to take account of unexpected defaults and I would probably be a tiny bit more flexible around this notion of "fixed". That is how I see it.

Q168 **Rachel Reeves:** During the discussion we have just had and the backwards and forwards we have had, it seems that you have more sympathy with the views of Nigel Wilson and Mark Wilson than you did at the beginning. You say it is the rules that are to blame and not the PRA.

Sam Woods**:** To be honest, I just think they are overdoing it. They are giving you the impression that Solvency II discourages long-term investment. I genuinely do not think that is true, but we could make it a bit better at the margin.

Q169 **Rachel Reeves:** Let me ask a question to Mr Belsham. Do you think these insurers would have invested more in infrastructure under the old rules than they will under the new rules?

David Belsham**:** I think Sam's earlier point is probably right; the availability of the assets is the problem. It is very difficult to find a pipeline of attractive long-term illiquid investment-grade fixed-interest assets.

Q170 **Rachel Reeves:** That is answering a different question, with respect, Mr Belsham. Everything else being equal, do you think that insurers will invest more or less in infrastructure under the new rules, compared to the old rules?

David Belsham**:** I think it would be very similar. The benefit of the matching adjustment and the incentive it gives them—as Sam said, the

£60 billion benefit of having the matching adjustment—is so big for firms that it is worth the process of going through some of the hoops that have been set by the strict criteria.

Q171 **Rachel Reeves:** What you would say then, Mr Belsham, is that they would invest roughly the same amount as before, but they will have to jump through more hoops to do so?

***David Belsham*:** Yes, I think there is a cost and operational disadvantage for firms, but I think the investment should still proceed.

Q172 **Rachel Reeves:** Once they have jumped through all those hoops, which is obviously costly to them as insurers and the cost has to be passed on somewhere, they will invest the same amount in infrastructure as they would have before. If the cost is higher, why would they not invest less in it, as the cost of other things might be a bit lower?

***David Belsham*:** It is because the matching adjustment benefit is so big. In the base scenario, capitalising the liquidity premium can give you an uplift in the asset value of 10%. In the 1-in-200 stress scenario, you get a further uplift as spreads widen and the liquidity premium goes up. This cost is a haircut off the benefit of the matching adjustment. That £60 billion would not come at zero cost under Solvency II. It is about 75% of the entire capital requirement of the industry, to put it into perspective. It is a very large amount that firms will still go after. As Sam said, we have seen the plans of firms that say they are intending to increase their holdings in illiquid long-dated assets, including infrastructure, from 25% to 40% of their annuity portfolios, over the next three years. That is everyone's plans aggregated. They are seeking to do this.

Q173 **Rachel Reeves:** Your response then, Mr Belsham, to Nigel Wilson and Mark Wilson, or your reading of what they have said to our Committee, would be that their annoyance is really not about not being able to invest in infrastructure, but that the cost of doing so is higher. Would that be fair?

***David Belsham*:** I think that is right, and they have added some colourful examples like a Greek bond, which is just not a suitable asset to back annuity business, because it is CCC and the cash flows on it are not the sorts of cash flows that a UK company would want to use. They can go and buy one very easily, but it still has to pass the sound and prudent person principles for guaranteed liabilities that it is meeting to UK policyholders.

***Sam Woods*:** Sorry to extend this, but we have some sympathy with the point being made that the stricter and tighter nature of the rules around this instrument, under Solvency II versus its predecessor under ICAS, have led us into a world where, in order to make some of these things work, we have added complexity. The best example is equity release, which David is talking about. We thought that ought to be the sort of asset that can go in there, but an equity-release mortgage plainly does not have a fixed cash flow, because you get the money back when the person dies. We said to firms that we would be open to them structuring groups of these ERMs into internal securitisations and then allowing the senior tranche, which is plausibly fixed in all circumstances, to play. That is not great actually. That is more complexity than I would like to have and that place where matching adjustment and securitisation rules meet is not an entirely happy place, so you are seeing some of that.

Q174 **Rachel Reeves:** I just have two short questions, if that is okay, Chairman. If it is going to become more expensive to invest in these assets which, as you say, Mr Belsham, are needed because other assets will not provide the matching function that is required, does that mean that the annuities, which are already pretty poor value, in my view, will become even more expensive? In response to the last point that Mr Woods made with regard to equity-release mortgages, if you are having to complicate things to get them through the hoops, are you not storing up the problems of the future, in a way? We are overcomplicating both the regulation and the design of products to meet the rules, rather than to reduce the risk or whatever Solvency II is supposed to be doing.

***Sam Woods*:** Shall I answer both of those? On annuities, we of course take an interest in annuity pricing across all of our objectives and I do not believe that this will have the effect of driving up annuity pricing. It is quite interesting, actually, if you look at annuity pricing over the last 10 years or so. Currently, if you are 65 and you put 100 grand into a company, you will probably get an annuity of something like £5,300. That is a bit up from where it was at the beginning of Solvency II—you would have got about £4,800—but it is down dramatically from the £8,000 or so you would have had in 2008. We have done an analysis to show what is driving that, and 90% of it is risk-free rates and corporate bond spreads. If you looked at the chart and you asked someone who did not know that we had implemented a new regime in the middle of this, they would literally not be able to see it.

Q175 **Rachel Reeves:** What is the other 10% then?

***Sam Woods*:** It is just stuff that we have not been able to explain. You certainly cannot see a bang-on Solvency II effect. On your last point, I agree. One of the things about Solvency II that I do not like is that it is quite a complex regime and quite a rigid regime. The rigidity I am talking about in this particular case here has led us into further complexity, which I think is undesirable. The basics of the regime are very sensible and are basically following on from the Equitable. Some of those things are not ideal and I agree with the ABI and the rest of the industry on that.

Q176 **Mr Jacob Rees-Mogg:** Good afternoon. Can I follow on briefly on the equity-release mortgages? With the internal securitisation, am I correct in thinking, because I have had correspondence that tells me this, that it means firms have to have a bespoke formula and are not able to use the standard formula?

***Sam Woods*:** It is true that, in order to achieve most of the benefit of that, they have to be on an internal model. They could do it without, but not for the benefit.

Q177 **Mr Jacob Rees-Mogg:** That means that it is a big disadvantage for smaller companies, for whom going away from the standard formula is inevitably a higher cost than for a larger firm.

***Sam Woods*:** It is true that, in that particular instance, there will be an advantage for most firms to moving on to an internal model. We have tried to be extremely careful to make sure that we do not introduce on the insurance side the problem that we have often discussed here on the banking side, which is that gap between the formula standardised for the banking side and models. We have had that in mind while going through this process.

Q178 **Mr Jacob Rees-Mogg:** In terms of competition, it is going to be harder for smaller companies, because you would have hoped that they could all go on the standard formula. If they need a bespoke formula to invest in equity-release mortgages, then they have higher costs. I just wonder how flexible you are being in helping firms in this position, because the correspondence I have had is in relation to a firm that, instead of setting up its internal securitisation, set up a bare trust mechanism and discussed it with you. They had legal advice that said this would work. You said you had legal advice that it would not work and basically said, "Take us to court". Do you think that that is a helpful way of proceeding or is there more of a negotiation that you could have and perhaps more of an explanation, so that people understand why things will not work?

***Sam Woods*:** I want to be a little bit cautious about getting into cases.

Mr Jacob Rees-Mogg: Do not get into detail, but just the broad principles.

***Sam Woods*:** I can tell you that we have often been on the other side of the equation, which is that the firm will say to us, "We will see you in court unless you agree to this", so I am afraid that a bit of this business is quite bruising, despite best efforts on all sides.

Sitting suspended for a Division in the Commons.

On resuming—

Mr Jacob Rees-Mogg: Do you remember where we were?

***Sam Woods*:** Yes, thank you.

Chair: This had better be a good reply.

***Sam Woods*:** I will do my best. I will reply to the narrow point and also the broader point. On the narrow point, it is true that the standard formula is pretty harsh on securitisations so, because we have had to go through this securitisations loop in order to enable firms to get the matching adjustment for equity release, it has made it more difficult for firms on the standard formula. Our solution to that, which is designed mainly in view of the tension that you raised about the extra cost, is to encourage or allow firms in that situation to apply for a partial internal model, so as to model that bit. Normally, we are quite cautious about that for cherry-picking reasons, but we have allowed that. More broadly, yes, of course we would prefer to settle things in a civilised way without people threatening to go to law. We get almost all of our business done that way, but not quite all of it.

Q179 **Mr Jacob Rees-Mogg:** Do you think that there should be a more formalised appeal system along the lines of commissioners of the Inland Revenue, so that people could have an independent appeal, without necessarily going to law? The reason I ask is that the same firm that contacted me, when putting together their bespoke formula, put in their evidence and got a response saying, "No, we would rather you used our standard matrices". They then used the standard matrices and got the response, "Oh well, your figures come out as what we don't really like, so we are going to make it different according to our benchmarks", which they of course cannot see for confidentiality reasons. They rather felt that they did everything that was expected of them but, at every turn, there was a stumbling block with no ability to say, "Can we have an independent view of this?" Do you think that would be beneficial?

***Sam Woods*:** There are two questions in there. The tribunal is the first place that this goes to, which is very much along HMRC lines. When I say "court"—we may in fact be talking about the same case; I am not sure—it would have been the tribunal. Of course, judicial review is the other route. It is very important that that is there. I would far rather be able to settle things before getting there, but that is where it is meant to go.

On the particular question of benchmarks, we have this thing—and the ABI raised this too—called our quantitative indicator framework, which is basically our view on all these risk factors that these firms are exposed to, longevity being a classic one. We think it is pretty important that we have a view; otherwise we will be pushed around. The history of modelling in financial companies suggests we ought to have such a thing. When I came into the insurance job those benchmarks had been agreed, but I wanted to look at them. I was very interested in David's view, he having spent his whole career in this area, as to whether those benchmarks were reasonable. He can probably speak better than me on this topic.

***David Belsham*:** I went through these with the team, because they had been agreed before I joined the board. I went through them, as a matter of my interest and to get confidence that the PRA were doing a sensible thing on things like longevity, credit risk and correlations, which are the most contentious and difficult areas on which to form a judgment. Based on having produced ICAS valuations for the previous 10 years, the assumptions that the PRA was using seemed to be in a reasonable range to me. They were certainly not excessive in relation to the uncertainty that exists around these things. Often, when one looked at the spread of assumptions being made by firms, the PRA were taking a similar view to many firms. The PRA does benefit from being able to look at all the different firms, all their different techniques and so on. I actually took comfort that this approach of quantitative indicators did work, because one of the problems with banking is spurious differences between the models the banks have. That is one of the things that needs to be avoided in insurance, so having these quantitative indicators is a way of getting into that and achieving that.

Q180 **Mr Jacob Rees-Mogg:** I assume that you therefore think that there will not be firms that are genuine outliers and ought to be away from these benchmarks. That would be very unusual.

David Belsham**:** There could be outliers and there are reasons for that. These are high-level indicators; they will not be appropriate for all of the different asset portfolios that a firm might have. They will not be appropriate for all the different mixes of annuitants, with their different longevity experience. Also, one of the points that I fed back to the PRA was that they should have more granularity in these items. There will not be just one number for corporate bonds, equity-release mortgages, infrastructure assets and commercial mortgages. They ought to be differentiating these more and looking at different durations, different sectors, different credit ratings and so on. In the same way that firms are developing their internal models, the PRA is developing its thinking. It is open. They are not people with closed minds here. They are open people, doing their best to take this forward in a sensible way.

Q181 **Mr Jacob Rees-Mogg:** Are you also open to viewing what other EU regulators are doing? One of the complaints, which I am sure you are familiar with, is that the PRA is gold-plating, while others are being more relaxed. There are some pointers that that may be the case. I was sent one figure that slightly surprised me: that the solvency ratio of the UK life sector under Solvency II is the third-lowest in Europe, only above Greece and Portugal. Can it possibly be found, on a uniform basis across the EU, that an industry that most of us would think was quite strong in the UK turns out to be the third-weakest in Europe? How would you explain the figure that comes out of 142% solvency ratio in the UK, 272% in Germany and in Italy—Italy—a 243% solvency ratio. I may be being very unfair, but it is surprising that it would be so much higher.

Sam Woods**:** One way to think about that is, up until the introduction of Solvency II, you had people doing completely different things around Europe. None of us had a similar kind of method. Solvency II has brought everybody into the same framework. Clearly within that there is still room for different regulators to form different judgments in their market, and we do not have perfect insight into all of that, in terms of what other regulators are doing.

I do not think we have overdone it, because we have not approached it with the mindset of a race to the bottom or a race to the top. We have just said what our view of longevity is, being reasonable about it, as David said. With these quantitative indicators we have approved some models where firms were able to prove that they were different for substantive reasons.

Another very crude statistic is that, in its stress test, EIOPA published quite an interesting table, which was the surplus of assets over liabilities that insurance industries have around the 28 countries. It is quite noticeable there that the average across Europe is 9.5%. This does not get into requirements; it is just how much they are actually holding, de facto. There are 9.5% or 9.6% more assets than liabilities. In the UK, the number is 8.5%, so we are in the bottom third there, but that does not immediately suggest to me that we are overcooking it in terms of how much we are making people hold. There are all sort of business mix effects and other things in there.

Q182 **Mr Jacob Rees-Mogg:** Are they taking those figures from the regulators, or are they examining them themselves? They might get two very different answers, depending on classifications. If you take the Italian figure and the UK figure, if you did it on the same basis for both countries, you may find that the difference is not 101% between the solvency ratios of the UK and Italy.

Sam Woods**:** That is possible, and I think it would be very unwise for me to claim that it has been absolutely universal.

Mr Jacob Rees-Mogg: The EIOPA figure is interesting, but it is not definitive.

Sam Woods**:** It is not definitive, but it tells you the facts on the ground of how many assets they are holding, versus how many liabilities, leaving aside the entirety of regulatory views. If it was the case that UK companies were holding, say, twice as much surplus assets over liabilities as everyone else, it would be much more conclusive.

Q183 **Mr Jacob Rees-Mogg:** Are those assets and liabilities being calculated in identical ways?

Sam Woods**:** I think they will largely be. Most of the discretion here, to the extent there is some, is around things like the quantitative indicator framework, where it is likely that there are different views. I might add one other very small point, which goes to this point about whether we have overcooked it. Another way to think about it is what the impact was of the introduction of the new regime, compared to the old regime. To me, that is quite instructive. The all-in capital requirement that we mentioned before is £126 billion under the new regime. The amount that is surplus of UK insurance companies changed, with all these moving parts and all the rest of it, from one regime into the next, by about £1 billion. The move was less than 1% of the capital requirement. Now, that says to me that we have certainly not aimed to increase capital requirements through this process and the evidence is consistent with that.

Mr Jacob Rees-Mogg: That is not what Legal & General tell us. I am sure you have seen their paper.

Sam Woods**:** I have, yes; they shared it with us.

Q184 **Mr Jacob Rees-Mogg:** For a £100 premium from the customer, they think a reasonable level of capital would be £8 and they say that Solvency II requires £27. Would you disagree with that assessment?

Sam Woods**:** I would disagree with that. Very kindly they shared with us the letter they sent to you, in order to enable us to think about it. Our view, based on the industry that we see in front of us and the actual new business strain for annuities that we see coming in, including firms like L&G, is that a number like £13 is more appropriate than their £27. That is a combination of a number of things. In his letter, Nigel Wilson gave you £92 for reserves. That seems broadly right; I think it is probably about £93. Then there is a question on the risk margin, where he has given you a number of £15. What we see is about £8. Then there is the capital requirement, where he has given you the number of £20 and we have a smaller number. We think the new business strain is higher under the new regime, but really because of the risk margin. The risk margin is a place that we all agree is overcooked.

Q185 **Mr Jacob Rees-Mogg:** The risk margin, as I understood from the meeting that we had with the insurers, is the margin on top of the basic idea that you need to account for a one-in-200-year event. It is a margin on top of a prudent risk level.

***Sam Woods*:** Yes, that is right.

***Victoria Saporta*:** Broadly, of course, you are right, Mr Rees-Mogg. Precisely, it is the margin above the best estimate of the liabilities, which is a central estimate of how much they are worth. On top of that, you add the risk margin. The Solvency II regime is a so-called market-consistent regime, so it tries to assign a market price to the liabilities. The liabilities do not have a market price outside, of course. Therefore, actuaries calculate the best estimate and the risk margin is basically an estimate on top of that, to try to make the liabilities market consistent. It is not on top of the capital requirement; it is on top of the liabilities.

Mr Jacob Rees-Mogg: At the moment, you get an exceptionally high risk margin because you have very low interest rates. That is what underpins the calculation of the long-term liabilities.

***Sam Woods*:** That is right, and we think that the calculation that involves holding a flat cost of capital out in the future and discounting it at a risk-free rate, so the risk-free rate drops and then it gets much bigger, is much too sensitive to risk-free rates. That has the result of making it much bigger than it should be. For the life industry, it is about £44 billion at the moment, at the end of Q3 2016. It has probably come down a bit since the change of guard in the US. We totally agree with the industry that it is overcooked. We have been very clear that the mitigation we have for that, which are the transitional measures that shield firms from the impact, will give firms the full benefit of what we regard as high-quality capital. It is very important that the market understands that, while we sort this problem out.

Q186 **Mr Jacob Rees-Mogg:** One of the other problems that came up, which seemed extraordinary to me, was that you have to revert to your base currency, in terms of the capital that you need, even if you have liabilities in foreign currencies. The foreign currency does not seem to count. Is that something that is in your discretion or in the Solvency II regulations?

***Sam Woods*:** There are some peculiarities—Vicky may want to add; I am not sure—about how Solvency II works for international groups. This gets us into the dreaded topic of equivalence. Crudely, if you think about a group with a US entity, if the US is deemed to be equivalent under one of the provisions—I think it is 227—we say that we regard the local regs as equivalent, and then bring in a certain portion of the capital that is surplus from above a certain threshold, and that is added into the group's amount. That is one example. There are various other wrinkles too, but it is one of the slightly more complex and not very satisfactory parts of the regime.

Q187 **Mr Jacob Rees-Mogg:** Would you look to change these? Would you look to a fundamental reform of this after 1 April 2019?

Sam Woods**:** Could I answer that first, very briefly, with what I think about the regime, which we have not really had a chance to say? I think it informs the answer. Basically, Solvency II is a sensible regime and it is a good regime. Why do I say that? It is because it is a regime in which we try to look at the values of assets and liabilities, as they are today and consistent with the market. That is basically the learning from the Equitable. If you do not do that, if you have some other way of valuing liabilities and assets, you may well be caught short if the firm gets into trouble. It is a very UK idea. Then there is this thing of the matching adjustment to encourage long-term investment. That is all good, but there are things about Solvency II that are bugs that need to be fixed and design features that are not good. The biggest and most obvious bug is the risk margin, but there are also design features that I would like to change if I had a free hand.

Q188 **Mr Jacob Rees-Mogg:** I am slightly surprised that you are as pro Solvency II as you are. Certainly, from the evidence that has come to us, there seems to be quite a high cost to consumers. Ultimately, extra capital is a cost that will fall on consumers, which makes insurance more expensive. One firm said to me that their annuity rates were 5% lower because of Solvency II, and that they had had to increase their capital by 50% from the ICAS regime to Solvency II. This eats into the returns that consumers can expect and it is harder for new firms to get going, because of the high capital levels. Then the regime has been subject to lots of adjustments, so people have not quite known where they stood to start with. Other questions are going to come. The Chairman is looking at me, so I have to stop now.

Sam Woods**:** Look, I am not a cheerleader for Solvency II. There are things about it that I do not like and that I would definitely want to change but, in terms of the impact on the cost to consumers, we have not, and the numbers absolutely support this, increased capital requirements going from ICAS into Solvency II. We simply have not. However, the introduction of the risk margin has in effect soaked up a lot of capital except that, for a moment, we have a transition that largely offsets it. When you look at it in the round, we are okay for now, but we need to fix that bit.

Q189 **Mr Jacob Rees-Mogg:** Is that before the transition has ended?

Sam Woods**:** Yes, and there is a debate between us and the industry about how we should do that. The other part of Solvency II in terms of the cost is the running cost. You have heard a lot about the reporting burden and I actually have an open mind about whether where it is currently set is quite right. Perhaps we could come on to that. I think it is useful to keep these things in context, because the all-in running cost is about £200 million a year, maybe £250 million. That is 0.08% of the income of this industry. On a motor policy of £440 that is just 35p. Now, I am not at all complacent about adding 35p but, from you have heard, you could have had an exaggerated notion of quite how difficult this is.

Q190 **Mr Jacob Rees-Mogg:** Speaking as an investment manager, if I was going to get 0.8% on all the funds I managed, we would be charging more than we currently do.

***Sam Woods*:** It is 0.08% to be clear. It really is quite small.

Mr Jacob Rees-Mogg: Sorry, I thought it was 0.8%.

Chair: He would probably be charging more than he currently does anyway.

***Sam Woods*:** I hope you can get 0.8%; it is quite good.

Mr Jacob Rees-Mogg: We do not get 0.8% sadly.

Q191 **Chair:** You are hedging your language a bit. By "not very satisfactory", you really mean very unsatisfactory, do you not? By "overcooked", you mean very heavy-handed, do you not? "A bug that needs to be fixed" means seriously flawed, does it not? Is there anything I have said there with which you disagree?

***Sam Woods*:** I would disagree with all of those statements if you want to characterise my view of Solvency II in the round.

Chair: It was with respect to the specific risks. The third was on the foreign exchange point.

***Sam Woods*:** On the risk margin, I am not quite sure about the words, but I think the calculation of that is fundamentally flawed and needs to be fixed. There are other things that I would like to change about the regime too, which the industry is less focused on, but which I think are quite important.

Q192 **Mr Steve Baker:** Good afternoon. I would just like to turn to what I hope is one of the things that you might like to change. If I may, I will read in some of the evidence we have received about Pillar 3 reporting. We have been told variously that the Pillar 3 reporting requirements are "disproportionate". We have been told they are "excessive and of limited use to regulators, investors, intermediaries and policyholders". We have been told that the "sheer volume of the rules and guidance acts to limit understanding and effectiveness of Solvency II", which seems pretty damning to me. There are "hundreds if not thousands of pages". It is not clear what supervisors—you—can make of all the information they receive.

This is all from participants in the industry. I will just do one more. This is one quote from the evidence: "A large life and pensions firm is required to produce over 400 detailed reporting returns, many of them on a quarterly basis. For one firm quarterly asset reporting alone amounts to 90,000 lines of data, which would fill more than 3,500 pages of A4 paper if printed out". Do you need all of this information?

***Sam Woods*:** We tend not to print it. That is an absolutely fair characterisation of what you have heard through the submissions. To me, it is probably the most consistent theme across the shop on this. In summary, I have an open mind about whether this is currently being put down in exactly the right place. It is a very significant increase from what we had under ICAS.

Mr Steve Baker: It is four to eight times, I think.

***Sam Woods*:** It is four to eight, according to the ABI. My team tells me it is four to five but, look, it is a lot. We have done some things. The most important thing is the thing I mentioned before, which is that we have given 85% of firms by number the opportunity to get a pass on around 70% of that quarterly reporting. If I step back from it one level, directly to your point, there are 112 of these templates. Three quarters of them are things that you could think of like a spreadsheet. That is a closed-form spreadsheet. The total number of lines for those spreadsheets is 1,300. We can all debate if that is a lot or a little. I do not think the argument is about that stuff so much and I do not think that is a crazy number to have for regulating the insurance sector.

The hottest part of the argument is around the open templates, where firms have to send to us at ISIN code level—i.e. bond by bond if it is bonds, and the same for equities—what assets they have, and do that on a quarterly basis. That is one of the things where we have allowed people to get this waiver not to do it quarterly. The big numbers you are quoting are precisely from that data set. At the moment, we are getting that from the big firms quarterly. I think we should keep an open mind as to whether that is the right place. I would be happy to have another look at that. There are some constraints in the directive around proportions of the market that you have to cover and such, but I think we should have another look.

The only point I would want to add is that that data is useful. I will tell you how it is useful. It is in the very obvious way that, when this frequently happens and we see that Company X is getting into financial difficulties, I can ask the supervisors to tell me what the exposures of insurance companies to that company are. Are we going to take a hit? Is there a big problem? They can tell me very rapidly, in the course of a few hours, what that situation is. That is really going to matter when, hopefully far in the future, we come to bail in a bank. The first question that I am going to be asked, if I recommend that we should do such a thing, is, "Is that going to bring down the UK insurance sector?" We will know, in a way that we have not before, what the answer to that question is. There is value in this, but it is a big step up. We have done what we can to reduce it, but I am very happy to have another look at that question, given the views you have heard.

Q193 **Mr Steve Baker:** That is excellent. It is like you read my mind, because my next question was going to be why you need so much information. From what you have said, I would interpret it to mean that, although it is very intrusive, it allows you as the regulator to go right down to the detail of whether or not an insurer is exposed, as you have explained. While it is extremely intrusive, you think it is necessary because of the potential for a bail-in.

***Sam Woods*:** Reporting is all a question of degree. Could we exist without it? Of course we could; we did for many years. Is it really quite useful, however, particularly for that sort of analysis? Yes, it is. By the way, we do not have the ability under the directive to drop it entirely and I actually would not want to. Where we may have flex is around the frequency of it, so I think that that is a legitimate question. By the way, this stuff is quite a big challenge for us. When I was in the insurance seat, I had to create a new division, which I did by pulling headcount of 30 people from other bits to help us manage this data and get use out of it. That is still an evolving picture.

Q194 **Mr Steve Baker:** What occurs to me is this: what is the legitimate limit on the extent to which you duplicate the management functions of the firm's own staff? Another way to do this is to go out to the management of the firm and ask them how exposed they are to a particular company. Perhaps I could bring you in on that point, Mr Belsham, then come back to Mr Woods.

***David Belsham*:** Exactly, firms should be able to work out their counterparty exposures at very short notice, all of the time. In principle, the availability of this data is an important ability for firms to have. I am sympathetic to the firms' view that quarterly reporting of it all to the regulator does feel rather onerous in that, for most firms that hold this asset data, the assets are not being turned over so quickly that quarterly reporting is necessarily appropriate. I support the idea that there should be a review of this over time to see whether waivers can be given, if the data is proving not to be essential at that sort of reporting frequency.

Q195 **Mr Steve Baker:** The thing that slightly concerns me, without wishing to be pejorative, is a regulator's enthusiasm to have the data in order to see right inside the firm and go beyond what perhaps, in a free society, you might hope would be the boundaries between what people do with their own property in a free market, and what a regulator is entitled to do, looking over their shoulder. You are a non-executive, are you not?

***David Belsham*:** Yes.

Mr Steve Baker: As a non-executive, is that a subject that exercises you, as you regulate the regulator from the perspective of the board?

***David Belsham*:** Yes, it is. The whole question of proportionality and what the regulator should be seeing, compared to what an individual bank or insurance company is doing under its own management, is important. The whole data point is another example of where it is not necessarily the PRA saying, "We must have this data". This again is an example of the rules that say this data must be provided and that the regulator can give waivers. It is for the PRA to make that judgment of where it wants to step back from the maximum data that could be required under the rules. If we went into another credit crisis, and I hope we will not for many years, this is exactly the sort of data that you might say you would now like to see quarterly, for the time being. It is the difference between having the facility to do things and necessarily having to turn the handle constantly.

***Sam Woods*:** It is a very big philosophical question. The only thing I would add is that, from my experience in this line of work, you often need to get to the third layer of the onion to understand what is going on. Trying to supervise in a very generalist type of way, by just chatting to senior management and looking at the business plan, of course you need to do. It is very important but, unfortunately, you need to drill in as well. That is not a defence of all of this though. As I say, I am with David and I think we can look at this again. Sorry, Vicky; I have cut you off.

Q196 **Mr Steve Baker:** I am very keen to bring you in but, on this point, it feels like I ought not to press you too far. At the moment, you are open-minded and I do not want to talk you into requiring all this data. It would be good to offer firms some hope that there was the possibility of containing some of this data, perhaps getting back and maybe reducing it to a quarter of what it was. Would that be feasible?

***Sam Woods*:** Gosh, that sounds. You have pushed me a bit.

Q197 **Mr Steve Baker:** Sorry, I phrased that slightly wrongly. It has increased four or five times, by your own estimate. Could you feasibly get it back down to where it was?

Chair: That is much less than a quarter, is it not?

***Sam Woods*:** That would be a pretty tough, but I do genuinely have an open mind. We may come on to this, but the ABI has made a number of recommendations to you, 23. I have them in three buckets: there are things that I flat disagree with; things where we are half in agreement; and things where they probably make a reasonable point. That is broadly where we are.

***Victoria Saporta*:** My points have been covered. On the philosophical point, you are absolutely right that, in principle, the firms should know their counterparties and be able to produce the data, as soon as possible. Now, my experience is that this is not always the case. Obviously this was not the case during the crisis with some of the firms, not all of them. Of course, through the recommendations of this Committee, we have tried to improve governance. One hopes that, through the senior managers regime, we have improved that, but you cannot be absolutely certain that this has happened. Unfortunately, whenever there are problems, you need to know that there is a process to produce that data.

Q198 **Mr Steve Baker:** In a previous life, I became a modest expert in electronic financial reporting. I wonder to what extent you are using electronic financial reporting to collect these things. You mentioned spreadsheets; spreadsheets are of course notoriously appalling to process automatically, particularly if they are open-ended. Have you looked at how you might automate this data?

***Sam Woods*:** Yes, we have. We have put a huge effort into that. I used spreadsheets as a sort of example. We are actually using XBRL, which will probably be more familiar to you.

Mr Steve Baker: I am sure I am the only MP who could handle XBRL.

***Sam Woods*:** We have created a wonderful system called BEEDS, which hoovers this stuff out of the industry. We now have a desktop tool for all of the supervisors, on the fourth floor of the PRA, called the STAR tool, which allows them to go in and look at this data. Touch wood, there is a big pipe of data coming in. This has gone quite well, but that leaves the basic complaint of the industry that there is a hell of a lot coming into the pipe.

Q199 **Chair:** Have you asked the industry what the compliance cost of the collection of all this is?

***Sam Woods*:** Yes, I think we know that, according to the ABI, it is about £250 million. We have had another estimate of £200 million a year. That is mostly the reporting, so it is of that order of magnitude.

Q200 **Chair:** Have you looked at how they put that number together?

***Sam Woods*:** I personally have not.

Q201 **Chair:** Could I suggest that you do? The reason is that the real cost to a firm is not the first-line compliance cost that is incurred because they have had to hire people in compliance to collect it. It is the second and third-tier cost to the business as a whole, as the compliance officer starts to take people off front-line business creation, gathering or doing whatever they are doing, often at the front desk, who then have to come off and feel that their careers may be at stake if they make a mistake in this reporting regime and that the firm may be guilty of a regulatory breach on a technical matter; that is, of a failure to report accurately. Therefore, in not doing their normal line of business, they waste a great deal of time collecting information that you may not use in the end. Could I ask you to go and have a look, and find out if that number is remotely accurate?

***Sam Woods*:** Yes, I would be very happy to do that. We should do that in the context that we are going to review if there is more we can do in this space. That would be natural.

Q202 **Chair:** Could I suggest that you put in place some sort of system that also drills down right to the level of the firm, where you are checking it for a small proportion of firms? You would effectively be doing a survey to find out what the real cost is. You can then draw up a cost-benefit analysis for yourself of whether this information is really worth having at that level of cost. Would you be prepared to do that and report back to the Committee on how you are getting on?

***Sam Woods*:** I am very happy to have a look at that.

Q203 **Chair:** Could you also consider collecting some of this information by exception? Why do you need to ask every single firm all this stuff? Why can you not pick out those firms that you think might be the most likely miscreants, were trouble to erupt in the industry, and give them an added incentive to sort out their act, because you have put them into the special measures of your very high level of reporting compliance?

Sam Woods**:** There are two bits to that. One is that the law is pretty clear that we just have to collect some of this stuff.

Q204 **Chair:** Sorry, I forgot to ask you about that before making the point. You said at one point that you are of course constrained by the directive. You are up to a point, Lord Copper, as indeed you have made clear. You have found flexibility in a number of areas but, in any case, we are leaving the EU, so you can make recommendations on how we could find ourselves in a better environment post-Brexit.

Sam Woods**:** It is of course true that, absent the constraints that we have, we would have more flexibility around some of this.

Q205 **Chair:** Stripping away the directive point, what about my earlier point about not collecting this universally?

Sam Woods**:** Quite a lot of what is being collected here informs the basics of supervision. If we want to know how big the risk margin is, how big the liabilities are and how many owned funds, this is basic stuff that I think we should have. I do not start from a place of thinking that we just should not know that for a whole range of companies. There are bits of it, and the asset data is a case in point and the derivatives data is the same, which are very reasonable questions to ask. As I have said, we have done quite a bit already by taking all of these firms out of most of the quarterly stuff. We have drawn a judgment there. Could we put that judgment in a different place? What I am saying to you is that we should review that and, if there is room for us to move it, we should.

Q206 **Chair:** What you are hearing from the Committee on this is that we are asking you to take this review very seriously and to do it in an extremely thorough way, in view of the evidence that we have heard. If you come back and give us a very thorough and detailed explanation of why you cannot change anything at all, then no doubt we will accept your argument. We are not necessarily making a specific recommendation for any change. It may be that all the material really is needed, but what we have heard is very much in a different direction and is of considerable concern to us. Some of us have been in these industries and have seen first-hand just what this burden can look like, particularly for the medium-sized and smaller businesses. The big ones have professional teams doing this and, in any case, it acts as a barrier to entry. There is a benefit to them from high levels of regulation, as it protects them from competition. For the medium-sized firms, it is a very high-stress business when they get these requests for information.

Sam Woods**:** We absolutely will have a thorough look at it and, as I say, we will genuinely do that with an open mind. I do not start from the assumption that where we have set this down right now is the perfect place.

Q207 **Chair:** I was once sitting with the chief executive of a medium-sized firm who, while I was with him, received a request for information from what was then the FSA. He said, "This is the sort of thing I am having to deal with. I am in the middle of a transaction. I do not really have time to talk to you, Andrew, but in any case look what I have just received. The compliance officer has decided that he cannot handle this without direction from me, because I am going to have to take about 20 people off what they are doing in order to fill in this 36-page questionnaire".

***Sam Woods*:** There is of course a point there. My only caution the other way is that we need a decent amount of data to do the job. If we go all very generalist and do not have data, it will honestly be a disaster. You can believe that and believe at the same time that there might be room to move a bit.

Chair: You heard what I said about justifying what you are doing, and then you are likely to get acceptance from the Committee.

Q208 **Kit Malthouse:** Mr Woods, you have been straining to tell us about the risk margin.

***Sam Woods*:** Yes, I would love to.

Q209 **Kit Malthouse:** You obviously think there are problems. What are they? What can you do about them? What are you inclined to actually do about them?

***Sam Woods*:** The problem, simply expressed, is that the calculation is a bad one and it is a bad one because it is far too sensitive to movements in risk-free rates. The historical evidence does not support there being such a relationship, and it has potentially a pro-cyclical effect and the effect of making this risk margin much bigger than it should otherwise be at the moment. As I say, the number for the life side was £44 billion at the end of Q3 last year, but is a bit lower now. The industry and we are in complete agreement on that. They would probably describe it the other way round; they would go, "It is too big, and the reason is this", but it frankly amounts to the same thing.

We are having a debate with the industry, which you have heard in this Committee, in the shared acceptance that there is a problem, as to the best way to solve it. To characterise the argument crudely, we want to go and fix it at source, in the Solvency II regulation. We think that, even in a post-Brexit world, having this fixed in what will always be a massive piece of global insurance regulation is a prize worth having.

We are having a very constructive discussion with our colleagues in Europe about that. I spoke to Gabriel Bernardino about it only two weeks ago. I saw Mr Rees-Mogg's comments in InsuranceERM, where he speculated that our ability to negotiate such things must be impaired. It was a very sensible supposition to make, but I will tell you that, in this case, we seem to be making good progress. On the other hand, the industry wants us to break glass locally and put in place a quick fix, for the UK only, in order to deal with the problem now. We could do that. It is possible. To come to your point about could and would, we could do that, but we had a long and very difficult discussion about this at the PRA board. We are sympathetic to the basic argument being made but, in the end, we decided that the particular route that the industry is proposing was a bad idea for two reasons.

Q210 **Kit Malthouse:** Which route do you think is a bad idea?

***Sam Woods*:** The industry has effectively proposed a mechanism through which we could assume a management action, i.e. that firms would do something in the future, which would bring it down. We had a look at that and said whether we think it is a good idea or not. In the end, with some reluctance because we are sympathetic to the argument, we decided that it would not be wise to do that and that was for two reasons. One was that we cannot get any cast-iron reassurance that, if we allow the genie out of the bottle in that way, in relation to the risk margin, that same genie cannot be let out of the bottle in all sorts of other parts of the framework, for instance in relation to capital requirements and technical provisions. The collective view of the PRA board was that that would be a very dangerous thing to let loose.

The second argument was that, if we break glass locally, I am sure it will undercut us in Europe. That seems to be highly likely, and we would therefore be unlikely to be able to fix the thing at source. We would have this imperfect local fix and we might be stuck with it for a while, with something different in Europe. In the meantime, it is very important that we say that transitionals get the full benefit for capital purposes here in the UK, because that gives us a bit of time here. That is where the matter rests for now.

Q211 **Kit Malthouse:** How long will you give the European negotiations?

***Sam Woods*:** I wonder if Vicky might want to set out the timeline for the review that is currently going on.

***Victoria Saporta*:** Solvency II says that the review needs to be finalised—that is, the Commission needs to have changed the law—by the end of next year. It is going to do so on the basis of advice by EIOPA, which is due towards the end of this year, in 2017. We will know whether EIOPA is going to advise the Commission to fix the problem at source or not, by the end of this year.

Q212 **Kit Malthouse:** EIOPA is basically going to tell the Commission what to do.

***Victoria Saporta*:** It is going to advise them.

Q213 **Kit Malthouse:** They have said that they will already follow the advice.

***Sam Woods*:** They have asked for it. The Commission have asked for advice. It implies a degree of recognition that there is a problem.

Q214 **Kit Malthouse:** Okay, so there will be more clarity by the end of this year, but then actual change by the end of 2018.

***Victoria Saporta*:** That is right.

Sam Woods**:** We think that is probable, as long as the market understands our position on transitionals.

Q215 **Kit Malthouse:** Does the transitional position still require more capital?

Sam Woods**:** No, the transitional basically runs off over 16 years. You get cover for the impact you had from this on day one and it then reduces over time. We have also allowed it to be dynamic, so it can recalculated from time to time, if risk-free rates move around, which they have. For instance, for the increase that we had in the first half of last year, we allowed a recalculation of the transitional to cover it. The ABI has made a separate point to us, which is whether that recalculation process could somehow be simplified. My answer to that is that I am absolutely in the market for simplification ideas; if they can bring something forward, that would be great.

Q216 **Kit Malthouse:** It was put to me that an alternative route might be to dump the whole thing and go for a resolution regime. Why would that not be attractive?

Sam Woods**:** The subject of insurance resolution is quite a vexed issue, in that there is currently no regime of that sort in the UK. We as the Bank have been clear that we think it would be useful to have a regime of that kind.

Q217 **Kit Malthouse:** If you had one, would you need that?

Sam Woods**:** That is a reasonable question. We lived very happily, for the best part of 15 years, under the ICAS regime without such a construct, so it would be very strange if I sat here and told you that it was absolutely necessary, particularly if you had a better resolution regime. The basic idea of the risk margin, as opposed to its calculation, for the reason Vicky gave, is sensible, if you are trying to have a market-consistent balance sheet. The best estimate will not capture what gets done if someone needs to take over those liabilities. That will require a bit extra for the uncertainty. The way it is calculated is a serious problem.

Q218 **Kit Malthouse:** I might be mistaken, sorry. I thought the risk margin meant that no insurance company would ever go into run-off.

Sam Woods**:** No, I certainly do not think it gets you that.

Kit Malthouse: It gets you beyond the one-in-200 here.

Sam Woods**:** It gives you a bit of extra wriggle-room, particularly for White Knight type deals. It makes it a bit easier for another firm to take on the liabilities of an insurance company. David may wish to comment, but I do not think it at all follows from that that insurance companies would never go into run-off. We have many firms in run-off and I think that will continue.

David Belsham**:** It does give you more options in resolution because it means that, after this theoretical one-in-200 event, the firm would have enough assets to transfer their policyholders to another firm, at a market price. The policyholders would then clearly benefit from being part of an open firm, that was properly capitalised, as opposed to being left in a sort of zombie fund running off with barely any capital and all the risks that that would entail.

I was interested in the risk margin. I think it is nowadays considered as part of a best estimate or fair value of insurance, because it is now being included in the IFRS framework that is due to be discussed later this year. It is also in the international capital standard for insurers, so I think it is now widely seen as part of a sensible solvency framework. The issue we have in the UK is that, if you are going to have it, you have to calibrate it properly.

Q219 **Kit Malthouse:** If you fail in your renegotiation with the EU and you do not take any action, what is the ultimate backstop cost to the punter? If there is £44 billion un-transitioned, what is that going to cost me on my car insurance?

Sam Woods**:** It really is mainly an annuity issue. Here is a way to think about it. Let me do an estimate here. For the life side, it is about half of the capital requirement for insurers. Now, that does not mean that the cost of the policy will go up by half, but it does mean that there is another half of the capital being held. The capital requirement is about 5% of their assets in total, so imagine adding another 2.5% of equity to the cost of what was there already and that would give you a rough approximation. I should say that I do not think it is going to come to that, because we should be able to get this fixed at source. If we cannot, my conclusion is not that we leave this thing. We will then have to think about it in another way.

Q220 **Kit Malthouse:** The final question from me then is: if it does not get fixed and stays where it is, what happens to longevity risk? We have been told that it would exit the UK and go to Switzerland and elsewhere.

Sam Woods**:** On the back book, we have these transitionals. On the front book, firms are reinsuring large volumes of longevity out of the UK, in order to avoid taking this hit. The numbers that I gave you for our assessment of 113, which we were talking about with Mr Rees-Mogg, is without doing that. If you do that, it comes down to maybe 107 or so. We are watching that market very closely, because of course we have a natural concern that, if that is happening, policyholder protection might be diminished. We have just done a review of that internally and we are going to go deeply, firm by firm, to check that things like collateral are being managed in a sensible way. There is another point the ABI made, which is that firms think that we are requiring to give approval for those deals. I can say simply here that we are not. We agree with the position of the ABI that we should not require approval. We do want to know what is going on, though, for the reason given.

Q221 **Chair:** I have just one more question on Solvency II. The ABI has given the Committee a list of changes to the implementation of Solvency II that are in your gift to make. You have seen that list.

Sam Woods**:** I have seen that list, yes.

Q222 **Chair:** Is that a credible list?

***Sam Woods*:** There are 23 on the list. I disagree with eight. I personally agree with five and see some merit in them. I would have to have views from the rest of the PRA board on that. The rest, the other 10, are in the middle.

Q223 **Chair:** Do you agree with them, first of all, that they are in your gift?

***Sam Woods*:** In almost all cases, yes. There is an agreement that they have managed to isolate the things about which we are forming a judgment. The reason I hesitate slightly is that one of the things in the middle bucket is what we are doing on the matching adjustment.

Q224 **Chair:** Why do you not drop us a line explaining which, if any, of those 23 are not in your gift, and then also explaining the five you feel you should do, the 10 that are up for debate and the remainder, the eight, that you are giving a big no to straight off?

***Sam Woods*:** I would be very happy to do that

Q225 **Mr Jacob Rees-Mogg:** I just have one clarification on the issue of transition with the risk margin. Is that a transition for new business as well as old?

***Sam Woods*:** No, it is only back book.

Q226 **Mr Jacob Rees-Mogg:** There is quite a problem for challenger businesses, because their capital has to be so much higher.

***Sam Woods*:** They can also do these deals, but there is a generic issue, which is that this stuff is being shipped out across borders. Mortality risk has often been shipped out across borders, so we should not be against that of itself, but this is not a sensible outcome, which is why we need to fix this thing.

Chair: Partly because of the banking crisis, and because we did not have an AIG, we have not looked at insurance as rigorously as we have banking but, as you can tell, we are now beginning to take an interest and we will continue to do so in the months ahead. Thank you very much for the evidence you have given to us this afternoon. We look forward to receiving the written material, which you have kindly also offered us.