LONDON MARKET GROUP

**European Affairs Committee**
**UK-EU relationship in financial services**
**London Market Group evidence submission**

## Introduction

- London Market business is defined as commercial and wholesale specialty risks written in London through brokers or direct with clients usually by an insurer, reinsurer or Lloyd's syndicate. This is backed by capital in an entity regulated by the UK Prudential Regulation Authority (PRA).
- The market protects against risks that domestic insurers choose not to write due to the non-standard risk characteristics, for which the London Market can offer competitive insurance solutions.
- The market is of a fundamentally different character to that of the domestic life and pensions market. Clients seeking insurance for large risks are significant corporate entities, or other insurance firms with strong risk management capability who either employ internal expertise or procure reliable external advice.
- Clients' interests are almost always represented by professional brokers - regulated by the Financial Conduct Authority (FCA) - throughout London Market placements. This enables them to make an informed choice as to their insurance provider and the structure of their programmes.

The UK's commercial reinsurance and insurance markets, centred within the City of London, now lead the world in taking on the most difficult and sophisticated risks[1]:

- The London insurance market is bigger than all of its competitors combined: Bermuda, Singapore and Zurich. Nowhere else in the world has the same concentration of insurance expertise and diversity of capital.
- Over US$110bn of income is earned by the London Market, making it one of the UK's major export industries, equating to 23% of the City's GDP.
- Approximately 85% of that income is earned by companies domiciled outside the UK.
- The market also brings considerable foreign investment into the UK. Over 66% of the capital that comes to the UK's commercial insurance market is foreign owned.
- The London Market's claims payments have resulted in US$181bn of economic impact across the world since 2015. To put this figure in context, this is roughly equivalent to the GDP of New Zealand in 2018.
- The London Market's income from North America increased by 6% between 2010 and 2018, making it now the largest source of earnings for the market.

The success of the market is key to maintaining the UK's competitive position and will play a significant role in growing our exports and delivering increased levels of foreign inward investment.

[1] London Market Group: London Matters 2020

**Current trading situation**

## 1. The impact so far on the UK financial services sector of the UK's departure from the EU Single Market

1.1. A loss of financial services passporting rules and no financial services trading provisions within the UK-EU TCA has meant that companies have had to restructure in order to continue serving clients within the EU.

1.2. Both brokers and underwriters have therefore been compelled to create new EU based subsidiaries which have branched back into the UK. Whilst they may still provide expertise and advice on European risks, business from the continent is no longer overseen and managed in the same way, but reported directly to operations located within the EU:

1.2.1. Out of the London and International Insurance Brokers Association's (LIIBA) 152 broker members, 60 have created an entity in the EU post-Brexit. The anecdotal feedback we're getting so far is that home state regulators in the EU are nervous of what happens outside of their direct supervisory control, however so far member state regulators have not reneged on the agreements reached with firms in creating a new entity in that jurisdiction.

1.2.2. National regulators have been rigorous in their approval processes, following the lead of the pan-European regulator EIOPA. We expect that as time goes by there will be increasing pressure from EIOPA on national regulators to be more consistent in their enforcement. The question is whether the European authorities will still accept the handling of key insurance functions from London. This is still something of an unknown.

1.3. These new arrangements have clearly had a knock-on impact on premium. The International Underwriting Association's (IUA) latest market statistics report[2] is the first to illustrate a material impact on income earned as London companies have established these new operating models in order to continue serving international clients post-Brexit.

1.4. Given no special trading relationship was secured, this was inevitable, as premium must now be recorded by the continental operation instead:

1.4.1. Overall, the IUA found that controlled premium overseen and managed by London operations has fallen by 30% from £8.9 billion in 2018 to £6.2 billion in 2019. Income originating from

[2] https://www.iua.co.uk/IUA_Member/Publications/London_Company_Market_Statistics_Report.aspx

Europe (excluding the UK and Ireland) is down by 60% from £4.9 billion to £1.9 billion.

1.4.2. Whilst the overall decline of 30% in controlled premium is significant, it has been masked by a number of companies reporting increases in such income for various other reasons. Similarly, premium written in London has grown by almost 10% over the past year.

## 2. The impact of the absence of a functioning framework for UK-EU regulatory cooperation

2.1. Disappointingly, equivalence rulings have stalled and the ratification of the Memorandum of Understanding on UK-EU regulatory cooperation seems to have been indefinitely delayed on the EU side.

2.2. Given the level of European investment into the London Market we did think it was important that the UK gave the EU equivalence on all three Solvency II rulings - particularly group supervision and group solvency – to continue to provide confidence to these European firms investing in London.

2.3. **We maintain that it is still important for the long term that the UK seeks reinsurance equivalence under Solvency II with the EU.** We believe that there are mutual benefits for the UK and EU to find each other equivalent under Solvency II provisions and it would avoid UK-based firms having to continue to navigate the patchwork of measures of EU27 jurisdictions.

2.4. **The activity of brokers has no equivalence regime under the Insurance Distribution Directive**. Broker contingency plans are currently based on interpretations by member state regulators based on guidance from EIOPA[3] published in February 2019. At the moment these operations seem to be working well on the basis of that guidance. We are of course following closely the EU's review work of the Insurance Distribution Directive but at the moment no significant developments have emerged.

2.5. Given the ongoing uncertainty over equivalence, and that it was never a perfect solution anyway – it feels like much of the London Market is moving on from that debate and looking towards the potential that domestic reform could bring.

2.6. The London Market Group is pleased to see that HM Treasury's Future Regulatory Framework (FRF) and Solvency II Reviews are progressing, and we have engaged at length with officials about the proposals suggested in the latest iteration of both consultations. We look

[3] EIOPA, Recommendation 9 – Distribution activities - Recommendations for the insurance sector in light of the United Kingdom withdrawing from the European Union, February 2019

forward to engaging further on these pieces of work in the coming months.

## 3. The future of cross-border UK-EU financial services trade in the absence of equivalence

**Treatment of 'reverse branches' by UK regulators**

3.1. The UK's withdrawal from the EU has necessitated firms to open a subsidiary in one of the 27 nations. These subsidiaries have established branches in the UK in order to introduce business to insurers based in London. The EU policyholder/EU risk business will now be introduced in London via the UK branch of the EU entity.

3.2. We're pleased that the UK regulators have accepted this model as an example of an acceptable approach to transacting business, however we want to ensure that over the longer term the regulators take a proportionate approach - particularly to the reverse branches of brokers - as these branches are crucial in continuing to bring EU based business to London.

3.3. These new international firms typically have no UK clients. We would therefore expect the regulators to pursue a proportional approach to supervision. Once the EU entity is authorised and the FCA are satisfied that the correct staff have oversight both in the branch and in the head office, there is little more that FCA will need to know about the activities of either the firm or the branch.

3.4. This light touch approach will be further supported by FCA's ability to rely on the supervisory activities of the home state regulator. It would be useful therefore if FCA was to publish a list of acceptable home state regulators. We would presume that this list would include the 27 National Competent Authorities (NCAs) in the EU.

3.5. It is vital that the FCA respects the competitive position of these new international firms that London Market firms have created to continue to service this business.

**UK Solvency regime reform**

3.6. The industry incurred significant expenditure in preparing for and implementing the Solvency II regime - approx. £2.7 billion - almost all of which is non-recoverable cost.

3.7. We do not support wholesale changes to the regime but would like to see certain refinements to the UK regime and for some of the unnecessary requirements, specifically regarding processes on calculation and validation of capital requirements; reporting requirements; and treatment of branches of overseas firms - to be scaled back to what is actually important to clients, supervisors and firms.

3.8. Fundamentally the London Market's strength lies in encouraging inward investment. Much of this investment comes from EU entities who choose to do business in London. Making wholesale amendments to the UK's solvency regime could seriously reduce the likelihood that the EU will find the UK to have an equivalent third country regime. This will be important for harmonising reinsurance market access across the 27 member states.

3.9. However, we do believe the regulators can use the powers within Solvency II to reduce unnecessary regulatory barriers and encourage continued overseas investment.

Examples include:

3.9.1. **Treatment of reinsurance branches:** The PRA treats pure reinsurance branches as similar to direct insurance branches, which goes beyond the requirements set out in Solvency II. This includes additional solvency requirements, duplicating reporting requirements as well as additional governance requirements. This approach detracts from the attractiveness of the UK. The clients of reinsurance branches are other insurance companies, and the branch is fully protected by the Group company. Given the cross-border nature of reinsurance we are concerned that continuing such an approach will make the UK less competitive and we will lose further ground as a centre for the global reinsurance market.

3.9.2. **Non-EEA branches**: As the UK further develops its regime for overseas firms, the PRA should also be willing to place more reliance on the known quality of supervision provided by non-EU regulators, when supervising UK branches. For example, where a jurisdiction is recognised to be equivalent to the UK Solvency regime - now the case with Bermuda and Switzerland - in relation to its supervision of groups and reinsurers, the PRA should not apply additional regulation at UK branch level, at least in respect of those areas where equivalence has been found. This approach should also be extended to US firms seeking to create a reinsurance branch in the UK, using the UK-US Covered Agreement as a basis to reduce regulatory burdens on those firms.

3.10. To have to go through additional and unnecessary regulatory processes which duplicate work already performed by other trusted regulators is very costly and time-consuming and acts to inhibit overseas firms from operating in the UK.

3.11. For example, many jurisdictions actively use their solvency regime to ensure they stay competitive. Bermuda uses a "deduction and aggregation" method of consolidation of the group capital position of international reinsurers. This acts to reduce reporting requirements and workload and makes Bermuda an attractive place for reinsurers while still retaining its equivalence status under Solvency II with the EU.

3.12. It is in both the UK and EU's interests to avoid market fragmentation, and we should both seek to continue to work towards international regulatory convergence, which eases cross border trade of (re)insurance services. This is a joint endeavour which the UK may be able to find common cause with the EU when it comes to international standard setting.

**EU announcements on Solvency II and IDD reform**

3.13. We have obviously noted with interest the EU Commissions announcements on its proposed Solvency II reforms. They seem to have a received a mixed response so far. There has been a general welcoming of a more proportionate approach to capital requirements, albeit that at the moment they're not intended to be permanent reductions in capital requirements, while on the other hand we've also noted the concerns of Insurance Europe that the proposals for new reporting and group requirements include elements that would unnecessarily increase costs and complexity.

3.14. On the Insurance Distribution Directive (IDD) Review, we understand that the EU Commissioner for Financial Services, Mairead McGuinness, may move towards greater alignment with MiFID at certain levels, but Capital Markets Union is her real priority. As yet there are no details on the non-life insurance aspects of the Review, and there seems to be no appetite within the Commission to discuss the international aspects of IDD.

3.15. It is still very much early days and we'll need to see the details that will be provided during the further stages of development to understand how much this may or may not diverge from where the UK is heading.

**UK domestic opportunities**

3.16. Given the realities of the situation with the EU, it is unlikely that in the near future we are going to see any further measures that will ease trade flows. Instead, the focus is on making what we have continue to work for clients.

3.17. Given this reality, the opportunity must be to consider ambitious domestic reforms. Action must be taken to maintain the UK's competitive position, grow our exports and deliver increased levels of foreign inward investment into both London and across the regions of the UK, where the market is expanding.

3.18. The emergence of centres of capital in places such as Singapore, Dubai and Miami have significantly increased the number of markets able and willing to write risks that previously might have had no choice but to go to London. While these new centres do not currently have London's depth of knowledge or expertise, they are a lot cheaper to operate in. Over time our concern is that these new centres will become far more viable alternatives and compete for premium, putting further pressure on London's share.

3.19. The LMG has called on the Government and the regulators to consider the following issues as they consider the next steps for the UK regulatory frameworks:

- A more proportionate approach to individual sectors within the insurance industry and the type of client they serve. This would make a greater contribution to the UK's economic recovery, boost UK competitiveness and make the London Market more attractive to international investors.
- Having a more prominent role for international competitiveness within the regulatory structure would send a positive message the UK is 'open for business, that we welcome new investment and trading opportunities, within the context of a robust regulatory framework, a system that promotes good governance and supports investor and client confidence.
- The regulators should consider their role in encouraging inward investment to the UK, perhaps through a dedicated inward investment unit, akin to the Irish Development Agency (IDA), to provide more proactive support and guidance to overseas firms seeking to come to the UK and trade within the London Market.
- We would also like to see the expansion of the Sandbox approach to regulated activities by the PRA to encourage more innovative products and services to be developed in the UK. Such an approach would bring down costs of innovations and reduce barriers to entry, while allowing the UK regulators to collect valuable information prior to approval.

## 4. The impact of regulatory divergence and agreements with third countries on UK-EU financial services trade.

4.1. The prospect of regulatory divergence is difficult to ascertain at this stage given both the UK and EU are in the process of reviewing key elements of their regulatory frameworks.

4.2. Some divergence is inevitable, particularly as we see our government develop a more UK-specific regime. However, the indications are at the moment that the nature of any divergence is likely to be incremental rather than a big bang.

4.3. We believe that the Government and the regulators have the ability to refine and adapt the UK solvency regime to a UK context within the current framework and without compromising the prospects of a subsequent equivalence ruling with the EU or causing market fragmentation.

4.4. For example, both Bermuda and Switzerland have equivalence in all three areas of the EU Solvency II regime yet maintain their own internationally competitive regulatory systems. They have not adopted the Solvency II legislation and maintain regulatory freedom over their own domestic markets.

4.5. What would have been helpful is to have secured the agreement on the Memorandum of Understanding regarding regulatory cooperation – we had hoped for a speedy resolution of this – but that does not look possible. Continuing regulatory dialogue, we believe would help to manage this process of divergence.

**The London Market Group**

The London Market Group is the only body which speaks collectively for all practitioners in this significant market, representing the views of insurance brokers, those insurers and reinsurers operating within Lloyd's, and branches of overseas insurers and reinsurers operating in London – reflecting the full extent of the Market.

This submission reflects the perspectives of the International Underwriting Association of London (IUA), the Lloyd's Market Association (LMA) and the London & International Insurance Brokers' Association (LIIBA) and Lloyd's of London.

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