ICIR International Center for Insurance Regulation

Inaugural Lecture

Better (Insurance) Regulation: Search for the Holy Grail

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Agenda

- Better Regulation in the EU
- From Better Regulation to Smart Regulation
- Smart Regulation in Practice
- International Recommendations (OECD)
- Financial Services Regulation
- Insurance Regulation: The case of Solvency II
- Smart Insurance Regulation
- Concluding Remarks

Better regulation in the EU (1)

- **The Mandelkern Report of 13 November 2001**
  - **Role of better regulation**:
    Make the EU the most competitive and dynamic knowledge based economy in the world (Lisbon Council 2000)
  - **Seven principles**:
    Necessity, Transparency, Accountability, Accessibility, Simplicity + Subsidiarity and Proportionality (Maastricht Treaty 2001)
  - **Recommended practices:**
    – Policy implementation options
    – Regulatory impact assessment
    – Consultation
    – Simplification
    – Access to regulation
    – Effective structures and implementation

Better regulation in the EU (2)

- **Commission White Paper on European Governance (2001)**
  - Principles of good governance: openness, participation, accountability, effectiveness, coherence + proportionality and subsidiarity
  - Proposals for change: better involvement of citizens, better policies, regulation and delivery, acknowleging the global dimension, refocused policies and institutions

- **Inter-institutional Agreement on better lawmaking (2003)**

- **Commission Communication on updating and simplifying the Community Acquis (2007)**

From better regulation to smart regulation (1)

- **Commission Communication on Smart Regulation in the EU (2010)**
  - Look at the whole policy cycle: design of legislation, implementation, enforcement, evaluation and revision
  - Shared responsibility of EU institutions and Member States
  - Involvement of stakeholders: longer consultation periods
- **Commission Communication on EU Regulatory Fitness (2012)**
  - Launch of REFIT (Regulatory Fitness and Performance Program)
  - Eliminate unnecessary regulatory cost
  - Ensure that the body of EU legislation remains fit for purpose

From Better Regulation to Smart Regulation (2)

- **Commission Communication on progress with REFIT (2014)**
  - 53 withdrawals of pending proposals after consultation with Council and EP
  - Decision not to present a number of proposals, for instance “Occupational safety and health of hairdressers
  - Council and EP have adopted a number of proposals on simplification and burden reduction
    (25% target by 2012 has been met and exceeded)
  - Call on Member States: timely and full implementation in the least burdensome way (no gold plating)

- **Mr Better Regulation (Frans Timmermans) in new Juncker Commission as First Vice-President (2014)**

Smart Regulation in Practice (1)

- **Life of an EU Rule:**
  - Green Paper (only instrument not requiring IA)
  - White Paper or Communication
    (usually after consultation on Green Paper)
  - Legislative proposal by EC
  - Adoption of proposal in co-decision
    (in practice no IA by Council or EP)
  - Transposition / Implementation by Member States
  - Monitoring and enforcement
  - Compliance check
  - Ex-post evaluation

Smart Regulation in Practice (2)

Steps of IA based on EC Impact Assessment Guidelines:

- Services start with drawing up a Roadmap
- Creation of IA steering group, involving all relevant EC services
- Consultation of interested parties, collecting expertise and data
- Carrying out an IA analysis
- Presentation of findings in draft IA report
- Presentation of draft IA report to IAB followed by opinion of the IAB
- Revised IA Report, IAB opinion and draft proposal go into inter-service
- IA Report, Executive Summary, IAB opinion and draft proposal submitted to College of Commissioners
- Final IA Report, Executive Summary, adopted proposal made public

Smart Regulation in Practice (3)

- **Impact Assessment Board established by President Barroso in 2006**
  - **Composed of senior EC officials** appointed by President for 2 year term
  - **Positive opinion from IAB** is in principle needed before a proposal can be put forward to the College
  - **2013**: 97 IA examined; 142 opinions issued; 40 opinions requesting resubmission; resubmission rate: 41% (declining); DG Markt: 8 resubmissions out of 13 IA
  - **Issues for improvement:**
    - Clearer description of the problem
    - Better assessment of the need to act
    - Added value of EU action
    - Development of clear alternative options to tackle the identified problems
    - Quantification of impact on SME's and competitiveness

International Recommendations (1)

- **OECD Recommendation on Regulatory Policy and Governance (2012):**
  - Commit at the highest political level to an explicit whole-of-government policy for regulatory quality
  - Adhere to the principles of open government, including transparency and participation in the regulatory process to ensure regulation serves the public interest and is informed by the legitimate needs of stakeholders
  - Establish mechanisms and institutions to actively provide oversight of regulatory policy procedures and goals
  - Integrate Regulatory Impact Assesment into the early stages of the policy process for the formulation of new regulatory proposals
  - Conduct systematic programme reviews of the stock of significant regulation
  - Regularly publish reports on the performance of regulatory policy and reform programmes and the public authorities applying the regulation

International Recommendations (2)

- Develop a consistent policy covering the role and functions of regulatory agencies in order to provide greater confidence
- Ensure the effectiveness of systems for the review of the legality and procedural fairness of regulations and decisions on sanctions
- Apply risk assessment, risk management and risk communication strategies to the design and implementation of regulation
- Promote regulatory coherence between supranational, national and sub-national levels of government
- Foster the development of regulatory management capacity and performance
- Give consideration to all relevant international standards and frameworks for co-operation

Financial Services Regulation (1)

- **Financial crises** have raised the **question of regulatory failure**
- Reference has been made to **“financial repression”** and **“regulatory capture”** as important causes for regulatory failure
- Much of the literature is US based and deals more specifically with securities regulation and banking (not with insurance)
- **Problem of the regulatory cycle (too little, too much, too late):**
  - Evidently needed reform will often only come after crisis or scandal
  - After crisis or scandal: risk of regulatory overshooting
  - In boom time (don’t kill the goose that lays the golden eggs!) or in time of slower growth (we need economic growth!): pressure to reduce regulation

Financial Services Regulation (2)

- Definition of regulatory capture (Carpenter, Moss and Stinnett):

  "Regulatory capture is a result or process by which regulation (in law or application) is, at least partially, by intent and action of the industry regulated, consistently or repeatedly directed away from the public interest and towards the interests of the regulated industry"

- ICFR: Making Good Financial Regulation (2012)

Financial Services Regulation (3)

Causes of regulatory capture:

- **Political capture:** light touch regulation – more is less and less is more: "Despite a general American acceptance of the importance of regulation, the most effective short-term political strategy is to treat regulation as if it is a fundamentally illegitimate intrusion into a preordained free market" (Baxter)
- **Intellectual capture:** intellectural convergence between like-minded individuals across the public and private sector as a result of socialization
- **Lack of independence of the supervisory authority** (industry representation on the board, "revolving door" between the supervisor and industry)
- **Assymetrical nature of stakeholder's participation** in the regulatory process (where are the consumers?)
- **High level of technicity requires information** from regulated firms and leads to interest group advocacy: "informational subsidy"

Financial Services Regulation (4)

Regulatory capture can be overcome:

- **Better regulation**: cost-benefit analysis, public consultation, proportionality, transparency, enforcement, monitoring, public oversight, periodical review
- **Supervisory Authority**
  - **Sufficiently independent of government** as well as regulated industry
  - **Clarity** about the way it intends to give effect to its legal mandate
  - **Must act as it says it will act**, irrespective of pressures to change regime without legislative cover and give protection to staff that are under pressure to do otherwise
  - Must be **staffed with people with the appropriate mix of personal character and experience** to withstand inappropriate pressure from market participants
  - Must be **adequately funded**
  - **Must be rotated,** so that they do not develop too narrow a focus of their responsibilities or too close an affinity with the regulated entities

Financial Services Regulation (5)

Risk of collective intellectual failure (Briault, former UK regulator):

- **Prevailing philosophy of supervision** ahead of the financial crisis was based on the assumptions that market forces and market disciplines keep both the economy and individual regulated firms broadly on track and that the senior management and boards of regulated firms have a strong and long-term interest in firms performing well (Turner Report, 2009)

- **Possible remedies:**
  - Society needs to decide what it wants the financial sector to look like (cf. false debate about the choice between financial stability and economic growth)
  - More attention needs to be paid to macro-prudential oversight
  - Market participants and policymakers need to recognise that not all risks can be anticipated and that resilience needs to be built to cope with risks once they do materialise (importance of recovery and resolution plans)

Insurance Regulation: The Case of Solvency II

- **The development of the Solvency II** project has been frequently quoted as a good example of the better regulation approach
- **Design based upon close cooperation between EC, Member States and insurance supervisors** with intensive consultation at all stages of the project, full transparency, public hearings + 5 QIS exercises
- **Solvency II was developed before the financial crisis and before the Lisbon Treaty (2007)** and was a perfect application of the Lamfalussy approach (3 levels of regulation: principle based Directive, implementing measures to be adopted by the EC and guidelines to be adopted by insurance supervisors (CEIOPS)

Solvency II:
Impact Assessment

- **Impact Assessment Report (60 p. with 1000 p. of annexes)**
  - Procedural issues and consultation of interested parties
  - Problem definition
  - Objectives of the Solvency II project (general, specific, operational)
  - Policy options, impact analysis and comparison (with banking)
  - Overall expected impact of Solvency II
  - Monitoring and evaluation
  - Overview of analytical work conducted

- **Opinion of the Impact Assessment Board**
  - One meeting – no resubmission necessary

Solvency II: Follow-up

- **Omnibus II not a good example of better regulation**
  - Change of legislative approach “en cours de route”: no more Lamfalussy after the Lisbon Treaty (from principle based to rules based) – see also the different approach under CRD IV
  - Regulatory capture in the implementation phase: definition of the risk free rate (life is beautiful without market risk!)
  - Need to change the date of application twice through quick fix Directives
  - Priority given to the banking agenda delayed the negotiations and adoption of the Directive unnecessarily
  - Positive aspect: impact assessment of long term guarantee package through EIOPA
    (increasingly treated as technical advisor to the EP)

Solvency II:
Aspects of Smart Regulation

- **Level 1:** phased-in application; review clauses (cooperation between supervisory authorities, group support, SCR standard formula, LTG package and equity risk); proportionality (reporting, governance)
- **Level 2:** review clause (calibration of risks); proportionality (governance, market consistent valuation)
- **Level 3:** proportionality (governance, reporting templates); involvement of the stakeholders in Insurance and Reinsurance Stakeholder Group
- **At all levels:** required impact assessment
- **Single EU rulebook – Supervisory handbook**

Solvency II:
Smart Regulation Questions

- Have we not reached the stage of consultation fatigue?
- Will “regulatory capture” not stand in the way of the economic risk based approach which is at the heart of Solvency II?
- Who will monitor the transposition of the Solvency II Directive?
- Who will monitor the application of Solvency II?
- Will national supervisors live up to a uniform EU regulatory approach?
- Will EIOPA have the necessary funding to deliver?
- Will EIOPA not be trapped by “self-capture”, i.e. run its own agenda?
- Who exercises public oversight over EIOPA?
- What is the practical difference between RTS, ITS and guidelines?

Smart Insurance Regulation (1)

- **Regulation should respect the unique feature of insurance**, which is a service and not a product
- Because it is a service, the **consumer focus** must be a high priority
- **Consumers do not behave as a “homo economicus”:** consumer behaviour cannot be planned
- **Not everything that counts can be counted and not everything that can be counted counts** (Einstein)
- **Proportionality must be applied at all stages, including in supervision**
- Because insurance is **long term business, insurance regulation** (and supervision) **should be forward looking** to anticipate problems

Smart Insurance Regulation (2)

- **Consumer agenda should not be overly protective**, i.e. if all risks for the consumer are removed by regulation (paternalistic approach), the premium will go up or the product will disappear
- For important risks (longevity, long term care, natural catastrophes), insurance regulation should provide for **public-private sector partnerships in order to avoid a transfer of these risks to society**
- **Consumers will always need insurance advice**, i.e. insurance intermediaries will continue to have a role to play (danger of advice gap)
- Insurance regulation should follow an **interdisciplinary approach**

Concluding Remarks

- Insurance remains **the great unknown**
- Banking regulation should not be the first or only inspiration for smart insurance regulation
- Smart insurance regulation can benefit from **interdisciplinary academic research**
- The **principle based approach** of Solvency II should not be destroyed by an ever-increasing amount of level 3 rules
- **Not everything that can be regulated should be regulated**

The Holy Grail

- “Everything should be made as simple as possible, but not simpler” (Albert Einstein)

- “Be content with what you have.
  Rejoice in the way things are. When you realise there is nothing lacking, the whole world belongs to you” (Lao Tzu)

- The Holy Grail of smart insurance regulation may be found in the application of the principle of modesty