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# AVOIDING THE RISKS OF REGULATORY RED TAPE

Insurance regulation for the 21st century

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# Executive summary

- The extent of regulation of insurance companies has grown significantly in recent decades.
- The ‘freedom with publicity’ regime which defined the regulatory approach from 1870 to 1970 appeared to work and ran with the grain of the market.
- Arguments that are given today for prudential regulation of insurers tend to be spurious or not well founded.
- Much government regulation of insurance companies is unlikely to achieve its declared objective and might even encourage problematic behaviours within insurance markets.
- Regulation to ensure good governance and good information flows to markets may have some benefits and is less likely to cause the problems that other forms of regulation create.
- A case can be made for regulation designed to promote the objective of consumer protection. However, all the benefits of such regulation can be achieved with far fewer costs by creating a voluntary system of government regulation. Whether an insurance policy was written by a company which was part of the government regulatory system should be very clear to consumers at the point of sale.

# Introduction

A distinction is often made between two types of financial regulation. Firstly, there is regulation related to market conduct and consumer protection. As far as insurance is concerned, this generally involves regulating the sales process for insurance products. In the UK, this form of regulation is mainly the responsibility of the Financial Conduct Authority (FCA). Secondly, financial companies are subject to regulation relating to how they manage the risks they face and the capital they hold. That is, regulators set rules that are designed to ensure that the assets of insurance companies will be sufficient for them to meet their obligations to policyholders and to remain solvent. This form of regulation is often described as 'prudential regulation' and is handled in the UK by the Prudential Regulation Authority (PRA). It is the prudential regulation of insurance that this paper addresses.

At first sight, ensuring the solvency of an insurance company might be thought of as an obvious function of a government regulator. After all, the insolvency of an insurance company could seriously damage policyholders. A widow might be left with insufficient money to cope after the death of her husband, or pensions might go unpaid, or people might not receive compensation after a car accident, and so on.

However, until the 1970s at least, the prudential regulation of insurance companies was extremely 'light touch' and yet insolvencies were very rare. This should not be surprising. Customers do not want to deal with insurance companies that are likely to not meet their obligations.

Although policyholders wish to deal with insurance companies that are highly likely to meet their obligations, they will not want security at any price. Thus, the objective of the regulator should not be to prevent the failure of an insurer. Regulators should have a more limited objective of protecting policyholders' legitimate interests, and possibly those of the wider public, where they are not protected by market mechanisms.

These issues are examined below, and an alternative approach to regulation is proposed. This alternative involves returning to a lighter-touch regime and making prudential regulation voluntary.

# Arguments for the prudential regulation of insurance companies

## *Regulation to ensure that the customer is not 'duped'*

The Financial Services Authority (FSA) was the predecessor body of both the FCA and the PRA. Soon after its formation, it published a paper on the economic rationale for financial regulation. In this paper, Llewellyn (1999) laid out the classical reasons for the prudential regulation of insurance companies. Consumers, it was argued, might not have sufficient information to take rational decisions and information might be expensive to acquire. This will lead to what are often described as 'information asymmetries'. Related to this, it was also argued that no amount of information given at the point of sale of a financial product could prevent an insurance company behaving imprudently after the product had been sold. Given that insurance contracts can last many decades and it is very difficult to specify in the contract how the insurer should behave in the future, this could lead to serious problems. It is argued that regulation can be used to ensure that the original aspirations of the purchasers of insurance, in terms of the security of their contract, are met.[1]

## *Insurance companies and systemic risk*

More wide-ranging justifications for insurance company capital regulation are provided by Debbage and Dickinson (2013), writing as employees of the PRA. They note that the general objectives of the PRA include the promotion of the safety and soundness of the firms it regulates, especially in relation to financial stability. In addition, the PRA has a specific objective to help ensure that insurance company policyholders are appropriately protected. As well as reiterating arguments similar to those made by Llewellyn, Debbage and Dickinson make additional arguments for insurance regulation. Firstly, they suggest that the failure of an insurer may make it difficult for the insured to obtain cover on terms that are as favourable as those with the failed insurer. This might happen because the insured has a long-term contract and the risk factors surrounding the insured may have deteriorated.

1 For a fuller discussion of this aspect of the justification for insurance company regulation, see Booth and Morrison (2007). See also below.

The authors also express concerns about the possible impact on financial stability resulting from the failure of an insurer. By way of example, they cite AIG, which was rescued during the financial crisis, though they note that any impact on financial stability would have arisen as a result of AIG's connections to the banking system which would have transmitted the risks from the insurer to the financial system as a whole.

Additionally, Debbage and Dickinson suggest that financial instability can arise if insurance companies are incentivised to act in a way that amplifies asset price movements. There could be problems, for example, if insurance companies sold relatively risky assets, such as equities, in concert and their actions then led to a fall in the price of those assets. As a consequence of this, insurers may then be concerned that they hold too little capital (because their remaining equity assets will have fallen in value) and, in an attempt to reduce risk and therefore reduce the amount of capital they need to hold, they might make further sales of their risky equity-based assets thus reinforcing the downward spiral.[2]

Debbage and Dickinson also argue that markets might be disrupted, with particular lines of insurance becoming unavailable, if a dominant player failed. French et al. (2015) take this argument further, suggesting that vital insurance services could be disrupted by an insurance company failure. Effectively, they use an argument analogous to that used in utilities, such as in the provision of water services. In that case, it is often claimed that the industry should be regulated in such a way that there is no disruption to services if a water company fails.

2 There are other, more technical, ways in which such problems could occur. For example, in the late 1990s, life insurance companies were worried about their capital position and bought long-dated gilts in a market with few assets available. They did this in order to hold assets to match their longer-dated liabilities. Their attempts to buy such gilts reduced interest rates which raised the value insurance companies had to put on their liabilities. This reduced their capital further and increased their desire to buy the longer-dated gilts.

# Critiquing the case for regulation

## *Are insurance companies really systemic?*

It is possible that the activities of insurance companies might lead to system-wide problems throughout the financial services industry. But it is unlikely and, in any case, this possibility does not justify the regulation of insurance companies.

The most serious systemic risks will arise when insurers are linked to the banking sector. This is why the case of AIG, which held credit default swap positions, is so often cited. However, to focus on regulating insurance companies to contain such risks is to hold the regulatory telescope the wrong way round. The regulation of banks is often proposed because of the systemic risk that arises from the failure of a bank. This is an arguable position, but one that is widely held in the literature. If banks are regulated for this reason, regulators should take into account the security of their insurance company (and other) counterparties when setting bank capital requirements. This is precisely the approach of the Basel Accord rules which require a bank to vary its minimum capital requirements with the credit quality of its counterparties. But the financial regulator need not, and should not, then dictate the capital of the counterparties (at least, not on this ground). Having the financial regulator interfere in the business of an entity that has an important relationship with a bank could lead to the absurd position of a financial regulator taking responsibility for any company the failure of which might significantly affect the capital position of a bank.

The other main financial stability argument is related to the possible impact of insurance companies on investment markets. As noted above, a problem may arise if insurance companies unconsciously co-ordinate their investment behaviour and, in doing so, move investment markets in such

a way that their solvency is collectively impaired. Although, such problems have arisen from time-to-time, regulation is likely to exacerbate rather than alleviate such problems. This is because the response of insurers to asset price movements tends to arise from attempts to protect their regulatory capital position.

For example, the regulator typically requires insurance companies to hold more capital when they invest in equities. A decline in the value of equities will reduce the amount of capital insurance companies hold, because their assets will have fallen in value relative to their liabilities. This, in turn, might lead insurance companies to reduce their equity investment further in order to bring the amount of capital they are required to hold by the regulator down to the level they actually hold. If all companies reduce their investment in equities in this way, the problem will be exacerbated and might even turn into a vicious circle.

In the absence of regulation, insurance companies could make judgements about the price of and prospective returns from equities in relation to their risk. If prices fall, they might be happy to hold less capital, expecting the problem to be temporary. At the very least, if companies make independent decisions about how much capital to hold, it is less likely that their behaviour will be as co-ordinated and cause the problems described. Similar arguments have been made about the problem of rigid regulations leading to co-ordinated behaviour in the banking sector, including during the financial crisis (see Myddelton 2009).

In the past, regulators have relaxed capital requirements in the above circumstances, which is perhaps an indication of regulators admitting that regulation is at least part of the problem rather than the solution to such co-ordinated behaviour and apparent systemic risk in asset markets.

Do regulators need to protect customers against information asymmetries? The most compelling reason for the prudential regulation of insurance companies would appear to be the information asymmetry argument. The important question here is why the soundness of insurance companies should be ‘under-supplied’ in the market. The providers of capital to insurance companies do not want insurers to become insolvent and neither do their policyholders. The sound management of an insurance company should have a value in the market. Insofar as reduced risk comes

with a cost, why would consumers not be willing to pay the cost? As far as the providers of capital are concerned, well-capitalised insurers will provide lower returns to shareholders, but they will also be less risky for shareholders and policyholders.

The standard answer appeals to the so-called 'lemons' problem (see Akerlof 1970). An insurer that was managed soundly may not be able to distinguish itself from a less sound company in the eyes of policyholders. As such, an insurance company might get no benefit from holding more capital or from otherwise behaving soundly.[3] This could lead to lower prudential standards and a reduction in the size of insurance markets.

However, the existence of information asymmetries is not in itself a problem that demands government regulation. There are institutions within the market that can assess the soundness of an insurer and communicate this in simple ways. These institutions include credit rating agencies and financial intermediaries. These market institutions will employ investment analysts and financial advisers who should be able to interpret complex information. Indeed, the system for regulating life insurance that prevailed from 1870 until 1970 relied on companies publishing information with the expressed purpose that it could be interpreted by intermediaries and, through that mechanism, affect consumer decisions.[4] During that century there were only two failures of life insurance companies and neither of those affected policyholders adversely (see Booth 2007).

In fact, regulatory interventions have worked against the development of market institutions that solve these problems without regulation. Until 1979, the sale of insurance and retail investment products was essentially unregulated or, more correctly, it was regulated by general contract law and by market institutions. One important such market institution was a maximum commission agreement amongst life insurance companies. This helped ensure that intermediaries made recommendations based on the soundness of the life insurance company whose policies they were recommending, or on the basis of other characteristics valued by the purchaser. This agreement was abolished by the competition authorities under pressure from the EU.

Markets can also develop corporate governance arrangements to deal with specific problems that might be of concern to customers. The mutual

3 Indeed, because of limited liability, shareholders might benefit from the upside of risky strategies whilst their losses from the downside of risky strategies are limited to the value of their shares.

4 This system was known as 'freedom with publicity'.

ownership form, for example, reduces conflicts of interest between policyholders and owners and therefore reduces the significance of information asymmetries. The mutual form might be inefficient in other ways: for example, it makes access to capital more expensive and it tends to increase conflicts of interest between managers and owners. It is notable that the number of mutual life insurance companies has fallen almost to zero since the statutory regulation of insurance companies expanded in the 1980s.

Another, more persuasive argument for regulation, related to the information asymmetry argument, is the 'time consistency' or 'commitment' problem (see Booth and Morrison 2007; Llewellyn 1999). This problem is a little more subtle than the standard information asymmetry arguments. Even if an insurer were sound when a customer takes out an insurance policy, over the course of the life of the policy, which may last decades, the insurer might begin to behave more recklessly. This is a more difficult problem to resolve than the information asymmetry problem. However, it can be resolved by the adoption of particular types of corporate structures – especially the mutual structure which, as noted, helps to better align the interests of owners and customers. Nevertheless, this specific problem can justify the use of statutory regulation and it is addressed further below.

# Public choice arguments against government regulation

As well as critiques of the specific arguments which have been developed to justify the prudential regulation of insurance companies, the whole conceptual framework used to justify government regulation of insurers can be questioned.

Proponents of regulation often use 'market failure' arguments to justify regulation (see, for example, Debbage and Dickinson 2013). Indeed, the arguments above fall into that category. However, it should not be assumed that regulators have the knowledge or will in practice act to remove market failures efficiently. Just as participants in markets do not act according to the textbook assumptions of perfect competition, regulators cannot be assumed to act in such a way that imperfections will be corrected. For example, they will not have knowledge of policyholders' preferences for risk. In addition, regulation can be captured by industry insiders and designed to make new entry and competition more difficult. Regulation may also be used to pursue the objectives of politicians or regulators themselves. This may lead to the development of highly complex forms of regulation and control which, in turn, will lead to a requirement for large regulatory bureaus to implement regulation and supervise insurance companies. In summary, it is very difficult, in advance, to determine whether giving particular powers to a regulatory body will improve or worsen consumer welfare.

As a result of these problems, regulation may have damaging side effects and may not achieve the desired results. The failure of Equitable Life in 2000 provides a good example of this. It was notable, for example, that insurance regulation had expanded rapidly through the 1980s and 1990s whilst not, in any sense, addressing the huge risks that the company was taking on. Indeed, the particular actuarial and accounting methods that regulation encouraged were especially unsuited to the risks that the Equitable had taken on.

There is also little incentive for a government regulatory body to contain costs, which, in the UK, are effectively borne by insurance companies' customers. The implementation of the EU Solvency II regime is estimated by the UK Treasury to cost £2.6 billion with an ongoing cost of £196 million a year.[5] The total length of the Solvency II directive and related instruments from the European Insurance and Occupational Pensions Authority is 3,200 pages and the UK regulator has imposed further costly requirements on top.

The increase in the total costs of financial regulation since the Financial Services Authority (FSA) was formed has been substantial. Insurance companies are now regulated by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). Table 1 shows staff costs for the FSA and then the FCA and PRA combined for 2001/02, 2006/07, 2011/12 and 2016/17.

**Table 1: Direct costs of main government financial regulatory bodies – selected years**

| Year | Cost of FSA (PRA and FCA combined for 2016/17), £million | Cost of FSA (PRA and FCA combined for 2016/17) in 2016 prices, £million |
|---|---|---|
| 2001/02 | 195.8 | 303.0 |
| 2006/07 | 274.1 | 377.0 |
| 2011/12 | 470.0 | 527.6 |
| 2016/17 | 773.3 | 773.3 |

It is perhaps not surprising that there was an increase in supervision costs following the 2008 crisis, though whether there should have been is another matter. However, even since 2011/12, the total direct costs of financial regulation have increased by 46 per cent. In addition to the direct costs of regulation, there are costs of compliance borne by firms (and their customers) and costs borne by consumers resulting from market distortions and reduced innovation.

The side effects of earlier government regulations in encouraging herding behaviour amongst investors is exacerbated by the international harmonisation of regulation. This approach to regulation, which increasingly

5 https://publications.parliament.uk/pa/cm201719/cmselect/cmtreasy/324/324.pdf 20

dominates the financial services landscape both inside and outside the EU, can raise systemic risk because insurers might respond in a like manner to a shock, with their behaviour driven by regulatory requirements. The effect was summed up by Yale law academic and NBER scholar Roberta Romano (2014) in her paper describing the Basel Approach to bank capital regulation:

> Recent experience suggests that regulatory harmonization can increase, rather than decrease, systemic risk, an effect that is the precise opposite of the objective of harmonization. By incentivizing financial institutions worldwide to follow broadly similar business strategies, regulatory error contributed to a global financial crisis…The Article contends, accordingly, that there would be value added from increasing the flexibility of the international financial regulatory architecture as a means of reducing systemic risk.

In addition, the IMF (2015: 33) has suggested that pension funds and insurance companies are less able to absorb shocks in asset markets arising from the behaviour of other institutions as a result of capital regulation.

Cognisant of the arguments set out in this section, the Better Regulation Task Force[6] suggested in its various reports that alternatives to direct government regulation should always be considered. These alternatives included doing nothing, voluntary codes of practice, and using regulatory approaches that evolve within the market itself.

6 This later evolved into bodies with different names. See, for example, http://webarchive.nationalarchives.gov.uk/20100407173247/http://archive.cabinetoffice.gov.uk/brc/upload/assets/www.brc.gov.uk/principlesleaflet.pdf

# A new approach to insurance regulation

Before discussing the details of the proposed regulatory regime, it should be noted that an important aspect of the legal regime in relation to insurers is the approach to managing bankruptcy. Unlike banks, insurers tend to fail in 'slow motion' – this is true even with non-life insurance such as motor, aviation or liability insurance. A shortfall of assets becomes apparent and the company has to be wound up. Since 1870, the normal approach with life insurance companies is to top slice payouts to the insured.[7] The insurance company's business can be run-off, perhaps being sold as a book of business to another company. This is the approach being taken to the business of the Equitable, the most recent large life insurance failure. The law should continue to facilitate this approach, which ensures an equitable way of dealing with losses and enforcing contractual obligations. However, this leaves the question of how far regulation should go beyond simply ensuring an orderly failure of insurance companies.

## *Requiring disclosure*

Although scepticism is expressed above about the need for regulation to address the problem of information asymmetries, it is worth noting the relative success of the form of regulation used throughout the 20th century. Such regulation was, in fact, designed to address information shortfalls. The 1870 Life Insurance Companies Act (and a number of following Acts which made small amendments and extensions to the scope of the legislation) allowed insurers to be free to act as they wished as long as they published information to the market. Correspondence between the overseeing government department (the Board of Trade) could also take place and, if desired, be published. This act was not intrusive and it was successful in ensuring that there was a thriving and stable insurance market.

7 Since 1975, policyholders have been compensated by a central fund (now the Financial Services Compensation Scheme) to ensure that they receive benefits of the value of between 90 per cent and 100 per cent of their claims if their insurance company is insolvent. This scheme is funded by the industry.

8 There is a good description of the winding-up and run-off processes in French et al (2015), page 46.

In this spirit, it is suggested that regulation along the lines of Pillars II and III of the EU Solvency II insurance regulation framework has the greatest chance of being most helpful and least damaging. These pillars require procedures to be adopted by insurance companies that ensure sound governance and transparency in their operation. There are dangers arising from regulators requiring insurers to produce large numbers of documents to demonstrate that they are soundly governed. Process can easily become more important than the crucial job of ensuring accountable governance. Nevertheless, it can be argued that these aspects of Solvency II are the least problematic and may bring certain advantages.

## *No need to regulate capital*

However, regulation should not require insurance companies to hold a specific level of capital designed to be apparently compatible with a given probability of insolvency. The most important and complex aspect of the Solvency II EU framework, as implemented by the PRA, involves the regulator setting regulatory capital levels for each company. As discussed by Bettis et al. (2016)[9] and the references therein, under the Solvency II framework, the regulator sets capital requirements so that insurance companies have a 1 in 200 chance of failure over one year.

Firstly, this raises the question 'why 1 in 200?'. Reducing risk comes at a cost. How do we know now much risk policyholders want to take? The theory around information asymmetries does not suggest that regulators know more about how much risk policyholders want to take than policyholders do, only that policyholders might not be able to effectively monitor insurance companies. Secondly, regulating capital to ensure a given probability of failure for all companies requires the development of a generalised model of capital setting that is necessarily incredibly complex. This leads directly to the problem of the complexity, length and cost of Solvency II discussed above. Furthermore, mathematical models designed to set capital can only ever quantify risk and not the kind of radical uncertainty that often generates the shocks that bring down insurance companies (see de Soto 2009).

9 See: http://www.lse.ac.uk/GranthamInstitute/wp-content/uploads/2015/11/Working-Paper-217-Bettis-et-al-2016.pdf

Indeed, the idea that we need regulators to determine insurance company capital is highly questionable. As Bettis et al. note, 'in practice, insurance companies normally hold sufficient capital such that the risk of ruin is far lower than this level [1 in 200]. Large reinsurance companies such as Munich Re and Swiss Re typically aim for a credit rating in the region of AA. An estimate of the average default probability for corporations rated AA over a one-year horizon is currently 0.02% or 1 in 5,000'.

The Solvency II capital-setting framework and its derivative UK regulation should be replaced by a simple requirement for an insurance company to demonstrate its solvency and the extent of its free capital. It should be able to do so at any time upon request from the regulator and periodically publish the result and the assumptions upon which the calculations are based. The role of the regulator should be to monitor and supervise. It should be able to raise concerns with the company privately and, if deemed appropriate, publish correspondence (together with responses from the company) about the risks the company faces and its underlying solvency position.

## *Making regulation voluntary*

The above model would be an updated version of the approach to insurance company regulation that was taken before the UK entered the European Union. It addresses the main problems in insurance markets which economists believe may cause 'market failure'. However, the proposal does not address the 'commitment problem'. How does a policyholder know that an insurance company that is sound at the time of sale will remain sound throughout the term of the policy (and possibly beyond in the case of some insurance contracts)? As has been discussed, this problem can be resolved by market institutions such as the mutual ownership model. However, a voluntary regulation regime run by a government regulator would provide an additional mechanism that would compete with approaches that developed within markets designed to ensure that insurance companies operated in the best interests of policyholders.

Through this mechanism, a state insurance regulator would provide a regulatory framework which insurance companies could choose to join. This could provide regulation on, for example, the amount of capital that should be held by an insurer. If a company left the state regulatory

framework, existing business would continue to be regulated by the government regulator and new business would have to be written in a separate subsidiary which would be outside the government regulatory regime. This approach is necessary to resolve the ‘commitment problem’: consumers must know that, once they take out a policy, it will be regulated under the regime promised. If consumers deemed the benefits of the regulatory regime to be greater than the costs, they would be attracted to doing business with companies that subjected themselves to the regime. It would seem unlikely that consumers would underestimate the value of regulation. Of course, a company’s products should be clearly badged to show whether they are regulated by the government regulator.

This mechanism would allow innovation in private forms of regulation. It would also ensure that innovation within the market was not stifled by regulation. The approach would give the government regulatory body an incentive to ensure that regulation was proportionate and efficiently administered. Customers could also choose to do business with insurance companies regulated according to another country’s regime, including EU companies following an unreformed Solvency II regime post Brexit.

# Conclusion

In common with other parts of the financial system, there has been a huge expansion of the regulation of insurance companies in recent years. However, such regulation rarely comes with any explicit and solid justification. The reasons given for prudential regulation of insurance companies are tenuous and do not take into account the difficulties of improving market outcomes through regulation.

The strongest justification for regulation is that consumers might lack the ability to make judgements about the soundness of insurance companies. With this in mind, regulation should focus on the provision of information and not inhibit the development of market institutions designed to interpret information. Regulation designed to ensure good governance within insurance companies is likely to be more productive (or less unproductive) than the direct regulation of insurance company capital which has many problematic side effects. The economic arguments for regulation lead strongly in the direction of insurance company regulation from statutory bodies being voluntary. If such regulation were effective, it would be valued by consumers and insurers would have to subject themselves to it.

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