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Original Article

The politics of insurance regulation and supervision reform in the European Union

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Abstract In the late 2000s, the European Union (EU) undertook a significant reform of the framework for insurance regulation and supervision through the Solvency II directive, which substantially updated prudential rules and supervisory practices. This article addresses the question of what has driven the reform of the framework for insurance regulation and supervision in the EU. It is argued that the politics of the Solvency II directive was characterised by a strong alliance between the Commission and the United Kingdom, backed up by the large member states, some old member states and industry, particularly large companies and transnational groups. The United Kingdom was, however, the pace setter, whose influence was underpinned by the size of its insurance market; the expertise and effective coordination of national policymakers, and a state-of-the-art domestic regulatory model.
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Introduction

The ongoing global financial turmoil has brought into the spotlight the political salience of financial services regulation. In the insurance sector, the main US insurance group, the American International Group, Inc., which is also the largest insurance group worldwide, had to be rescued by the US federal authorities. The regulatory framework of the European Union (EU) is crucial in the multi-level governance of financial services because the national legislation of the member states is shaped by, or at the very least incorporates EU rules. After the re-launch of the completion of the Single Market in financial services through the Financial Services Action Plan (FSAP) and the

setting up of the so-called Lamfalussy architecture (see Mügge, 2006; Quaglia, 2007), there has been intense activity in the EU concerning the regulation of securities markets, as well as in the banking sector (for an overview see Posner, 2007; Macartney and Moran, 2008). Belatedly, in the late 2000s, the EU undertook a significant reform of the framework for insurance regulation and supervision through the Solvency II directive, which is designed to set in place a risk-based, principle-based approach to the prudential regulation of insurance companies. It is also the first directive in the insurance sector adopted through the Lamfalussy architecture.

This article addresses the question of what has driven the reform of the framework for insurance regulation and supervision in the EU by looking at the Solvency II directive, which substantially updates prudential rules and supervisory practices. Theoretically, this work feeds into two main bodies of literature reviewed in the section 'State of the Art on the Politics of Financial Regulation in the EU and the Analytical Framework'. First, there is the academic debate concerning the politics of financial market integration and regulation, which is framed around three competing understandings of political economy, namely the 'battle of the system' approach, the supranational entrepreneurship of the European Commission and the role of transnational capital. This body of political economy literature is linked to 'traditional' European integration theories in the following section. Second, there is the theoretical debate concerning the factors affecting the 'uploading' of rules and policy templates from the national level to the EU level and the influence of the member states in the EU policymaking process.

It is argued that the politics of the Solvency II directive was characterised by a strong alliance between the Commission and the United Kingdom, backed up by the large member states, some old member states and industry, particularly large companies and transnational groups. The United Kingdom was, however, the pace setter, whose influence was underpinned by the size of its insurance market, the expertise and effective coordination of national policymakers, and a state-of-the-art domestic regulatory model.

The State of the Art on the Politics of Financial Regulation in the EU and the Analytical Framework

Several different answers have been given by political scientists as to what drives financial market integration in the EU, even though the insurance sector has been understudied in comparison to other financial services. Only the path-breaking work of Story and Walter (1997) included the insurance sector, stressing the intergovernmental character of the negotiations concerning financial market regulation in the EU. This work regarded financial market

integration as the 'battle of the systems' (which is part of the title of the book), whereby the member states were keen to set EU rules that were in line with their domestic regulatory approach and did not create comparative disadvantages or adjustment costs to national industry and the public authorities.

A similar approach was also taken by Underhill (1997) and Coleman and Underhill (1998), who, like Story and Walter, highlighted how the 'triangle' of the three main financial systems in the EU – the British, the French and the German – played out and shaped EU financial regulation in the 1980s and early 1990s. This explanation can be linked to the scholarly debate on varieties of capitalism in Europe (Hall and Soskice, 2001; Schmidt, 2002; Hancké *et al*, 2007) in that the persistent diversity of national financial systems across Europe and their different links to the rest of the economy are part and parcel of the varieties of capitalism that remain in Europe. In the literature on European integration, this explanation would fit in into an liberal intergovernmentalist account of European financial market integration (Moravcsik, 1998).

A second explanation focuses on the role of a supranational bureaucracy, the European Commission, in driving forward financial market integration (Posner, 2005; Jabko, 2006). This explanation coincides with a supranational governance approach to European financial market integration (Sandholtz and Stone-Sweet, 1998). A third explanation focuses on the role of the private sector, in particular transnational capital, keen to expand and operate across border (Van Apeldoorn, 2002; Bieling, 2003; Mügge, 2006; for a qualification of this argument see Macartney, forthcoming; for an interpretation playing down the role of economic interest groups in financial market integration see Grossman, 2004). This explanation can be regarded as a variation of the supranational governance approach, which has much in common with its ancestor, the neo-functionalist approach (Haas, 1968), which postulates the shifting of loyalties of interest groups from the national level to the EU level.

Other scholars have focused on networks of regulators in the EU (Coen and Thatcher, 2008; De Visscher *et al*, 2008; Quaglia, 2008a). This approach, however, has limited explanatory power in the making of level 1 legislation, in which these committees perform only advisory functions.[1] All these works provide useful insights, but none of them deal with insurance markets. The explanatory power of the intergovernmental 'battle of the systems' approach, the supranational 'Commission-led' approach, the transnational 'industry-led' approach is assessed against the empirical record of the making of the Solvency II directive in the section 'Explaining the Reform of Insurance Regulation in the EU'.

The analytical framework of this research has two main building blocks. To begin with, borrowing from Héritier (1996, pp. 150–151) and other public policy approaches based on the concept of 'policy cycle' (for an overview

see Hill, 2005), the analysis divides the EU policymaking process into three consecutive stages: the 'brain storming' stage of 'problem definition' (pre-legislative); the 'policy formulation' stage of 'problem solution' (the drafting of legislation); and the political co-decision stage, characterised by traditional EU negotiations involving the member states and the European Parliament (EP).

Second, the literature on the 'uploading' phase of Europeanisation is drawn upon. This literature can be divided into two main (inter-related) bodies of scholarly works, which often overlap. On the one side, the vast majority of works use the concept of 'policy transfer' and tend to focus on institutional variables at the EU level (Radaelli, 2000; Padgett, 2003; Bulmer and Padgett, 2004; Bulmer *et al*, 2007; Howell, 2004). This approach has a considerable explanatory leverage when different policy-making processes and case studies are analysed and compared, but it is somewhat less revealing when applied to one case study, especially if the research objective is to explain what has driven the reform process.

On the other side, there are works that focus on national specific variables in order to explain member states' ability (or not) to upload their policy preferences at the EU level (Börzel, 2002; Wallace, 2005). Besides, the literature on member states in the EU (Bulmer and Lequesne, 2005), and in particular small member states in the EU (Maes and Verdun, 2005) also deals with this aspect. This perspective seemed to be the most suitable for this research because early on, while conducting empirical research, it became clear that one member state, the United Kingdom, had a crucial role in the shaping and coming about of the Solvency II directive.

The literature on the role of the member states in the uploading process highlights the concept of 'policy capacity', which, in turn, is determined by a variety of national factors: the size of the member states, which affects the resources that can be deployed in EU policymaking (see also the literature on Council negotiations, Hayes-Renshaw *et al*, 2006 and bargaining in the EU; Bailer, 2004), the expertise (or not) at their disposal (Radaelli, 1999; Tallberg, 2006); the effective (or not) coordination among national policymakers (Kassim *et al*, 2000a, b); the 'first mover advantage', meaning an existing national model of regulation suitable to be uploaded at the EU level (Padgett, 2003). Synthesising this literature, it is possible to postulate that there are four main sets of country-specific factors that can affect member states influence in EU policy-making: political and economic weight; expertise and subject specific knowledge; effective coordination among domestic policymakers; suitable national regulatory models (many of these factors are pointed out by Wallace, 2005).

Methodologically, this research proceeds as follows. The next section outlines the context in which the Solvency II directive was negotiated: the main features of the insurance market in the EU as well as the existing regulatory environment, paying particular attention to the reform that took place in the

United Kingdom in 2004–2005. The section following this discusses the content of the Solvency II directive and employs the *congruence procedure*[2] in order to highlight whether (or to what extent) the regulatory outcomes – namely, the content of the Solvency II directive – was in line, or compatible with the preferences of British policymakers. The subsequent section applies *process tracing* to the making of the Solvency II directive, highlighting the influence of the main actors, in particular the United Kingdom, at each stage of the policy process. After this, the explanatory power of country-specific factors in the United Kingdom is evaluated against the empirical record. This section also assesses the analytical leverage of alternative or complementary explanations of the politics of financial services regulation in the EU put forward in the literature reviewed in this section.

The Context of the Reform of Insurance Regulation in the EU

The EU has the largest insurance industry worldwide, providing insurance and reinsurance services also to markets outside Europe. Over the last two decades, the premium income of the insurance industry in Europe has outpaced that of North America, starting from a position of clear inferiority. The largest insurance industries in the EU in terms of premium income and number of employees are located in the United Kingdom, Germany and France, followed by the Netherlands and Italy (see Table 1). The top eight largest insurance groups are located in Germany, France, the United Kingdom, Italy and the Netherlands (see Table 2). The new member states host several subsidiaries of insurance companies based in the old member states, in particular the five countries that have the largest insurance groups.

As far as the regulatory environment is concerned, the solvency margin is the amount of capital that an insurance undertaking is required to hold against unforeseen events. Such requirements have been in place in the EU since the 1970s and have been amended by the Solvency I directive in 2002, which raised the minimum guarantee fund. However, the Solvency I directive was based on

Table 1: European insurance industry in figures (2006)

Country	*Number of companies*	*Number of employees*	*Premium income in Euro million*
Germany	642	218 900	163 200
France	480	143 800	194 310
United Kingdom	1050	177 500	295 045

Source: CEA, 2006.

Table 2: Largest European insurance groups (2006)

Rank	*Company*	*Home country*	*Turnover (Euro million)*
1	Allianz	DE	91 095
2	Axa	FR	75 731
3	Prudential	UK	74 536
4	Generali	IT	64 526
5	Aviva	UK	60 499
6	ING	NL	55 267
7	Aegon	NL	49 523
8	Legal & General	UK	48 710

Source: CEA, 2006.

minimum harmonisation, hence the member states were left with considerable room for manoeuvre in shaping their domestic framework for insurance regulation and supervision.

When the discussions on Solvency II began in the early 2000s, all the member states except the United Kingdom had a rule-based approach to solvency requirements, based on the use of standard models; fixed ratios for the solvency requirements of the supervised entities; zero-tolerance of failures; limited (mainly *post hoc*) supervisory review; and no market disclosure. This is what the British Member of European Parliament (MEP) rapporteur of the Solvency II directive, Peter Skinner, and several (mainly British) policymakers labelled as the 'tick box' approach (Tait and Davies, 2009). Within this model, there were, however, differences across the member states, for example concerning which financial instruments would qualify as capital and their valuation.

By contrast, before the proposal of the Solvency II directive was put forward, the United Kingdom, recognising the limitations of the Solvency I rules, set in place an innovative principle-based approach to solvency requirements (FSA, 2001, 2002). The solvency regime devised by the Financial Services Authority (FSA) was centred on Individual Capital Adequacy Standards (ICAS). Such regime was based on targeted risk-sensitive solvency requirements; the presence of dual capital requirements (a 'minimum' capital requirement and an 'enhanced' capital requirement); the possibility of using firms' internal models to calculate solvency requirements; a non-zero failure approach; and intensive ongoing supervisory review (HMT and FSA, 2006a). All these elements, even though with some modifications, were incorporated into the Solvency II directive, as explained below.

The reform introduced in the United Kingdom in January 2005 followed a series of domestic policy failures in the insurance industry, which triggered political pressure to reform the regulatory regime, leading to the so-called 'Tiner reforms' (FSA, 2005a, b). Notwithstanding the consultation at that time

underway at the EU level on the Solvency II project, the FSA concluded that the benefits of introducing its own risk-based capital regime were such that it wanted to press ahead with the reform of the domestic capital adequacy framework without waiting for the negotiations of the Solvency II directive (HMT – FSA, 2006a, b; Deloitte, 2007).

The United Kingdom put self-assessment at the heart of regulation when the FSA introduced the ICAS. All except the smallest British insurers are required to produce internal models to demonstrate their financial strength, whereas few firms outside of the United Kingdom appear to have internal capital models. As for group issues, few firms outside of the United Kingdom have produced results based on group consolidated balance sheets FSA.[3] As a result of this, the British insurance industry and the public authorities are well placed to take advantage from the introduction of the new Solvency II regime.

The Content of the Reform of Insurance Regulation in the EU

The Solvency II directive has a much wider scope than its forerunner, the Solvency I directive. It applies to all life and non-life insurance undertakings and reinsurance undertakings, albeit small mutual undertakings and some small (non-mutual) insurance undertakings are exempted. Pension funds are covered by a specific directive issued in 2003, even though there are ongoing discussions about extending part of the Solvency II directive to pension funds. The Solvency II directive does not change the regime applicable to financial conglomerates, which were regulated by a specific directive issued in 2002. The Solvency II directive is designed to streamline EU legislation, replacing 14 existing directives regulating insurance services with a single directive. As explained below, this legislative approach was advocated by the United Kingdom as an alternative to the legislative approach initially proposed by the Commission.

The new approach is articulated across three pillars that deliberately resemble the three-pillar structure of the Basel II accord that set international capital requirements for banks. Indeed, there are several similarities between the risk-based approach adopted by Basel II and by the Solvency II directive. According to the first pillar of the Solvency II directive, insurers are required to hold capital against market risk, credit risk and operational risk. All these types of risk potentially affect insurers' solvency, though they were not covered by the Solvency I legislation. Pillar 1 outlines two capital requirements, which have different purposes and are calibrated accordingly: the Solvency Capital Requirement, which enables an institution to absorb significant unforeseen losses, and the Minimum Capital Requirement, below which supervisory action is triggered (Commission, 2004). The former cannot be lower than the latter. Subject to supervisory approval, insurers can use their own internal

model to calculate capital requirements. These concepts are similar to those introduced in the United Kingdom by the 2004 domestic reform of insurance regulation discussed in the section 'Context of the Reform of Insurance Regulation in the EU'. The terminology used in the British and EU legislation is the same, with the difference that in the United Kingdom the Solvency Capital Requirement is called 'Enhanced Capital Requirement'. In the drafting of the Solvency II directive, this term, originally drawn from the British regulatory model, was slightly changed to Solvency Capital Requirement for political correctness (interview, London, 30 September 2008, 23 July 2008).

The second pillar of the Solvency II directive, which complements the first one, consists of a supervisory review process of the overall financial position of insurance undertakings. Depending on the outcome of the review, supervisors might require additional capital. The scope of the second pillar also relates to the harmonisation of the supervisory activities. The third pillar outlines requirements concerning the disclosure of information, with a view to impose market discipline on insurance undertakings. These two pillars were also in line with the existing regulatory framework in the United Kingdom, as elaborated in the section 'Context of the Reform of Insurance Regulation in the EU', even though market disclosure, which was completely absent in the regulatory framework of the other member states, was present only to a limited extent in the United Kingdom.

The most controversial issue, which emerged relatively late in the negotiations, was the creation of group support and supervision. According to *group supervision*, a single authority would be appointed with coordination and decision powers for each insurance group. The group supervisor would be given primary responsibility for key aspects of group supervision (group solvency, intragroup transactions and so on) to be exercised in cooperation and consultation with host supervisors (Commission, 2007). *Group support* concerns capital management by groups, which would allow, under certain conditions, a parent undertaking to use declarations of group support to meet part of the Solvency Capital Requirement of its subsidiaries.

According to almost all the interviews conducted during the fieldwork, the United Kingdom is credited for being the crafter of the relevant provisions on group supervision and group support, articulated in a draft document produced by the British Treasury (HMT) and the FSA in November 2006 (HMT-FSA, 2006b), and subsequently taken on board by the Commission in its official legislative proposal presented in July 2007 (interviews, Brussels 9 April 2008; Berlin 23 April 2008; London, 23 July 2008, 30 September 2008). The other large member states, namely, France, Germany and Italy, which like the United Kingdom and the Netherlands, are home to several large insurance groups (see Comité Européen des Assurances, CEA, 2005), also supported the proposal, together with Belgium, although to different degrees. For example,

Italy and Germany did not feel as strongly as the United Kingdom on issues of group supervision (interviews, Berlin, 23 April 2008; Rome, 23 June 2008).

The countries in favour of the group supervision and support regime argued that this would make group supervision more efficient and more effective because risk in pan-European insurance groups is managed at group level (HMT and FSA, 2006b). Moreover, the directive would streamline the supervisory requirements to which the regulated entities are subject, facilitating the activity of cross border groups, the completion of the single market in insurance and the international competitiveness of insurance industry in the EU (HMT and FSA, 2006b). By and large, a similar argument was also articulated by industry (see CEA, 2007b), as elaborated below.

By contrast, 12 member states, led by Poland and Spain and encompassing several new member states, which mainly host subsidiaries and branches of insurance groups, disagreed with the proposed approach (Tait, 2008; interviews, Brussels, 9 April 2008; Berlin, 23 April 2008; Frankfurt, 10 September 2007). The argument used by those opposing the new regime was that group supervision would substantially reduce the power of the supervisory host authorities to control what happens in their jurisdictions and the host supervisors would be 'left to pick up the pieces if local problems emerge' (Felsted and Tait 2008; interviews, Brussels 9 April 2008).

Why was the traditionally somewhat 'Eurosceptic' UK treasury keen to promote group support and supervision in the insurance sector, despite their possible interpretation as a step forward in terms of EU cross-border supervision? One could argue that this was owing to a broader change in the regulatory climate during the 2000s. However, policymakers in certain EU member states did not seem to have been affected by such a change, given the fact that they opposed the inclusion of group support and group supervision in the directive. A more convincing explanation might be that the United Kingdom is the home country of many insurance groups, hence the UK authorities would be the group supervisor for all of them, unlike for example, in the banking sector, whereby the United Kingdom hosts several foreign banks.

Towards the end of the negotiations, owing to the persistent division within the Council (Tait and Davies, 2009, interview, Paris, 7 May 2009), the outcome moved towards the inclusion of a watered down form of group supervision with a legally binding commitment to review the controversial issue of group support 3 years after the entry into force of the new legislation.

The Reform Process of Insurance Regulation in the EU

Borrowing from the literature on policy stages applied to the EU regulatory policy (see Héritier, 1996), the policymaking process of the Solvency II

directive can be divided into three main phases: the ‘brain storming stage’ of ‘problem definition’ (pre-legislative); the ‘policy formulation’ stage of ‘problem solution’ (drafting legislation); and the ‘political decision-making stage’ of co-decision between the EP and the Council of Ministers.

The ‘brain storming stage’ of the reform

In 1999, the Commission began a review of insurance regulation, issuing a paper entitled ‘The Review of the overall Financial Position of an Insurance Undertaking – Solvency II Review’ (Commission, 1999). This was followed by another document issued in March 2001, with the presentation of the proposed work (Commission, 2001a) and a series of Commission’s notes exploring specific issues, such as the relevance of the banking rules on capital requirements for the insurance sector in June 2001 (Commission, 2001b). A general study on solvency was carried out by KPMG on behalf of the Commission at the beginning of 2002 (KPMG, 2002).

The predecessor of the Committee of European Insurance and Occupational Pension Supervisors (CEIOPS), the Conference of Insurance Supervisors (CIS), was asked by the Commission to make recommendations for the review of legislation. A working group of insurance supervisors chaired by Paul Sharma of the British FSA met several times between July 2001 and September 2002. The mandate of the so-called ‘London group’ was: to formulate a more up-to-date picture of the risks that European insurance firms face, and to this end, to identify and analyse the risks that have led to actual solvency problems between 1996 and 2001; and to evaluate how supervisors might respond to these risks (CIS, 2002). The main conclusions of the report were that the review of solvency rules needed to encompass governance and risk management, focusing on qualitative factors such as quality of management and suitability of systems and controls (CIS, 2002, pp. 9–10).

In the ‘brain storming’ stage, the main division concerning the reshaping of the solvency regime in the EU was owing to the coexistence of different regulatory regimes in Europe. These varied from a ‘zero-failure’ target (the prevailing view in Continental Europe) to ‘market-based’ regimes (the UK view), where orderly exits of failed companies are allowed and even expected, as highlighted in the so-called ‘Sharma Report’ submitted to the CIS in December 2002 (CIS, 2002). A (compromise) solution on this divergence was found in the calibration of the so-called confidence level. A ‘market consistent’ approach would result in a 65 per cent confidence level and a ‘prudent’ level would reflect a 80–90 per cent confidence interval. The suggestion of a compromise around 75 per cent made by the United Kingdom and supported by other member states was picked up by the EU Commission and included in

the 'Solvency II Roadmap' as a 'working hypothesis' in the call for advice to the level 3 committee in the insurance sector, the CEIOPS (Geneva Association, 2005, pp. 9, 14).

Overall, quite early on in the discussion, agreement was reached on key principles such as 'risk sensitive capital requirements', 'market consistent evaluation' with 'the use of internal models', taking into account 'diversification', and aiming for 'a non-zero failure rate'. In the document issued in 2002, the Commission summarised the work carried out in the preparatory phase as well as presenting an overview of possible alternatives for a Solvency II system, largely based on these regulatory concepts. In getting this core of the reform proposal, accepted British policymakers were able to set the terms of the debate (problem definition), which also informed the subsequent stage of the drafting of legislation (problem solution).

The 'policy formulation' stage of the reform

In the preparation of the draft legislation, the Commission issued three waves of calls for advice to the level 3 committee, the CEIOPS, regarding different aspects of the new solvency system. The CEIOPS established four working groups to respond to the requests for preparatory work. The CEIOPS also produced a number of Quantitative Impact Studies in order to understand the effects of different proposed models of risk mitigation at the company and industry levels.

In April 2005, the Commission presented an outline of the framework directive, outlining three legislative approaches (Commission, 2005). The approach favoured by the Commission was to simultaneously draft three different framework directives on Solvency II: one directive amending and recasting (where necessary) the Life Assurance Directive, one directive amending and recasting the Non-Life directives and a third directive amending other relevant directives (for example the Insurance Groups Directive) (European Insurance and Occupational Pensions Committee, EIOPC, 2005). The UK delegation proposed a fourth legislative approach. It suggested that the Commission should start from a blank sheet of paper with the aim of codifying and revising the existing directives (life, non-life, reinsurance, group and so on) in one single directive. The proposal was, with some modifications, supported by nine other delegations and the Commission decided to follow this route (EIOPC, 2005). The Solvency II directive was officially proposed by the Commission in July 2007, ending the 'preparatory' stage, after which the political 'co-decision making stage' unfolded.

The draft directive proposed by the Commission matched almost all the main objectives set by the United Kingdom (House of Lords, 2008: Ev. 36). As

remarked by an interviewee, the group supervision and group support regime was not part of the original documents circulated by the Commission in 2004. It was inserted by the Commission at a later stage, substantially incorporating the main points articulated in a paper on group supervision produced by the British Treasury and the FSA in 2006 (interviews, Brussels, 9 April 2008; London, 23 July 2008). At the beginning of the discussions on Solvency II, British policymakers had been reluctant to put forward the idea of group supervision, expecting to encounter some resistance to the innovations already put forward concerning a risk-based approach to solvency requirements. As these concerns did not materialise, it was felt that time was ripe for the proposal on group supervision and group support (House of Lords, 2008: Ev. 36), which was strongly backed up by the Commission and industry.

The 'political decision-making stage' of the reform

The political decision-making stage was based on the co-decision procedure involving the EP and the Council. Pending the EP election in the spring of 2009, there was the clear intention to pass the directive in fist reading, hence a 'trialogue' took place between the Commission and the other two institutions. Whereas the Council was internally divided on the issue of group support and supervision, as outlined in the section 'Content of the Reform of Insurance Regulation in the EU', the EP supported group supervision, even though, in an attempt to find a compromise solution, it recommended increasing the involvement of the host supervisor concerning information dissemination and consultation (EP, 2008). The final stage of the negotiations was very much based on trade-offs and horse trading (Tait, 2008). For example, several attempts were made to downplay the opposition to group supervision, in particular winning over Spain's opposition and separating it from the Polish negotiating position, also using issue-linkage outside the financial sector (interview, Berlin, 23 April 2008). In the end, the directive was adopted as EU fast track legislation, that is adoption at first reading after having been negotiated in a small circle of decision makers.

The insurance industry was active in the debate and consultation of the policymaking process of the directive. At the EU level, the main players were the Comité Européen des Assurances (CEA), which represents the European insurance and reinsurance industry through national insurance associations; the Association Internationale des Sociétés d'Assurances Mutuelle (AISAM) and Association of European Cooperative and Mutual Insurers, which represent mutual insurers and cooperative insurance companies on a global basis; the Chief Risk Officers Forum, which represents 14 large European insurance groups, focusing on risk management; the Chief Finance Officers

Forum, which focuses on accounting issues; and the Groupe Consultatif Actuariėl Européen, which represents the actuarial profession in Europe. FIN-USE, which focuses on consumer issues, was also involved.

The (re)insurance industry, represented by CEA/International Association of Mutual Insurers (AISAM)/Association of European Cooperative and Mutual Insurers (ACME), worked closely with the Commission and the Committee of European Insurance and Occupational Pension Supervisors (CEIPOS), responding to consultations and producing a variety of studies. Industry also interacted with the national authorities, as elucidated below with reference to the United Kingdom, which was particularly effective in this two-way interaction with industry. Industry stressed the importance of taking into account the diversification of risk in all forms (geographical, lines of product, group diversification and so on), arguing that failure to do so would result in higher capital requirements than otherwise, to the detriment of the competitiveness of the European insurance industry (CEA, 2007a, p. 5). The CEA also expressed its support for group supervision, arguing that the ultimate supervisory responsibility must be located at group level for both national and multination groups (CEA, 2007b). The concept of group supervisor was heavily backed up by large international insurance groups, such as Aviva, Axa, Allianz, Generali, Fortis (Tait, 2008), which have headquarters in the large member states and in the Netherlands and Belgium. For example, the issues of the group diversification benefits and the use of the group model had been raised by industry in periodical meetings with the FSA.[4]

Explaining the Reform of Insurance Regulation in the EU

What explains the reform of insurance regulation and supervision in the EU and the politics of the Solvency II directive? Several competing explanations derived from previous research on the politics of financial market integration in the EU reviewed in the section 'State of the Art on the Politics of Financial Regulation in the EU and the Analytical Framework' should be considered: the Commission-led approach; the industry-led approach and the intergovernmental battle of the systems approach.

The *Commission-led* explanation would stress the role played by the Commission in driving forward the reform, in line with many supranationalist accounts (Sandholtz and Stone Sweet, 1998). Indeed, the empirical record suggests that the constructive cooperation between the United Kingdom and the Commission was an important factor in the project coming to light. However, upon the whole, the Commission tended to present policy lines that were largely consistent with the British approach, as documented above. As suggested in several interviews, Commissioner Charles McCreevy is widely

regarded as favouring a free-market approach to the regulation of the single market, in particular financial services, which chimes with British preferences.

The *industry-led* explanation would postulate that the private sector was the pace setter of the reform. At the EU level, industry was largely supportive of the Solvency II directive, though it did not appear to be the main driver for it, with the exception of group support, which was a priority for insurance groups. Although the insurance industry is divided internally, not least between mutuals and listed insurers, space constraints prevent a detailed analysis of how rifts within the industry impacted on the policy process and specific provisions of the directive. Here, it suffices to say that on most of the key points of the legislation industry had similar preferences.

One could, however, argue that the regulatory and supervisory reform championed by the United Kingdom – at the domestic level first, and at the EU level later, as explained below – was very much in line with what industry wanted, given that the size of the UK insurance market. More generally, British policymakers tend to be attuned with and attentive to financial market preferences and industry priorities (Moran, 1991; Josselin, 1997). Yet, the domestic reform undertaken in the insurance sector in the United Kingdom, which preceded the EU reform, suggests that the public authorities and not industry were the first mover and, at least initially, industry was lukewarm towards the proposed change.

An explanation based on the 'battle of the systems' (Story and Walter, 1997), in line with an *intergovernmentalist* account (Moravcsik, 1998), would argue that the reform was possible because no member state (or EU institution) opposed the trust and main lines of the Solvency II directive, even though, as pointed out above, there were at times considerable disagreements on specific parts of it. The issue of group support and supervision proved to be the most controversial. Yet, one also has to explain why there was overall a consensus on the reform. The proposed regulatory framework appealed to policymakers in the member states because it was regarded as state of the art, it was in line with what had been introduced in the banking sector with the Basel II accord and in the problem definition phase policymakers had been successfully convinced (first and foremost, by the British authorities) that this was the right way to go. The British were by and large able to upload their preferred regulatory approach to the EU level based on risk-based assessment, dual capital requirements, the possibility of using firms' internal models, the non 'zero-failure' target and ongoing supervisory review.

The United Kingdom as a pace setter in the reform: Explanatory factors

The United Kingdom was the pace setter from the very beginning, during the brain storming phase of problem definition, which was principally carried out

by the so-called London group (House of Lords, 2008: Ev 2). The United Kingdom remained a key actor in the policy formulation stage of legislative drafting, when the Commission substantially borrowed from the British regulatory regime and the provisions on group support were almost lifted by the HMT–FSA paper. Yet, British influence decreased during the political decision-making stage, when the draft legislation was co-decided and amended by the Council of Ministers and the EP. Here, a compromise had to be sought with other member states in the Council and the MEPs – traditional diplomacy (EU 'horse trading') prevailed.

Overall, the United Kingdom was able to exert a substantial influence on the reform process and outcome – albeit this is not to say that it was the only influential actor – and its influence was greater in the early stages of the policy process. This account based on the concept of policy stages – brain storming, policy formulation and political decision making – is in line with what was predicted by previous research on regulatory policy of the EU. Basically, 'first movers' are more influential in the problem definition and policy formulation stages, than in the political decision-making stage (Héritier, 1996).

What is left to explain is why and how British policymakers were willing and able to act as pace setters in the reshaping of the framework for insurance regulation and supervision in the EU. Borrowing from the literature on member states influence in the EU, reviewed in the section 'State of the Art on the Politics of Financial Regulation in the EU and the Analytical Framework', and elaborating it further on the basis of the empirical record, several inter-related factors that increased British influence can be identified. The first is a traditional political economy explanation (Moravcsik, 1998): the *size and importance of the insurance industry* in the United Kingdom, which is by far the largest in Europe (see Table 1) and third largest in the world, after the United States and Japan (CEA, 2005). The London market and Lloyds provide an important international marketplace for wholesale business (especially marine and aviation insurance) and re-insurance.

The regulation of insurance markets in the EU is therefore a priority for the British authorities (it is a issue with high economic and political salience), which have invested considerable resources (human resources and technical resources) in the policy debate in the EU as well as internationally, especially in the International Association of Insurance Supervisors (IAIS), as elaborated below. Yet, despite the importance of other financial services (for example banking, securities trading and so on) for the national economy, British policymakers have been less successful (or at least, not as successful as in the insurance sector) in projecting their preferred regulatory framework at the EU level (for example, in the banking sector, see, Christopoulos and Quaglia, 2009; the case of securities markets is discussed below).

Second, policymakers at the British Treasury and the FSA mastered considerable *technical knowledge* and *expertise* on these issues, as recognised by several interviewees, and these resources are important in the policy debate (Radaelli, 1999; Börzel, 2002; Tallberg, 2006). In the case of the Solvency II, British policymakers chaired key committees and were regarded as points of reference in the debate (House of Lords, 2008: Ev 8–9; interview, London 23 July 2008; Rome 23 June 2008), which they were therefore able to influence to their advantage. In 'technical' fora, the FSA, led on this issue by John Tiner, was very much involved in the debate in the Conference of European Insurance Supervisors first and in the CEIOPS later. Paul Sharma was the chairperson of the London group, which produced the Sharma Report, which was influential in defining the policy problem that was to be addressed. Subsequently, during the consultation stage, he headed the technical committee of CEIOPS on Solvency II. In the IAIS, Rob Curtis chairs the technical solvency committee.

Yet, in other financial services as well, British policymakers have consolidated expertise, but have been less successful in articulating their views at the EU level. One notable case was the most important directive passed concerning the regulation of securities markets in the EU over the last decade, namely the Markets in Financial Instruments directive (MiFID) (see Mügge 2007; Macartney 2009). In the negotiations of the MiFID two main coalitions of policymakers and stakeholders, the Northern coalition, led by the United Kingdom and the Southern coalition, led by France, competed against each other in order to upload their preferred regulatory template at the EU level (Quaglia, 2008b). In that case, unlike in the insurance sector, the EU regulatory process had to reconcile very different views about how to regulate securities markets in the EU. These competing regulatory paradigms, which were embedded into national regulatory frameworks, were supported by different coalitions of economic interests. Hence, competing interests were also at stake.

In the case of insurance, policymakers in continental Europe were dissatisfied with the existing EU regulatory regime, did not have convincing national regulatory templates to upload at the EU level, whereas the British model following the 2004 reform was perceived as successful and state of the art. Broadly speaking, the insurance industry across Europe, especially large diversified insurers, also supported that model. Consequently, there were not entrenched competing interests or ideas (regulatory paradigms) playing out in the regulation of the insurance market. The only exception was the divisive issue concerning the allocation of supervisory competence and power between 'home' and 'host' countries, which is a controversial point in the regulation of all financial activities as well as the functioning of the Lamfalussy architecture (Quaglia, 2008a).

Third, in the United Kingdom there was *effective domestic policy coordination* among the national policymakers involved (see Kassim, 2000a, b). The policy activity concerning the making of the Solvency II directive was well masterminded not only in the EU and internationally, but also domestically. The Treasury worked very closely with the FSA throughout the process. In August 2005, the FSA created the Insurance Standing Group,[5] with membership from the FSA and industry, and which met monthly. The Insurance Standing Group was set up as a pre-consultation forum for discussing a number of issues relating to Solvency II, the Reinsurance Directive and related prudential issues, including domestic prudential policy issues. Yet, systematic consultation with industry, with pre-meetings and debriefings in London, is common practice for all main negotiations concerning financial services (Moran, 1991; Josselin, 1997).

The main explanation that is specific to the insurance sector is that the United Kingdom undertook a *successful domestic reform* of insurance regulation in 2004, which was 'super equivalent' to the existing EU regime and provided an attractive model for reshaping EU rules. The ICAS regime set in place by the United Kingdom was widely recognised as ground breaking in its approach, which was both risk-based and principles-based (FSA, 2005b, p. 4). The regime set in place in the United Kingdom in 2005 is very similar to the one introduced for the Solvency II directive (Geneva Association, 2005; Deloitte, 2007), even though there were some differences, for example in the calculation of the Minimum Capital Requirement and the Solvency Capital Requirement (the latter, in the United Kingdom, is called the Enhanced Capital Requirement), and in the types of information to be disclosed to the market under pillar 3 (interview, London, 23 July 2008).

Conclusions

Insurance regulation and supervision in the EU is undergoing a major change through the Solvency II directive passed in May 2009. This key piece of legislation, which had been in the making since 2000 and was one of the outstanding issues in the implementation of the FSAP and the completion of the single market in financial services, was driven by a strong alliance between the Commission and the United Kingdom, with the backing of the large member states and industry. The United Kingdom was the pace setter in the shaping and coming about of the new regulatory and supervisory framework.

At prima facie, this is not so surprising: the United Kingdom has the largest financial sector and insurance market in the EU and it is traditionally one of the main promoters of financial market integration in the EU (Story and Walter, 1997; Underhill, 1997; Coleman and Underhill, 1998; Mügge, 2006). On the other hand, it is puzzling how the United Kingdom managed to exert

such influence in an EU of 27 member states, especially given the fact that it was less able to do so with reference to other pieces of legislation concerning financial services, even before the two most recent rounds of enlargement. Political and economic weight (in particular the size of the financial sector), cutting edge expertise and effective domestic policy coordination increased the policy capacity of the United Kingdom in EU negotiations. This, however, holds for all financial services.

The main factor that explains the influence of the United Kingdom in the reform of insurance regulation in the EU was a state-of-the-art national regulatory model that proved attractive for the rest of the EU for a variety of reasons. For the Commission, which promptly embraced and sponsored it, the new regulatory framework was instrumental in promoting market integration in the EU and 'upgrading' EU financial regulation. This, in turn, proved to be important in the negotiations concerning the reform of insurance regulation internationally, in which the EU was to some extent able to upload elements of the Solvency II directive. The proposed reform along the lines of the British regulatory framework was appealing for the large countries and the member states with a relatively competitive insurance industry, which was keen to expand into other markets in the EU and to operate under risk-based prudential regulation, which was expected to reduce capital requirements for competitive and efficiently managed companies. Moreover, industry, in particular cross-border operators, was keen to operate under a harmonised set of EU rules, as this would reduce compliance costs.

This explanatory factor – a suitable, state-of-the-art national regulatory framework – can be generalised to other financial services and regulatory policies more broadly, with one main caveat. The British model proved to be relatively suitable to be 'uploaded' at the EU level because there were not alternative models being sponsored by other member states and there were not entrenched vested interests supporting alternative models. All the main actors had something to gain from the proposed reform along the British lines in the insurance sector. By contrast, as mentioned above, this was not the case, for example, in securities market regulation, in particular the MiFID directive, nor the regulations of telecoms and electricity (Bulmer *et al*, 2007).

The influence exerted by the United Kingdom is even greater if one considers that certain elements of the Solvency II directive, borrowed from the British model, found their way into the international insurance regulation drafted by the IAIS in 2008. For example, the IAIS standards contain rules on the Minimum Capital Requirement and the Prescribed Capital Requirement (referred to as Solvency Capital Requirements in the EU (interviews, Basel, 19 November 2008, London 30 September 2008)). This is the opposite of what happened with the Basel 2 accord in the banking sector, which was first agreed internationally by the Basel Committee on Banking Supervision and,

subsequently, ‘downloaded’ by the EU in the form of the Capital Requirements Directive. Hence, unlike in the banking sector, an explanation based on the influence of international institutions and rules on the regulation of insurance in the EU does not have much analytical leverage.

The United Kingdom was a pace setter in the insurance sector also if taking an international perspective: other important jurisdictions, such as the United States, Japan and China, are less advanced in embracing risk-based solvency regulation (interviews, Basel, 19 November 2008, London, 30 September 2008). This also dismisses a potential ‘US-dominance’ explanation (Moran, 1991), postulating that the United Kingdom first and the EU later were pushed to reform the framework for insurance regulation and supervision following similar reforms introduced in the United States.

Following the so-called de Larosiere report issued in February 2009 and the Ecofin Council decisions on 18–19 June 2009, the EU has engaged in the revision of its framework for financial regulation and supervision (the so-called Lamfalussy process), which might impact on insurance regulation and supervision in the EU. The EU is also discussing the setting up of ‘supervisory colleges’ for all systemically important financial institutions, including insurance. These colleges have already been set up for the main banks and might be a way of bringing back the concept of group supervision, whose implementation has been delayed in the final version of the EU directive. Furthermore, although the global financial crisis has not directly tested the main tenets of the Solvency II directive, which had not yet been agreed when the crisis unfolded, the Basel II accord has come under heavy criticism for features that are partly replicated in the Solvency II directive, especially the extensive reliance on financial firms’ internal models to assess risk.[6] This raises the question of whether, as a consequence of this, the directive will require any revision.

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Notes

1 Following the terminology introduced by the Lamfalussy architecture (Committee of Wise Men, 2001), at level 1, the EP and the Council co-decide framework legislation proposed by the Commission. At level 2, the implementing measures (generally directives, less frequently regulations) of the level 1 framework legislation are adopted by the Commission through the comitology process, which involves the so-called level 2 committees of member states representatives. At level 3, the committees of national regulators (the level 3 committees) advise the Commission on the adoption of level 1 and level 2 measures and adopt level 3 measures, such as non-legally binding standards and guidelines.

2 According to the congruence procedure, theoretical predictions concerning the outcome of the dependent variable are compared with the real outcome. If the real outcome is consistent with the predictions, then there is at least a presumption of a causal relationship (see George and Bennett, 2005).

3 http://www.fsa.gov.uk/pubs/international/isg_minutes13.pdf.

4 See the minutes of the Insurance Standing Group August 2005, http://www.fsa.gov.uk/pubs/international/isg_minutes1.pdf, see also the minutes of the meeting of February 2006 on the use of the group model, http://www.fsa.gov.uk/pubs/international/isg_minutes6.pdf.

5 http://www.fsa.gov.uk/Pages/About/What/International/solvency/isg/index.shtml, accessed June 2008.

6 I wish to thank a referee for this point.

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