In praise of openness in financial regulation: a critique of the Solvency II pre-consultations

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Introduction

The Solvency II project is aimed at delivering a new prudential regime for the European insurance industry. It will replace the current, Solvency I, regime. Solvency II is currently (June 2013) stalled by disagreements between member states and between the institutions of the European Union. These institutions include the European Commission, the Council of the European Union, the European Parliament and the European Insurance and Occupational Pensions Authority (EIOPA).

This article discusses the implications of an important, but little discussed, procedural decision of the Commission and EIOPA. The decision was to withhold full publication of much of the draft material likely to form part of the proposed regulatory regime under Solvency II. Instead of publishing this material openly they have sought to restrict access to it to those whom they identify as "key EU stakeholders".

I argue that this course was misguided and contrary to the objectives of the Treaty on European Union (TFEU) and of the Solvency II directive[1] itself.

Background

To develop my critique I go back to first principles.

Article 27 of the Solvency II directive says that "the main objective of supervision [of (re)insurance companies and groups] is the protection of policyholders and beneficiaries".

Insurance, however, is not just of interest to insurers and their policyholders. Insurers are major institutional investors and players on the financial markets. They must invest their technical provisions and regulatory capital and manage their risks. So the detail of insurance regulation is of interest, among others, to those who design investment, capital, risk management and asset management products targeted at insurers and to those who provide professional services to the parties concerned.

Regulation: past, present and future

Financial regulation is about the past and the future as well as the present. Where enforcement action is taken against financial firms, or they are sued in civil proceedings for infringement of the rules, it is by reference to rules in force at the time of the act complained of.

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* Solicitor. The author is grateful to Julian Philips of JP Risk, for his comments on this article.

[1] Directive 2009/138/EU

Firms and other interested parties also plan for the future. In some cases rules will be due to come into force on a definite future date. More often, however, there will be proposals for a new regulatory regime set out in consultation papers or otherwise. The initial consultation often precedes the commencement of the new regime by several years. In the meantime preparations have to be made.

In some cases the distinction between past, present and future becomes blurred, when the regulator consults on draft guidance as to what it considers to be the current obligations of firms under the existing law[2]. Complaints may then be made that the draft guidance represents, in effect, a regime of new obligations applied by means of a re-interpretation of existing ones. Even where the proposals are explicitly aimed at the future they may nonetheless have the effect of setting a standard of best practice for the present.

So, for instance, the first draft of the FSA's rules and guidance (running to 468 pages) for its current insurance prudential regime was published in January 2001[3]. The regime came into force in December 2004. In the intervening period the FSA published a series of sets of draft rules, followed later by "near final" rules for the regime. The final rules were not published until November 2004[4]. In the meantime any transactions and products likely to continue in existence beyond 2004 had to take into account the draft future rules, and later the near final rules, as well as the existing ones.

The purposes of consultation

Regulators such as the UK Financial Services Authority (FSA) and EIOPA consult on proposed rules and general guidance. Often, but not always, this is because they are required by law to do so. In theory, and generally in law, the purpose of publishing the draft rules is to seek views and take those views into account when the rules are finally adopted.

Public consultation also furthers the objectives of the European Union and of insurance supervision. Article 11(2) and (3) of the TFEU provide:

> "The institutions shall maintain an open, transparent and regular dialogue with representative associations and civil society. The European Commission shall carry out broad consultations with parties concerned in order to ensure that the Union's actions are coherent and transparent."

Article 31(1) of the Solvency II directive provides:

> "The supervisory authorities shall conduct their tasks in a transparent and accountable manner".

[2] As in *R (on the application of British Bankers Association,) v The Financial Services Authority & Anor* [2011] EWHC 999 (Admin) (20 April 2011)
[3] CP97 The Integrated Prudential Sourcebook
[4] See "The FSA's prudential rules: a continuing shambles", Jonathan Goodliffe, Complinet 23 March 2006.

In practice, however, arguably the most commercially important purpose of consultation for most firms and other interested parties is to have an early idea of what the regulator has in mind in order to start making preparations.

Pre-consultation

The process of developing policy requires the regulator to carry out research and to communicate with the outside world in order to propose a coherent and effective regime. This may sometimes involve giving some outsiders a general idea, usually on a confidential basis, of what the regulator has in mind.

There is a fine line to be drawn here. Where there is a legal duty to consult publicly this process of "pre-consultation" should not result in the regulator's policy being developed and refined to the point where its mind is fully made up, so that the subsequent public consultation becomes a formality. Lord Woolf, Master of the Rolls, has explained in *Ex parte Coughlan*[5]:

> "To be proper, consultation must be undertaken at a time when proposals are still at a formative stage; it must include sufficient reasons for particular proposals to allow those consulted to give intelligent consideration and an intelligent response … and the product of the consultation must be taken into account when the ultimate decision is taken."

Other dangers of "pre-consultation" are that "pre-consultees" may get a competitive advantage from early knowledge of likely regulatory trends, or that the influence that they provide at the pre-consultation stage may be unbalanced and difficult or impossible to shift at the later public consultation stage.

The original Solvency II regulatory structure

Chris Finney has described in full in an earlier article in the BILA Journal[6] the Solvency II regulatory structure. For present purposes I will merely provide a brief reminder.

When the legislative process for the Solvency II regime was initiated in 2007, the Commission proposed a Council Directive aimed at becoming "level 1" in the regulatory structure. The Commission announced in the explanatory memorandum to the proposed directive[7] that "the new solvency provisions are principles based".

Level 1 in any event is only supposed to contain the main principles of the regime. That at least is what was proposed under the classic Lamfalussy legislative structure[8]. The detail is supposed to come in at level 2. For political reasons, however, level 1 directives in the financial services sector often get a lot of detail "hard coded" into them. Solvency II is no exception. This may later cause problems because the process of revising level 1 directives is unwieldy.

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[5] *R v North and East Devon Health Authority Ex p Coughlan* [2001] QB 213 at [108]
[6] "The path to Solvency II implementation – rocks and hard places" [2011] 123 BILA Journal 13.
[7] COM(2007) 361 final, page 5
[8] Initial report of the committee of wise men on the regulation of European securities markets, November 2000.

The Solvency II level 1 directive was published in the European Union official journal in November 2009. Under the original "Lamfalussy" structure the level 1 text is supplemented by more binding implementing measures at level 2. The level 1 text sets out the Commission's delegated power to adopt the level 2 measures which were required, under article 301 of the level 1 text, to comply with the procedure set out in Decision 1999/468/EC. These might be contained in further directives which need to be transposed into the domestic regimes of member states. Or they might be contained in regulations which are directly applicable and therefore do not need to be transposed.

The level 2 rules were then to be supplemented by technical standards and non-binding guidance at level 3. Level 3 was the responsibility, within the insurance sector, of the Committee of Insurance and Occupational Pensions Supervisors (CEIOPS).

It was then the Commission's responsibility, at level 4, to review transposition of, and compliance with, the regime and to take enforcement action where necessary. It tends often to be necessary because member states often fail to transpose directives on time for a variety of reasons, including the complexity of the regime imposed. Few regimes are as complex as Solvency II.

The revised Solvency II regulatory structure

The Lisbon Treaty amended the two treaties which form the constitutional basis of the European Union. It entered into force in 2009. It required structural changes to the Solvency II level 1 directive. Further changes were also needed because of issues which had emerged in the course of preparations and negotiations relating to policy options.

By this time it had become clear that the Commission would adopt level 2 implementing measures by means of a regulation rather than a directive. This was partly justified on the basis that The Solvency II regime is more fully harmonised than Solvency I. So if the same rules (with some exceptions where member states have an option as to what rules to adopt) apply in all member states, it makes sense for them to be embodied in a European legal instrument.

The detail of the structural changes introduced by the Lisbon Treaty is described in Chris Finney's article[9]. In consequences of the changes, under the EIOPA regulation[10] CEIOPS was transformed into EIOPA, a regulatory body in its own right with enhanced powers.

Level 2 implementing measures were to be replaced by "delegated acts" to be adopted by the Commission under article 290 of the TFEU. I will continue, however, to refer to such delegated acts within the Solvency II context, as "level 2 rules".

[9] See note 6 above.
[10] Regulation (EU) No 1094/2010, "the EIOPA regulation".

The status of level 3 guidance was enhanced. Among other things national supervisors were required to comply with the guidance or explain why they did not do so[11].

A new level "2.5" of rules was inserted between 2 and 3. This was aimed at genuinely technical rules not raising politically controversial issues. Level 2.5 rules were to be proposed by EIOPA and adopted by the Commission. They would be fully binding. Rules at level 2.5 could be adopted by way of implementing technical standards (ITS) or regulatory technical standards (RTS). For present purposes the most significant difference between the two is that the European Parliament is in a better position to influence RTS than ITS.

The Omnibus II directive proposal

So at the beginning of 2011 the Commission proposed an "Omnibus II directive"[12] to bring the Solvency II directive up to date by adapting it to the new regulatory structure, providing for the enhanced role of EIOPA and making a number of further changes, including express provision for transitional arrangements. The commencement date for Solvency II was deferred to the end of 2012.

The proposed transitional arrangements gave the Commission power to provide for specific aspects of the Solvency II regime to come into force later than the commencement date. In particular there was power for the Commission to provide in the level 2 rules for specified Solvency I compliant capital instruments to be grandfathered into the Solvency II regime.

Given the choice between ITS and RTS the Commission not surprisingly opted for ITS, as they put it in a stronger position to drive through its agenda. So numerous provisions were, under the Commission's draft of the Omnibus II directive, to be inserted into the Solvency II level 1 text providing for level 2 rules to be supplemented by Level 2.5 rules. The timetable for development of the level 2.5 rules extended well beyond 2012, so most of them would not be in force at the commencement of the regime.

The initial draft of the level 2 rules and its non-publication

Meanwhile the European Commission had developed a set of draft level 2 rules under the Solvency II directive. The draft ran to some 340 pages[13]. The Commission decided not to publish this material. It seems this was partly because the draft rules anticipated some of the changes to be introduced under the Omnibus II directive. They were therefore based on a level 1 foundation which did not yet exist. "Seems" because the Commission has never given a fully reasoned public explanation for withholding this material.

[11] Article 16(3) of the EIOPA regulation.

[12] It was called "Omnibus II" because there had been a previous Omnibus I directive which was not directly related to Solvency II.

[13] It was described as "implementing measures", although the intention clearly was that it should ultimately represent the delegated measures required under the new legislative structure.

In understanding the Commission's approach one is therefore reliant on third party material, mainly deriving from the FSA's web site. So the minutes of the FSA's "Insurance Standing Group" (ISG) for 8 October 2010 report:

> "Firstly, Sophie [Lloret of the FSA] discussed the Level 2 consolidated package of implementing measures, which is expected in the week commencing 18 October 2010. This is a consolidation of all previous draft implementing measures from the Commission. Sophie indicated that this will not be made public, but will be shared with key stakeholders by the Commission and that the resolution of key pillar 1 issues will be put on hold until QIS5[14] results are available.
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> Sophie then went on to discuss Omnibus II, which is expected in November 2010[15]. She pointed out that Omnibus II should not detract firms from current planning as Omnibus II is not intended to reopen debate on the Solvency II Level 1 text[16]."

There has equally been no public disclosure of who the "key stakeholders" are. There does not appear to be a mechanism for adding or subtracting names from the list of stakeholders. As far as I know they do not include, for instance, any firms of lawyers in private practice.

I attended, however, a conference on Solvency II in London on 20 October 2010. At the end of that conference Peter Vipond, then director of financial regulation and taxation at the Association of British Insurers (ABI), announced that ABI members would shortly be receiving a copy of the level 2 measures. Membership of the ABI is only open to (re)insurance companies and most, but not all, UK authorised (re)insurers are members. It seems therefore that membership of the ABI entails identification as a "key stakeholder".

Following circulation of the level 2 rules a number of organisations posted copies on their websites. They subsequently withdrew them, it seems at the request of the Commission. The only location[17] at which the 2010 draft of the level 2 rules is currently accessible appears to be the website of the Finnish Parliament[18].

The second draft of the level 2 rules

A further draft of the level 2 rules was published in late 2011. The ISG minutes for 3 October 2011 state:

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[14] The Commission's 5th quantitative impact study (QIS5) was carried out in 2010.
[15] As mentioned above it did not arrive until the following year.
[16] As appears below it did in fact re-open that debate.
[17] http://217.71.145.20/TRIPviewer/show.asp?tunniste=E+177/2010&base=ueasia&palvelin=www.eduskunta.fi&f=WORD

[18] It may be that the Commission is not aware of this, as one only finds this document by "googling" on the Internet on passages from the text of the level 2 rules and one only gets within the document, to the text of the level 2 rules, after getting through 11 pages of text in Finnish.

> "Level two text: there is still uncertainty as to when the Commission will put forward the Delegated Acts, which is closely linked to the Omnibus II discussions. It was explained that it is not certain that there will be another consolidated level two text before the end of the year."

And for 5 December 2011:

> "M[artin] E[theridge of the FSA] confirmed that the Commission had issued its Level 2 consolidated text to a limited number of stakeholders. The FSA was not intending to circulate this text. The text was a culmination of a number of months' work at Commission level. Level 2 text could not be formally proposed until Omnibus II had concluded and, on current timings, this is expected in the first quarter of 2012 on current timings."

Again copies of the draft level 2 text were posted on various websites but subsequently withdrawn. As far as I am aware it is not available on the Internet. So the only publicly available version of the level 2 rules is, as noted above, difficult to track down and out of date.

Nothing in the regulatory regime explicitly requires the Commission publicly to consult on draft level 2 measures. I discuss below, however, the implications of non-consultation or incomplete consultation on those measures.

Level 2.5 consultations and pre-consultations

By contrast there is a clear duty to consult on level 2.5 and 3 material.

Article 15 of the Regulation[19] creating EIOPA states:

> "Before submitting draft implementing technical standards to the Commission, the Authority [i.e. EIOPA] shall conduct open public consultations and shall analyse the potential related costs and benefits, unless such consultations and analyses are disproportionate in relation to the scope and impact of the draft implementing technical standards concerned or in relation to the particular urgency of the matter."

Equivalent requirements in relation to RTS and level 3 guidance are contained in articles 10 and 16.

EIOPA, however, followed the same course as the Commission. The ISG minutes for 17 December 2010 record:

> "3 areas of Pillar 5 pre-consultation were discussed:
>
> 1. Governance
> 2. O[wn] R[isk and] S[olvency] A[ssessment]
> 3. Reporting

[19] Regulation (EU) No 1094/2010

> The formal process of consultation via the CEIOPS / EIOPA website won't happen until after the Level 2 has been finalised. Therefore, CEIOPS is beginning a private pre-consultation and will be sending draft consultation papers to key EU stakeholders. For UK firms papers will be made available through the ABI (who will themselves receive them from the CEA). Kathryn [Morgan of the FSA] highlighted that all comments would that have to go back through the same stakeholders to be included by CEIOPS (i.e. UK firms > ABI > CEA > CEIOPS)."

Later minutes of the ISG refer to subsequent level 2.5 and/or 3 consultations. For instance the 6 February 2012 minutes record:

> "With respect to the level 3 guidelines and Implementing Technical Standards (ITS), P[aolo] C[adoni of the FSA] explained that EIOPA started in January the consolidation of all material that has been already shared with the industry and other European stakeholders during the informal pre-consultations. This process will consolidate all existing material into two separate papers: one will contain all Solvency II related guidance and the other one all Solvency II related ITS …
>
> In response to B[ruce] P[orteous of Standard Life] (dialled in), PC stated that in terms of informal pre-consultation there will be no more material on internal models, but there may be more material from the EIOPA's IGSRR, IGSC and FINREQ Committees. For example, on the long term guarantees package, which is dependent on developments in the level 2 text."

Despite the misgivings about full consultation on level 2.5 and 3 material, voiced in the minutes, a few such full consultations have subsequently emerged. For instance, the ORSA pre-consultation was followed by a full consultation on the same subject a year later with the level 2 rules still not finalised. In November 2011 there was also a public consultation on a "Draft proposal on Quantitative Reporting Templates and Draft proposal for Guidelines on Narrative Public Disclosure & Supervisory Reporting, Predefined Events and Processes for Reporting & Disclosure". However, most of the level 2.5/3 material is still not publicly available.

Problems with the Omnibus II proposal

The Omnibus II proposal proved more problematical than had been expected. Some policy areas were controversial. These included the calculation of technical provisions for long term business and the treatment of firms and groups based in non European countries or having operations outside Europe[20].

There were also disagreements between the Commission and the European Parliament as to where rules on specific aspects of the Solvency II regime should lie as between levels 1, 2, 2.5 and 3. So the Parliament argued in favour of all rules embodying policy choices being promoted from level 2 to level 1 (where the Parliament was in a

[20] See Freshfields insurance and reinsurance news November 2012 "Delays to Solvency II"

stronger position to influence the outcome)[21], some being demoted from 2 to 2.5 and for more use of RTS and less use of ITS within level 2.5.

Trilogue discussions between the institutions have so far not resulted in an agreement. A possible formula, "the long term guarantees package", to resolve one of the major points of policy disagreement is to be tested over a period not expected to conclude before March 2013. Because the "package" is likely to be promoted from the level 2 to the level 1 text, Omnibus II cannot be finalised until after the testing has been carried out. The issue is scheduled for consideration by the European Parliament in the Autumn of 2013.

Meanwhile, as successive drafts of Omnibus II were published by the Commission, the Council and the Parliament, the likely commencement date for the regime initially drifted to January 2014. Now even that seems unachievable and 2015, 2016, or even later seems more likely. Andrew Bailey, managing director of the FSA's prudential business unit, has commented[22]:

> "I think there should have already been more accountability for how the processes of the European Union could have created such a vast cost for an industry for the implementation of a directive which has not even yet been finally agreed, and for which I cannot give you a date. Largely unseen in the banking crisis has been the shocking cost of Solvency II."

A "black market" in the pre-consultation materials

The level 2, 2.5 and 3 pre-consultation material has been in circulation for up to 2 and a half years now. Those who needed to have access to it and were not identified as key stakeholders had to do their best to try to get copies. This was necessarily a more difficult task for small rather than large organisations.

Often one was searching for identified material but in some instances it was difficult or impossible to keep track of exactly what pre-consultation material was being produced, so there were some "unknown unknowns". Meanwhile clients expected their professional advisers to be abreast of developments.

FSA approach to the issue

A number of materials on the FSA web site suggest that it may have been less than enthusiastic about expecting firms to prepare for a regulatory regime without making the detail of the regime publicly available. It did not, however, actually break ranks and question the wisdom of the Commission's approach.

So at the ABI conference on 8 December 2011, Julian Adams, Director of Insurance at the FSA, indicated that in preparing for the process of getting internal models approved in time for commencement of the Solvency II regime, firms should work by reference to the November 2011 version of the level 2 text. He accepted that:

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[21] See the minutes of the meeting of the European Insurance and Occupational Pensions Committee on 4 July 2012 http://ec.europa.eu/internal_market/insurance/docs/2012-markt-docs/2012-11-27-minutes_en.pdf

[22] Speech on 6 February 2013 http://www.fsa.gov.uk/library/communication/speeches/2013/0206-ab

"Using the recent version of the Level 2 text in the context of our implementation activities would, however, pose two particular challenges.

The first is quite simply that the text as it stands has not been published, and is not technically in the public domain. We are aware that a number of firms have it, but we are not in a position to make it available to everyone as it is not ours to publish.

The second is that the text is not yet final, and will not even be released for consultation until after Omnibus II is finalised in the first quarter of next year. So, we do not expect to have final Level 2 text until the middle of 2012 at the earliest.

On the other hand, the Contents of Application are out of date, having been published in April 2010 and not reviewed in light of more recent legislative developments, but they do represent an internally-agreed and public standard for the work that has been done to date, which we have consistently applied to firms in our pre-application process. They therefore represent the basis of most work done by firms to date.

On balance, we feel that basing our application approach on the Level 2 text is the most sensible way to proceed."

The justification for non-publication

As noted above the Commission never gave a fully reasoned justification for non-publication of the level 2 text and for the limited basis on which it was circulated. Nor did EIOPA justify non publication of the level 2.5 and 3 text. Doubtless it had no option other than to follow the Commission's lead.

The underlying reason seems to have been related to the fact that the level 2 text anticipated the existence of a legal foundation for the measures. That foundation had not yet been adopted. It is likely, in any event, to be adopted in a significantly different form to that originally anticipated.

So all consultation and preparation for the detail of the regime could have been held back until agreement was reached. However that would have created further delays. When the level 2 measures were developed the Commission was still working to the end 2012 commencement date. So time was precious. Given, however, the decision to proceed with the project it is difficult to understand the justification for limiting consultation to only a section, albeit a significant section, of those likely to be affected. This was calculated to create a bias in responses and public knowledge of the likely progress of the project.

The Commission is under no explicit legal obligation to consult publicly on draft level 2 delegated acts, but if it does Article 11 of the TFEU arguably requires it to do so in an open and transparent way.

EIOPA is required to consult on draft level 2.5 and 3 measures. If it chooses to consult in advance of getting its legal powers it should nonetheless arguably consult in a fair and open way, following, so far as feasible, the procedure specified in the Europa regulation.

Describing the processes as a "pre-consultation" does not answer this point, first because this was not a really a "pre-consultation" at all. The draft level 2, 2.5 and 3 materials were fully developed and circulated to a large number, albeit a limited range, of people.

Secondly, even a pre-consultation should be fair and should take into account in a balanced way the interests of everyone likely to be affected. This applies not least to policyholders and beneficiaries whose protection is the main objective of supervision under article 27 of the level 1 text. What little information is available about the "pre-consultation" processes does not provide confidence that this outcome was achieved.

Possible legal consequences

The next version of the level 2 delegated acts will probably need to be recast completely in the third draft. It will need to match the regulatory structure expected to be embodied in the Omnibus II directive, and from there within the Solvency II directive. So the inherent unfairness arising from the "pre-consultation process" may possibly avoid the successful legal challenges to the level 2 rules that might otherwise be expected. If, however, anyone does decide to try their hand at a judicial review, the process will be embarrassing for the Commission.

Areas of the rules in their eventually final form may, additionally, give rise to serious problems. For instance, article 135(2)(a) of the level 1 text requires "repackaged loans" in which insurers invest after 1 January 2011 to comply with requirements to be specified in level 2 rules. When this provision was inserted in the level 1 text it was doubtless expected that the level 2 rules would be developed well before 2011. If the level 2 rules are not finalised until, say, 2014 they are likely to be subject to challenge on the ground that they apply retrospectively. It might have been an answer, or part of an answer, to that argument for the Commission to say that the draft level 2 rules have been generally available. It cannot really say that when it has strived so hard to limit access to them.

The level 2.5 and 3 rules are a different matter. Here there is an explicit duty to consult and much of this material is unlikely to be affected by the transformation of the regulatory structure eventually effected by Omnibus II. So by the time EIOPA gets around to the full consultation, the 2 year purported "pre-consultation" will have hardened policymaking to the point where it will be difficult for EIOPA to argue that proposals are at a "formative stage". The consultation itself may be little more than a pointless formality. So if the principle articulated by Lord Woolf in *Ex p. Coughlan*[23] is to apply at a European level, there may be scope for a legal challenge.

Conclusion

[23] See note 5 supra.

There is no substitute for full transparency in the development of new regulatory regimes. It is required to meet the objectives of the TFEU and Solvency II. Moreover failure to apply it inevitably gives rise to serious problems.

The exclusion of lawyers in private practice from the consultation process, for instance, can be expected to reduce the legal robustness of the regime and increase the scope for litigation or problems in enforcement.

Many people must have given up on Solvency II mostly, no doubt, because of the complexity and the delays. This may have been partly also, surely, because of the lack of transparency. Why for instance, attempt to develop capital market products aimed at insurers, rather than other industry sectors, when the regulatory regime is so opaque?

The impression is created that the Commission's general approach is unbalanced. That may not in fact represent the reality of the Commission's state of mind. However, "justice should not only be done, but should manifestly and undoubtedly be seen to be done"[24]. The Commission's rather roughshod approach may, for instance, partly explain the problematical relationship between it and the European Parliament. The minutes of the meeting of the European Insurance and Occupational Pensions Committee for 4 July 2012[25] indicate that the Parliament is now arguing that the Level 1 directive "should contain all legislation involving policy choices and strategic decisions and not only principles. It is argued that Level 2 should only contain technical requirements[26]", perhaps because the Parliament does not trust the Commission in its handling of level 2.

The Commission should learn its lesson from this experience. Its considerable power within Europe appears to be shielding it to some extent from public criticism, e.g. from national supervisors. This must surely change.

[24] The words of Lord Hewart, Lord Chief Justice, in *R v Sussex Justices, Ex parte McCarthy* ([1924] 1 KB 256.
[25] See note 21 supra.
[26] A proposition which arguably renders level 2.5 redundant.