Developing risk professionals

18 February 2021

HM Treasury
1 Horse Guards Road
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via email: SolvencyIIReview@hmtreasury.gov.uk,
and FRF.Review@hmtreasury.gov.uk

Dear Sir / Madam,

IRM Response to HMT Consultations

The Institute of Risk Management (IRM) is pleased to submit a response from an insurance risk management perspective to HMT's consultation paper on 'Financial Services Future Regulatory Framework Review Phase II' and to HMT's 'Solvency II Review: Call for Evidence'.

The IRM is the world's leading enterprise-wide risk management (ERM) education Institute. We are independent, well-respected advocates of the risk profession, owned by our members who are practising risk professionals. IRM believes passionately in the importance of risk management and that investment in education and continuing professional development leads to more effective risk management. We provide qualifications, short courses, events at a range of levels from introductory to expert and market-leading thought leadership.

IRM supports its members and the wider risk community by providing the skills and tools needed to put theory into practice in order to deal with the demands of a constantly changing, sophisticated and challenging business environment. We operate internationally with over 8000 members and students in over 100 countries, drawn from all risk-related disciplines and a wide range of industries in the private, third and public sectors. A not-for profit organisation, IRM reinvests any surplus from its activities in the development of international qualifications, short courses and events.

This response has been developed by the ERM in Insurance Special Interest Group (SIG) of the IRM. The response has benefited from the consideration of a number of sources of evidence - responses to a short industry survey questionnaire, discussions at an industry webinar in December with Chief Risk Officers and other insurance industry and regulatory experts, additional discussions with insurance risk practitioners, and the review by the working group supporting the chairs of the ERM in insurance SIG.

Our key messages are summarised below.

Financial Services Future Regulatory Framework Review – Phase II Consultation:

- The impacts of financial regulation result from the combination of <u>what</u> regulatory policy is and <u>how</u> it is supervised and implemented. Regulators need to make sure independence and understanding, efficiency and challenge are well balanced across these different activities when regulating firms.

- It is therefore important to ensure the level of input and scrutiny over regulators' activities is appropriate. Given the increase in judgement as a result of the change in the relationship with Europe, we see this as requiring increased input and scrutiny from stakeholders, including industry as appropriate.

- The Future Regulatory Framework should be designed to be resilient to future challenges, so that it is able to address effectively and efficiently not only the crises of today, but also those of tomorrow.

- Competition is reflected in existing regulatory objectives and we would encourage HM Treasury to consider how effectively these objectives are operating as part of this review.

Review of Solvency II: Call for Evidence:

- While risk management and Pillar 2 are infrequently referenced in the call for evidence, this review represents an opportunity to improve the maturity of risk management and how it is enhanced by the relationship between regulators and firms. As an example, there is a risk that the ORSA is seen primarily as a regulatory report which could weaken its effectiveness as a risk management tool that supports Board decision making.

- We believe a better risk management relationship between regulators and firms would be based on more focus on substance over legal form, and be less about what capital is needed and more about the management of risk.

- We believe that, while capital is a valuable mitigant of risks, it cannot address all risks insurance firms face. At the same time, it is important that the PRA is satisfied that its regulatory judgements fully cover prudential risk management as opposed to simply focusing narrowly on Pillar 1 modelled capital. Policy makers, regulators and particularly governments must satisfy themselves that capital requirements are proportionate, and do not adversely impact on innovation and investment; we welcome recent comments from PRA that they are open to this debate.[1]

- We broadly support more reliance on principles and supervisory judgements, but this requires increased independent engagement in setting those principles, and appropriate oversight and scrutiny of supervisory judgements, given the potential consequences to business operations and capital of inconsistent and inappropriate regulatory judgements. This requires enhancing efficiency of regulatory process – for example, setting out broad principles to deal with issues before they arise, agile processes, and better sharing of viewpoints between regulators and industry. We also believe it is likely to require a focus on increasing the level of experience and expertise of those on the "front line" of supervision, to reflect the increasing importance of judgement over rules.

[1] Anna Sweeney, 'Goldilocks and the three pillars: how much capital is just right', speech given at the Westminster Business Forum, February 2021 (https://www.bankofengland.co.uk/speech/2021/february/anna-sweeney-westminster-business-forum).

- Our response supports several enhancements to the Solvency II regime that reflect the unique features of the UK insurance sector. We do not envisage that these enhancements would lead to material divergence with existing Solvency II requirements. They would support the objective of ensuring that equivalence with the EU's Solvency II regime can be maintained, so long as it does not harm the UK's national interests.

- All changes need to be made carefully, incrementally over time to reflect the significant effort firms have put into the implementation of Solvency II and the fact that processes and approaches are now embedded into the operation of insurers. We note that regulators are now joining firms in commenting on the "huge expenditure of effort by both firms and supervisors in the approval of models and model changes",[2] and we believe it is important that additional cost and change is added only where firms and regulators are convinced significant benefits can arise.

We trust that this input will help HM Treasury shape these important proposals, and we would be happy to provide further support to these considerations and discussions.

Yours faithfully,

Iain Wright Chair, IRM	Justin Elks Co-chair of IRM ERM in Insurance Special Interest Group	Isaac Alfon Co-chair of IRM ERM in Insurance Special Interest Group

[2] Charlotte Gerken, 'The fox and the hedgehog: preparing in a world of high risk and high uncertainty', speech given at the Insurance Risk and Capital EMEA 2020 virtual conference, December 2020. (https://www.bankofengland.co.uk/speech/2020/charlotte-gerken-insurance-risk-and-capital-emea-2020)

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Financial Services Future Regulatory Framework Review – Phase II Consultation

Q1: How do you view the operation of the FSMA model over the last 20 years? Do you agree that the model works well and provides a reliable approach which can be adapted to the UK's position outside of the EU?

Regulators operate in the context of a tension between independence from and understanding of the firms they regulate – much like risk functions within a regulated entity. It is necessary for the regulator to have an up-to-date knowledge and understanding of the industry and its challenges to deliver a risk-based supervision approach. However, this needs to be balanced against the importance of independent supervisory judgements not unduly influenced by the industry. This tension is inherent in regulation, cannot be easily solved and needs to be constantly managed. The balance between independence and understanding should be re-calibrated as part of this review, in a way that ensures it is capable of dynamic adjustment for the future. This will help to ensure that the regulatory system that emerges from the proposed changes in this consultation is resilient and can respond to future change and disruption in the wider interests of the UK.

One of the comparatively recent changes in the FSMA model was the creation of separate authorities focusing on conduct and prudential requirements. There are nevertheless a number of regulatory issues shared between regulators (in addition to authorisation) such as the regulation of investment management, the Senior Managers and Certification regime (SM&CR), systems and controls, operational resilience and cybercrime. Any future regulatory framework needs to ensure that FSMA enables efficient cooperation and coordination of policy, supervision and data sharing, and that HMT has the appropriate powers to ensure that this occurs.

While there are clear examples of effective regulatory co-operation, sometimes there do appear to be areas where co-operation could be more efficient. For example, while the FCA and PRA have shared interests in respect of operational resilience, an initial joint discussion document led to the publication of different consultation papers. It should be possible for single, joint papers to be published on common areas of interest and common policies, without this causing legal issues or challenges. If FSMA is regarded as creating legal barriers for this type of joined up activities, then this should be considered as part of this review.

Another aspect of the FSMA model is the sectoral split. We note that occupational pension schemes are overseen by The Pensions Regulator and outside the FSMA model. However, recent press reports about the interaction between the DWP and the Bank of England regarding the regulation of occupational pension schemes and the treatment of so called 'super-funds' suggests that it would be worth considering the limits and / or the adequacy of the coordination mechanisms. Given the increased role of data in financial services, coordination with the Information Commissioner's Office is becoming more critical and there is a risk that different objectives lead to conflicting and contradictory requirements of firms. At the same time within FSMA, while consistency between sectors is a useful principle, there is always the risk and danger that insurers are inappropriately treated as banks with unintended consequences for policyholders.

Q2: What is your view of the proposed post-EU framework blueprint for adapting the FSMA model. In particular,

- What are you views on the proposed division of responsibilities between Parliament, HM Treasury and the financial services regulators?

- What is your view of their proposal for high-level policy framework legislation for government and Parliament to set the overall policy approach in key areas of regulation?
- Do you have views on how the regulators should be obliged to explain how they have had regard to activity-specific regulatory principles when making policy or rule proposals?

We broadly agree with the proposed split of responsibilities between Parliament, HMT and the financial services regulators.

The regulators' joint role on both designing regulatory requirements and implementing them through supervision may well be "the most flexible and efficient way of ensuring the regulatory regime can respond to changing conditions". It also has the potential to result in actual or perceived conflicts of interest which can adversely impact on the effectiveness and efficiency of regulation. For example, while Solvency II recognises the principle of proportionality, it is not clear that this principle has been manifested as well as it could be in the supervision of Solvency II. Further there is a view prevalent in the insurance industry that there is a UK supervisory expectation for capital buffers above the Solvency Capital Requirement (SCR). This buffer is then treated as a de facto regulatory risk appetite limit, creating an additional level of intervention for a breach of that buffer in excess of the intentions of Solvency II and the approach taken in other jurisdictions, where the first formal intervention happens on breach of the SCR.

There is a risk that combining the design and implementation of regulation leads to either a perceived or actual focusing by policy makers on the ease of implementation for supervision, and the risk that supervisors are incentivised to be excessively cautious in the application of policy – at the expense of confidence in the regulatory system, and potentially at the expense of policyholders and other stakeholders.

The paper includes proposals aimed at mitigating this through increasing overall review and scrutiny of regulatory policy setting and enhancing the effectiveness of industry consultation, which we broadly support. In addition, we also believe that safeguards should be in place at the regulatory authorities to ensure that potential conflicts of interest between policy design and implementation through supervision are managed, in particular where the environment is shifting towards principles away from more detailed rules. Overall, it would be beneficial if regulators were more transparent about how these potential conflicts are managed, to expose approaches to both industry and parliamentary review and challenge. We believe this would help build stakeholder confidence and help to ensure a proportionate approach that is attuned to the features of the UK market.

Q4: Do you have views of whether the existing statutory objectives for the regulators should be changed or added to? What do you see at the benefits and risks of changing the existing objectives? How would changing the objectives compare with the proposals for new activity-specific regulatory principles?

As risk practitioners, we are not commenting specifically on the role of competition within the regulatory framework as another tool to deliver appropriate customers outcomes and innovation. We appreciate that this is part of the regulatory objectives (secondary objective for the PRA and primary for the FCA). However, we note that the extent to which these objectives are operating adequately does not appear to have been covered. We would encourage HM Treasury to consider this in more detail.

The feedback from our survey questionnaire does not provide a clear view on whether existing statutory objectives for regulators should be changed or supplemented by additional principles and guidance to help to ensure governmental policy objectives are met[3]. This demonstrates that the issue is balanced, and care needs to be taken to ensure proposals do not have unintended consequences. We believe the intention behind the proposal for new activity-specific regulatory principles, subordinated to the existing regulatory objectives, is a valid one.

We think that the concept will need further work to ensure that the principles are clearly expressed. This should include a sense of their relative priority at a point in time, noting that the PRA's statutory objectives already distinguish between primary objectives and facilitating effective competition. We also note that the more detailed principles become, the more complex they can be to follow effectively, and there is a risk that as they become more detailed they lapse into being seen as detailed rules to follow. Any implementation of activity-specific regulatory principles needs to recognise that they will represent an understanding at a point in time; there need to be dynamic mechanisms to ensure that they can be quickly and effectively updated and communicated if changes are required.

See also our earlier comment in respect of joined policy making in response to Q1.

Q6: Do you think the focus for review and adaptation of key accountability, scrutiny and public engagement for the regulators, as set out in the consultation, is the right one? Are there other issues that should be reviewed?

We agree that Parliament, supported by the Treasury Select Committee (TSC), should play an important strategic role in the overall direction of policy for financial services. However, it is difficult for Parliament and the TSC to scrutinise regulatory policy and financial services regulators at the level of detail needed in order to ensure the impact of regulation is clearly understood and that proposals are effective, understood and reasonable.

It would therefore be useful to explore the idea of an independent scrutiny function, modelled along the lines of BEIS Regulatory Policy Committee (RPC), which focuses on policy and as set out in the consultation paper. There are, however, crucial issues to consider and articulate as part of defining the scope of this body to make this suggestion work effectively in financial regulation.

Firstly, the breadth of the role of the independent scrutiny function in respect of policy, implementation and supervision. The importance of implementation and supervision of policy will only increase with the transition from more rules based, to more principles-based, regulation. We believe that an effective oversight mechanism should extend beyond pure policy to cover supervisory activity and judgements made. Secondly, the objectives of this body should be articulated. It should not be a mechanism designed with the intention of increasing regulation or capital requirements; considerations of the level of regulation and capital should be balanced with other demands, such as cost and complexity of implementation, consumer benefits and maintaining or increasing UK competitiveness. Thirdly, there needs to be clarity in respect of the interaction of the independent scrutiny function with the BoE's Financial Policy Committee. Finally, the independent scrutiny function should have real power that comes from the ability to report independently to Parliament.

[3] 22 people responded to the question "the existing statutory objectives for regulators should be changed or supplemented by additional principles and guidance to help to ensure governmental policy objectives are met", with 10 people either agreeing or strongly agreeing, and 7 disagreeing or strongly disagreeing.

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We think such a system would be preferable to the alternatives suggested in the consultation paper in providing the level of oversight required to build confidence in the effectiveness of the entire system of regulatory policy, implementation and supervision.

Q9: Do you think there are ways of further improving the regulators' policy-making processes, and in particular, ensuring that stakeholders are sufficiently involved in those processes?

Consultation papers are usually issued when the policy direction is clear and rules are already drafted. It would be useful if regulators formally engage with market participants at an early stage of their policy development process to enable industry to input into the process prior to proposed policy drafting having taken place. This should take place even earlier than in the case of the discussion paper on operational resilience where work had been undertaken with specific sectors and players to shape the overall approach. The early engagement needs to be more consistently applied and take place across the range of firms supervised and impacted by the proposed changes to approach.

Once a policy is agreed, we believe that there may be a role for the regulator in terms of co-ordinating and facilitating discussions in respect of how policy is implemented. As well as benefiting industry participants, this would benefit the regulator in being able to understand and assess the extent to which required outcomes from policy are being realised in practice, and to facilitate agile intervention to avoid the risk of unintended consequences persisting for an extended period.
While the FSMA established a system of independent panels, we note that some panels have their membership appointed by regulators. This weakens the potential and perceived independence and ability to challenge, and risks panellists not being drawn from a diverse range of stakeholder groups. As noted in response to Q6, we support the suggestion of an external and independent committee to scrutinise policy and its implementation, with appropriate powers which should include reporting to Parliament. The early engagement described above should also apply to any committee overseeing policy development.

Overall, a more transparent approach to consultation and more independent and transparent appointment of panels and operation have the potential to create more effective challenge. This would help to ensure policy making is scrutinised at a level of detail that parliament is not able to provide given the expertise and time commitment that this would require.

We also note that the proposed shift towards more principles and judgements would also have resourcing implications for the regulators. While we recognise current regulation relies on the judgement of supervisors, this increased reliance on judgement as opposed to rules could be expected to require an increased level of industry expertise and capability to ensure consistency as the approach to the future regulatory framework is implemented. This will need to be reflected in supervisory operating models.

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Review of Solvency II: Call for Evidence

Chapter 1: Risk Margin

Q1: What is the impact of the current design of the risk margin?

We support the original purpose of the risk margin to compensate for the relative uncertainty of the valuation of insurance liabilities which are not traded and therefore estimate the additional premium that a purchaser would require to take over the liabilities.

The responses to the survey questionnaire also supported the view expressed in the call for evidence that the approach to the risk margin should be revised.[4]

We also share the view mentioned in the call for evidence that unintended effects of the inappropriate operation of the risk margin are visible in the operation of the market; in particular, its volatility and the increasing amount of longevity reinsurance placed outside the EU and UK.

Q2: What changes, if any, should be made to the methodology to improve the operation of the risk margin?

We note that the challenge of an appropriate design of a risk margin for a best estimate of insurance liabilities has been considered in various fora and by various bodies such as Institute of Actuaries, IAIS and IFRS Foundation. We encourage HM Treasury to work with the PRA and consider these different approaches with an open mind, considering which methods might best achieve the purpose of the risk margin described in our response to Q1 above.

We urge HM Treasury to bear in mind the potential benefits of consistency with metrics that may be developed for other purposes and, ideally, avoid creating a specific measure for the prudential regulation of UK insurance industry that conflicts with other measures seeking to implement the same economic principle of compensating for uncertainty.

Q3: What are the benefits and costs of any proposed changes to the methodology to calculate the risk margin?

Any changes to the risk margin would need to be carefully considered to ensure that any new approach is less volatile than the current one, in particular its sensitivity in respect of interest rates. In addition, it is also important to ensure that there is a shared understanding of the impact on different insurance sub-sectors and of the knock-on implications on other aspects of the regime, including transitional arrangements.

[4] 22 people responded to the question “the risk margin is designed and operating appropriately”, with 3 people either agreeing or strongly agreeing, 14 people disagreeing or strongly disagreeing, with 5 stating they don’t know.

Chapter 3 – Matching adjustment

Q4: What changes, if any, should be made to the eligibility of assets for the matching adjustment?

We welcome the recognition of the role that the Matching Adjustment (MA) plays in meeting the retirement needs of annuitants and supporting the provision of long-term finance to the economy, and HMT's willingness to explore how to enhance the mechanism.

The eligibility of assets for the matching adjustment should be considered by reference to its fundamental economic aspect: the illiquid nature of the contracts and credit risk that can be measured with high confidence allow insurers to hold investments to maturity. None of these features are binary and in practice they reflect the quality of risk management that exists within particular firms. Considering it from this perspective, there are a number of suggestions about eligibility:

- *reflecting a substance over form view, assets with cashflows that do not meet the strict current requirements as being "fixed", but with quantifiable credit risk which do not undermine the ability to hold assets to maturity, should be permissible;*

- *equally, assets with "fixed" cashflows where credit risk cannot be objectively quantified through past default losses or a credible model should either not be allowed or should attract a higher Fundamental Spread or capital charge that recognises the quality of credit risk assessment.*

We also believe that eligibility rules could also apply to liability contracts allowed; there are other insurance contracts with similar features to annuity contracts where a matching adjustment could – and should - be allowed. A significant example is claims reserve on income protection, where morbidity risk plays a similar role to mortality risk in annuities.

Q5: What changes, if any, should be made to the calculation of the matching adjustment?

The calculation of the MA is currently shaped by a number of unhelpful factors: a single calibration of the fundamental spread reflecting fixed income; and no explicit requirements or oversight of internal rating models used to assess the credit risks of assets in the MA portfolio. These factors tend to result in the development of Internal Models for the SCR of the assets in the matching portfolios, with the consequential use of valuable resources in insurers and at the PRA. It would be helpful for HM Treasury to consider a more flexible system that would entail:

- *the PRA establishing some ground rules for the fundamental spread (both the probability of default element and the excess of the total fundamental spread over it) to inform the calibration of the MA for other asset classes beyond corporate bonds. These ground rules should be used by the PRA to recalibrate the fundamental spread consistently for asset categories, including new ones such as infrastructure and social housing; these ground rules would also allow the PRA to develop a generic risk-based calibration for other categories of assets that might arise in the future;*

- *explicit regulatory requirements for internal ratings models used by insurers to value illiquid assets in the matching adjustment portfolio. These models represent the core credit risk* *assessment of the assets; the requirements that apply to external ratings and the reporting of actual transitions and defaults might be a useful starting point;*

- *developing requirements for additional categories of assets in the standard formula to reduce the need for Internal Models, i.e. if a base balance sheet fundamental spread calibration is developed for (say) social housing or commercial mortgages, then similar calibrations should be available for the spread of these assets in the standard formula for capital purposes.*

Q6: What changes, if any, should be made to the matching adjustment approval process?

The matching adjustment approval process should be reviewed to avoid un-necessary applications being required from unanticipated changes in asset portfolios. As an example, climate change financial risk – and in particular transition risk – may represent a challenge to certain assets in MA portfolios which may now have a long-term credit outlook different than when the MA portfolio and application was approved. This could be managed within the portfolio, and ought not necessarily lead to asset sales. It is nevertheless worth recognising that there may be a higher than anticipated degree of portfolio turnover.

Another aspect of the approval process is the requirement for close matching of asset and liability cashflows. We welcome the tighter oversight introduced on cashflow matching introduced by MA. However, we believe that the current system leads to a binary outcome (matching / not matching) that could have unintended consequences, and results in "cliff-edge" changes in valuation. We suggest that HMT considers a system that seeks to avoids such binary outcomes.

Q7: What changes, if any, to the matching adjustment could be made to support insurance firms' provision of long-term capital to support growth including investments in appropriate infrastructure or other long-term productive assets?

See response to Q5 above and in particular the suggestion about ground rules for the fundamental spread. We also wish to emphasise that the risk assessment of an investment should be independent of the purpose of the underlying investment, e.g. infrastructure. There is a risk that an undue focus on the purpose of the investment leads to un-economic investments which could adversely impact policyholders. It is not in anyone's long-term interest to capitalise profit that does not then emerge in future.

Q8: What changes, if any, to the matching adjustment could be made to better reflect climate change related risks arising from investments and contribute to sustainable investments?

See responses to Q5 and Q7 above. Broadly, we believe that the changes above to the matching adjustment would better reflect climate change related risks arising from investments. However, in doing this it is important that insurers should not be encouraged to invest in uneconomic or significantly lower return assets. Investments in assets should reflect the risks, and not be unduly influenced by the purpose of the investment. Equally, applying a more principles-based approach to admissibility of assets as part of the MA portfolio could encourage more innovation in asset investment and reduce the "cliff-edge" effects of a binary approval process.

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Q10: What changes, if any, should be made to the PRA's powers to manage risks to the safety and soundness of firms, and the policyholder protection, arising from the use of matching adjustment?

As noted in the response to the Financial Services Future Regulatory Framework Review Phase II Consultation, regulatory outcomes are a combination of the policy adopted and how rules are implemented. The previous questions about the MA have focused on the policy requirements. It would also be beneficial for industry if regulators were able to explore ways in which they could share good practice (suitably anonymised) about submissions and decisions about MA, and engage in a more open dialogue for the benefit of industry and policyholders.

Chapter 4 – Calculation of the Solvency capital requirement

Q12. What changes, if any, should be made to the current approval process for new internal models and change to models? What type of its supervisory tool would be an appropriate alternative to the rejection of an insufficient model application?

The UK is perceived to have adopted a hard line to the approval of Internal Models, something that has been shared in other enquiries about the implementation of Solvency II.[5] *An increase in flexibility of approaches to internal model approval and increased use of judgement by the PRA would allow firms and the PRA to increase the focus of firms' internal models on risks in a less legalistic, more proportionate and effective way. There was an overwhelming support from respondents to our insurance industry survey on this matter.*[6]

However, increasing safeguards are needed to ensure that there is confidence over regulatory policy and how judgement is exercised as described in our response to the Financial Services Future Regulatory Framework Review Phase II Consultation.

The PRA should be allowed to approve specific components of an application for an internal model rather than be forced to accept or reject an application in its entirety. This would complement the suggestion under Q5 above to have a more granular set of components of the standard formula for credit-risky asset classes, although this principle of additional granularity of approvals is by no means confined to credit risk.

Q13. What changes, if any, should be made to the standard formula to better reflect the risk profile of the UK insurance industry? What are the costs and benefits of such changes?

Some of the Standard Formula calibrations understandably reflect a blend of EU exposures which could now be adjusted to focus more effectively on UK exposures and their risk profiles. Further, there are asset exposures that are reasonably common in the UK, but are missing from the Standard Formula, requiring firms to develop an Internal Model to properly consider their risks – for example, commercial mortgages.

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[5] "The development and approval of Internal Models in the UK has come under significant criticism from many respondents because of the work and cost that approval it entails, but also because of the resulting lack of flexibility." (p142 of the TSC, "The Solvency II Directive and its impact on the UK Insurance Industry", Oct 17).
[6] 22 people responded to the question "An increase in flexibility of approaches to internal model approval and an increased use of judgement by the PRA would allow firms and the PRA to increase the focus of firms' internal models on risks in a less legalistic, more proportionate and effective way", with 21 people either agreeing or strongly agreeing.

More generally, in the interest of transparency the PRA should start a programme of taking back ownership and control of Standard Formula calibrations. The PRA should publish and maintain calibrations, including its justification of calibrations against similar standards that firms are held to as part of internal model approval. This would help to ensure that all insurers are subject to a risk-based regime which helps them understand, at least some level, their exposures and the capital requirements driven by these risks. It would also help to avoid model drift in respect of the Standard Formula, and help to avoid the risk of regulatory arbitrage between Internal Models and the Standard Formula.

We also think it would be valuable to allow the wider availability of Undertaking Specific Parameters (USP) in the standard formula than is permissible in the current Solvency II Delegated Acts, which restricts further their availability compared to what was originally envisaged in the Solvency II Directive. For example, we note that there are no USPs for credit risk and other risks on the asset side of the balance sheet and we would suggest that this is considered as a 'half-way house' between the standard formula and a full internal model. In addition, the use of USP should also be contingent of the appropriateness of risk management, as is the case for internal models – so that, if firms can understand and manage a risk sufficiently well, they can use their own calibrations to calculate capital within an overall methodology set out in the standard formula.

Q14. In circumstances in which there is insufficient justification for a full or partial internal model how might the SCR be calculated for insurance firms or business for which the standard formula is deemed inappropriate?

Where a specific component of the Standard Formula does not reflect the risk profile of the organisation, the PRA should be able to ask a firm to recalibrate the Standard Formula in preference to applying for a partial internal model. This could include, for example, integrating the firms' Cat Models' results into the relevant component of the standard formula. The USP mechanism in the Directive and Delegated Acts, expanded suitably, could provide the basis of an appropriate control framework to implement this approach (see also our feedback on this in response to Q13).

There is a prescribed approach to capital add-ons in the Solvency II framework. In our view, a regulatory capital add-on should continue to be regarded as a last resort in the longer-term, but can and should be used where there are supervisory concerns or differences of opinion that are resolvable in the short to medium-term. For example, there may be scope for capital add-ons to be applied where there is limited amount of data to recalibrate a component of the SCR and different views about the impact on the balance sheet. In this area, regulatory judgement needs to be based on clear principles and subject to significant oversight and firms should be able to challenge and appeal regulatory judgements in this area. We think that it is equally important that capital add-ons are considered in principle relevant for some governance and culture concerns and not just for modelling and capital related issues.

We also note that there may be circumstances where the inappropriateness of the standard formula arises from underlying uncertainties in the valuation of assets. There are limited mechanisms for the PRA to address this; it may be useful to explore the possibility of providing the PRA tools to address this directly through, for example, some sort of balance sheet loading so that both capital requirements and resources could be subject to adjustment. This was available to the PRA under the previous ICAS regime but adjustments to capital resources were lost in the move to Solvency II.

Q15. What changes, if any, could be made to the methodologies that insurance firms used to calculate the SCR, including by removal of potential barriers, to enable them to provide long term capital to support growth including to invest in infrastructure venture capital and growth equity and other long term productive assets consistent with the government's objectives?

We note that the Solvency II framework already include provisions that allow a firm to classify an equity investment as strategic (article 171 of the Solvency II delegated acts) and apply a lower equity capital charge (article 170 of the Solvency II delegated acts and article 304 of the Solvency II directive). It is not clear how much that is used in practice because of the strength of the eligibility conditions for the assets. However, it may be useful to consider this approach to support these types of investments, subject to an appropriate balance between policyholder protection and firms' risk management approaches.

To some extent, the MA mechanism already provides a mechanism for achieving these objectives in respect of long-term debt, so a broader application of these principles, and an approach which favours substance over form could also support the achievement of the government's objectives. Please see our response to questions in Chapter 3 and in particular our comment about the tension between substance and form in respect of the assets' eligibility conditions.

Q16. What changes if any should be made to the SCR calculation to promote better measurement and capitalization of climate change related risks?

There are split views about this question from our industry survey.[7] This feedback probably reflects the two distinct approaches of this question: whether the SCR should be encouraging "green investments" (e.g., renewable investments) or discouraging "brown investments". There is a risk that changes to the SCR capital incentives at this point overly simplify a complex situation, with unintended impacts on investment returns or processes to compensating for a limited current understanding of the underlying investment risks.

We would therefore suggest that SCR capital incentives should presently remain focused on the existing creditworthiness and quality of investments. This will inevitably include some implicit allowances for climate risk, e.g. capital for an equity stress / changes in spreads is already allowed and will be available even if the stress is generated by the materialisation of climate change.

Our view is that the appropriate consideration of climate change financial risks requires a variety of mechanisms including stress testing and scenario analysis, ORSA[8] and public disclosures, with different time horizons. We would expect public disclosures to gravitate towards the medium / long term. The ORSA should focus on the planning horizon within the constraints of "assess[ing] the risks [the insurer] faces in the short and long term and to which it is or could be exposed" (article 45 of the Solvency II directive).

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[7] 23 people responded to the question "An explicit Pillar 1 capital charge should be provided to encourage firms to manage climate change and other risks not captured in the SCR", with 10 people either agreeing or strongly agreeing, and 12 disagreeing or strongly disagreeing.

[8] 22 people responded to the question "the Pillar 2 and ORSA processes should be expected to encourage better understanding, measurement and management of climate change related risks and other new risks", with 20 people either agreeing or strongly agreeing.

We also note that there are already supervisory mechanisms for the regulator to review insurers' risk profiles and engage with senior management if there are concerns that the potential impact of climate change financial risks is not adequately addressed. Given the complexity and novelty of climate change financial risk, we support a cautious approach that allows the PRA to test the effectiveness of existing supervisory mechanisms before seeking significant changes. As Mark Carney rightly observed, "Some have suggested we ought to accelerate the financing of a low carbon economy by adjusting the capital regime for banks and insurers. That is flawed. History shows the danger of attempting to use such changes in prudential rules – designed to protect financial stability – for other ends."[9]

Chapter 7 - reporting requirements

Q20: What changes, if any, should be made to insurance firms reporting requirements; what are the costs and benefits of such changes?

We considered the extent to which the requirement to report the ORSA adversely impacts the ability of risk to support wider organisational risk management within our industry survey. Responses were split on the subject.[10] *This reflects the tension between the ORSA as being not only an output from the risk management process but also a regulatory report – a point that has been previously noted by risk professionals.*[11]

We can see that a regulatory reporting focus on the ORSA may have been necessary in the early stages of Solvency II implementation when risk management was not sufficiently advanced across all firms to ensure an appropriate focus on strategic issues and risks. We feel that the industry has progressed since then and that a continuing focus on the ORSA as a regulatory report creates more confusion than value to risk management in the UK, in particular around long term issues like climate change financial risks. We also note that it can take a listed PLC a matter of months to pull together the various elements of the ORSA report; this reporting focus hinders its effectiveness as live risk management tool. Overall, we think it would be valuable for the PRA to consider re-visiting its expectations in respect of the ORSA as part of its approach to supervision and clarify that it should be considered primarily as a risk management process that runs continually through the year in support of Board decision making.

A specific concern with the ORSA, as perceived by regulators, is the tension between quantitative risk assessment and managing risk. There are business decisions for which there is simply not enough data to approach risk in a fully quantitative manner. In these cases, the regulators' preference for quantitative risk assessment can be limiting, and solutions are needed to allow firms and regulator achieve a mutual understanding about risk exposure and risk management. This may require a deeper reliance on insurers' own governance. An example where we see this trend already emerging is climate change financial risk – an area where there is, broadly speaking, limited historical evidence. The PRA has rightly emphasised in its approach proportionality considerations which in

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[9] Mark Carney, 'Breaking the Tragedy of the Horizon – climate change and financial stability', speech given to Lloyd's of London, September 2015. (https://www.bankofengland.co.uk/-/media/boe/files/speech/2015/breaking-the-tragedy-of-the-horizon-climate-change-and-financial-stability.pdf)

[10] 22 people responded to the question "The requirement to report the ORSA adversely impacts the ability of risk to support wider organisational risk management", with 10 people either agreeing or strongly agreeing, and 10 disagreeing or strongly disagreeing, with 2 stating they don't know.

[11] Lloyd's Market Association, 'Keeping the 'O' in ORSA. How Own Risk & Solvency Assessment ("ORSA) reports can be best used to promote a risk and capital culture', February 2017. (available from https://www.lmalloyds.com/orsa)

turn relies on insurers' risk assessment and own governance, underpinned by senior management responsibilities. We encourage the PRA to build on this approach for other aspects of supervision.

Q21: Insurance reporting comprises several layers: Solvency II templates, National Specific Templates, reporting expectations and supervisory statements and ad-hoc requests. What changes, if any, should be made to bring together the various layers to create a more coherent reporting framework?

There are opportunities for PRA to streamline the regular disclosures received from insurers (QRTs, including asset data, SFCR, RSR, ORSA), to reflect the value to existing supervisory processes, given their ability to ask for additional information. There was a consensus in the responses to our industry survey in this area about this.[12]

At the same time, we have also identified industry concerns with wholesale change in reporting at this stage, given that most of the reporting is now hard coded into reporting systems. Changes aimed at simplifying disclosure requirements should be carefully managed and include adequate engagement with industry because simply changing disclosure could add costs.

Clarity is also needed about how climate change financial disclosures are integrated into existing statutory (Annual Report) and regulatory (SFCR) disclosures. While clarity may emerge over time, it may be useful for the PRA to provide some indications, for example in respect of subsidiaries of non-UK groups.[13]

<u>Chapter 9 and 10: Thresholds for regulation by the PRA under Solvency II and Mobilisation of new insurance firms</u>

Q24: What changes, if any, should be made to the current regulations on the scope of application of Solvency II what are the costs and benefits of such changes?

We endorse the spirit of this question because, as has been recognised by employees of the Bank of England itself, arbitrary thresholds can have a "cliff-edge" impact on regulation.[14] *See also our response to Q25.*

Q25: What should be the key features of a regulatory regime for insurance firms not covered by Solvency II ('non-directive insurance firms')?

We think the principle of proportionality is a key part of Solvency II, which has not always been evident in the application of the Directive in supervision. However, it is important that proportionality takes into account the risks faced by businesses. We therefore believe that all firms, irrespective of their size, should have some baseline level of risk management, including a self-assessment similar to an ORSA process and an appropriate level of regulatory and public disclosure,

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[12] 22 people responded to the question "There are opportunities for PRA to streamline the regular disclosures received from insurers (QRTs, including asset data, SFCR, RSR), to reflect the value to existing supervisory processes, given their ability to ask for additional information.", with 19 people either agreeing or strongly agreeing.

[13] 22 people responded to the question "clarity is needed about how climate change financial disclosures are integrated into existing statutory (Annual Report) and regulatory (SFCR) disclosures", with 16 people either agreeing or strongly agreeing, 2 disagreeing and 4 stating they don't know.

[14] https://bankunderground.co.uk/2020/07/31/setting-boundaries-finding-thresholds-in-bank-regulation/

to ensure that all parties can be confident that the organisations do not pose an unacceptable risk to policyholders or regulatory objectives.

Q26: What changes, if any, should be made to the requirement that new insurance firms expected to exceed thresholds for size in Solvency II within five years of authorization are subject to Solvency II from the point that they begin operations?

We believe that the application of our proposed approach set out in our response to Q25 would put the focus on proportionality, which would reduce the need for thresholds and the risk of "cliff-edge" effects.

Q27: What are the key features that should be considered in developing a regime for new insurance firms if the full Solvency II regime is not applied from the point of authorization?

See response to Q25 above.

Q29: What, if any, areas of Solvency II not covered elsewhere should be considered for review?

Our survey suggested that changes to Solvency II should take place with the specific aim of reflecting the unique features of the UK insurance sector, but not leading to material divergence and with the objective of ensuring that equivalence with the EU's Solvency II can be maintained, so long as it does not harm the UK national interest.[15]

The PRA should review the recognition of non-proportional reinsurance to bring about a closer alignment of capital and risk mitigation.

As the effects of climate change become more pronounced, it is likely that questions of insurability of certain UK risks (e.g. flood risk) will come to the fore. There is a danger that a purely risk-based framework can lead to challenges of insurance capacity in the market, and the government needs to carefully consider how to balance this and ensure there is the right level of capacity in the market.

Our industry survey highlights a broad perspective in the insurance industry that the efficiency and effectiveness of the application of the prudential regime could be enhanced.[16] *There is a need for flexibility in regulatory interpretations to ensure that outcomes are risk based. However, doing this requires an increase in scrutiny of supervisory decisions as noted in our response to the Financial Services Future Regulatory Framework Review – Phase II Consultation. Further clarity could also be provided in respect of whether and what aspects of the future regime in this area could be subject to waivers, and how such a process might operate.*

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[15] 23 people responded to the question "the UK prudential regulatory regime could be enhanced to better reflect the unique features of the UK insurance sector", with 14 people either agreeing or strongly agreeing, 6 disagreeing and 3 stating they don't know. 23 people responded to the question "maintaining equivalence with EU regulation is more important than making improvements and enhancements to the application of the UK prudential regulatory regime", with 20 people either agreeing or strongly agreeing, and 3 disagreeing or strongly disagreeing.

[16] 21 people responded to the question "significant improvements could be made to the efficiency and effectiveness of the application of the UK prudential regulatory regime", with 15 people either agreeing or strongly agreeing,

More widely, regulators should place more emphasis in their supervision on the management of risks relative to the calculation of capital for risks. The SCR is only intended to capture quantifiable risks, and so it can never fully capture all risks and uncertainty. At the same time, excessive prudence in the capital requirements and any supervisory expectation for capital buffers above regulatory requirements that can become de facto stronger capital requirements in practice have a direct consequence for the economy and need to be considered in the context of regulators' objectives. It is important that the PRA is satisfied that its regulatory judgements fully cover prudential risk management as opposed to simply focusing narrowly on Pillar 1 modelled capital.

Ultimately, regulators should be supporting more effectively the work of risk professionals and functions to focus their businesses on managing risk, and not placing increasing focus on honing its measurement or reporting to supervisors on this measurement. The fact that this call for evidence hardly refers to Pillar 2 perhaps indicates that, despite positive rhetoric on risk management, there is a risk that we may lose sight of this fundamental principle of Solvency II. There is a danger that a focus on calibration of capital requirements results in capital tied up that is not required to protect against risk to the level envisaged by the regime, and that is therefore not used to innovate and invest in UK PLC. Our survey questionnaire indicated some industry desire to further improve the Pillar 2 aspects of Solvency II.[17]

Finally, the changes that emerge from this review will need to be carefully assessed from a cost-benefit perspective. Insurers are dealing with a significant amount of change, and there is a sense among many insurers and senior managers that the vast spend on Solvency II implementation was disproportionate to the benefits that were achieved in practice. Further changes need to be considered with an awareness of these concerns. They should be phased over time incrementally rather than through a "big-bang" of changes to Solvency II.

[17] 22 people responded to the question "changes are required to Pillar 2 aspects of Solvency II to enhance the risk-based nature of Solvency II", with 10 people either agreeing or strongly agreeing.