HM Treasury Review of Solvency II consultation

Bank of England/ Prudential Regulation Authority DP2/22 – Potential Reforms to Risk Margin and Matching Adjustment within Solvency II

Submission by The Financial Inclusion Centre, July 2022

About The Financial Inclusion Centre

The Financial Inclusion Centre is an independent, not-for-profit policy and research group (www.inclusioncentre.org.uk). The Centre's mission is to promote a financial system and financial markets that work for society. The Centre works at two main levels:

Promoting system level change

Research and policy development to promote sustainable, resilient, economically and socially useful financial markets that: benefit the environment; encourage responsible corporate behaviours and create a positive social impact; and efficiently allocate long term financial resources to the real economy.

Ensuring households' core financial services needs are met

Promoting fair and inclusive, efficient and competitive, well-governed and accountable, properly regulated financial markets and services that meet households' core financial needs. We do this by undertaking research into the causes of market failure in the sector, formulating policies to address that market failure, developing alternative solutions where the market cannot deliver, and campaigning for market reform.

For further information on our work in this field or on this specific submission please contact:

Mick McAteer
Co-Director
Financial Inclusion Centre
mick.mcateer@inclusioncentre.org.uk, or mickmcateer92@gmail.com

SUMMARY OF FINANCIAL INCLUSION CENTRE VIEWS ON REFORM OF SOLVENCY II

Introduction

This submission is structured primarily to answer the questions in HMT's consultation on Solvency II. But, the responses also cover the issues raised in the Bank of England/ Prudential Regulation Authority Discussion Paper DP2/22. We are unable to respond to all of the questions. We focus on the risk margin (RM) and matching adjustment (MA) which are the key elements of the government's consultation.

We have two primary concerns in relation to the proposed reforms of Solvency II and wider financial market reform.

- The prudential regulation of UK insurers (and therefore consumer protection available to policyholders) should be robust and maintain trust and confidence in the sector over the long term; and
- Market, prudential, and conduct of business regulation should align UK financial market behaviours with climate goals.

In terms of the format of our submission, we have summarised our position on the key issues in this section, followed by responses to specific questions contained in the relevant documents.

Impact on consumer protection

It is our view that the current approach to Solvency II – using the RM and MA as calibration mechanisms to determine overall financial resilience of insurers – is fundamentally flawed. The use of the MA is of particular concern. If we were starting with a clean sheet of paper, we would argue for replacing the RM and MA with a more coherent approach involving a single consistent measure of assets and liabilities and prudential requirements.

However, major reform of Solvency II is not on offer at the moment. Therefore, our priority is that the system protects consumers and any reforms do not further weaken financial resilience.

We are concerned that the insurance lobby's demands for reforms to Solvency II would result in a significant reduction in consumer protection for policyholders from an already weak position.[1] We believe the insurance lobby's demands are driven more by the desire to benefit shareholders rather than unlock capital for productive uses such as financing the green transition or levelling up.

We note that the government and BoE/ PRA's proposals would indeed mitigate the impact of the insurance lobby's demands. The BoE/ PRA would be content to reduce the RM but, to offset this, would tighten up on the use of the MA. But, it is also worth noting that the combined effect of the proposed reforms to the RM and MA would still reduce overall capital levels from their starting position and will inevitably lead to some reduction in financial resilience amongst insurers. [2] These would release capital equivalent to 10-15% of the current capital held by life insurers. We would argue that the current state of the insurance sector does not warrant ***any*** across-the-board weakening of prudential regulation standards. If anything, policymakers and regulators should be

[1] There are concerns that the use of the Matching Adjustment already artificially inflates the strength of the balance sheets of a number of major UK insurers. See: Regulation is masking the true condition of insurers | Financial Times (ft.com)

[2] PRA, DP2/22 – Potential Reforms to Risk Margin and Matching Adjustment within Solvency II, para 49

toughening prudential regulation standards given the current state of insurers – this is all the more important given the prospects for financial markets.

The use of the MA is fundamentally flawed as it enables insurers to artificially create capital. Insurers are able to recognise, up front, future returns from investing in MA assets so allowing them to reduce the amount of real capital held. This benefits shareholders at the expense of policyholders who are exposed to the risk that these higher returns do not materialise over time.

There are some rules on the eligibility of assets for the MA. Even so, the current approach already incentivises insurers to seek out 'too good to be true' assets – ie. those that provide a higher return but are rated as a similar risk to other assets offering a lower return. Moreover, many of those assets are ***internally*** rated by the insurers themselves which obviously creates conflicts of interest. [3]

Allowing insurers to assume that higher risk assets will deliver expected returns is inherently risky. But, the MA is even more perverse. It goes against one of the fundamental rules of finance – that if a financial institution is exposed to higher risks it should hold more provision against those risks. The MA allows insurers to reduce the amount of provision held against those higher risks.

The scale of MA assets already involved is already worrying. Total assets held in MA portfolios amounts to around £380bn. It delivers a capital benefit of £80bn – an increase of £20bn from £60bn when first introduced. That £80bn is more than two-thirds of the entire capital base of the life insurance industry of £112bn. For some specific insurers, the MA makes up the bulk of their capital.[4]

Moreover, the increase in the inclusion of illiquid assets in MA portfolios can heighten the risk to policyholders. The proportion of assets in illiquid assets has grown from 31 percent in 2018 to 41 percent in 2021.[5]

The widespread use of the MA to artificially create capital means there is an illusion of balance sheet strength in some of our major insurers. The UK approach to prudential regulation has already allowed the UK insurance sector to make far greater use of this artificial capital creating mechanism than its major EU competitor markets.

This cannot be a good position to be in. It is not just traditional personal pensions/ annuities that we need to consider. Employers have been transferring pension liabilities to insurers in very large volumes. In total, the BoE/ PRA estimates that over 8 million policyholders are served by this sector.

The insurance lobby wants to: i. see a reduction in the Risk Margin; *and* ii. to gain even more benefit from the MA. The BoE/ PRA proposals to tighten up on the use of the MA seems to have angered the insurance lobby who are saying that if they are not allowed to take further advantage of the MA (as well as get the benefit from the RM), they will not invest in green assets/ levelling up.[6] We would urge the government and BoE/ PRA to call the bluff of the insurance lobby on this.

The current approach in Solvency II tries to account for retained risks (such as credit and residual risks) in portfolios by excluding from the MA an allowance for those risks. This allowance is the

[3] Solvency II: Striking the balance – speech by Sam Woods, Deputy Governor for Prudential Regulation and CEO of the Prudential Regulation Authority, Bank of England Webinar, 8th July 2022, P7
[4] Sam Woods Solvency II: Striking the balance – speech by Sam Woods | Bank of England and Regulation is masking the true condition of insurers | Financial Times (ft.com)
[5] HM Treasury, Review of Solvency II, Consultation, April 2022, para 3.6
[6] Solvency II reform proposals need further work to meet objectives | ABI and Aviva explores using shareholder money to fund infrastructure projects | Financial Times (ft.com)

‘fundamental spread’. The government is considering reform to the fundamental spread used in the calculation of the MA and the BoE/ PRA is concerned that the current approach allows insurers to take too much benefit from the MA. The BoE/ PRA proposes dealing with this through the Credit Risk Premium (CRP) which is intended to ensure that insurers do not recognise excess levels of profit upfront.

The use of the CRP will not fully address the fundamental flaws in the MA. We share the views of others that insurers should be required to recognise credit risk in portfolios by accounting for *all* the market perception of those risks. It follows that the fundamental spread should be equal to the market spread and that the MA should be zero.

This would lead to a more financially resilient, better regulated insurance sector at the aggregate and individual firm level. Of course, the impact on specific insurers would be different depending on the degree to which they rely on artificial regulatory capital. Those insurers which depend heavily on the MA would clearly be affected more than their peers who do not rely on the MA. The MA reliant insurers would have to hold more ***real*** capital to meet regulatory capital requirements.

The government thinks that its reforms could release 10-15% of capital currently held by insurers and unlock ‘tens of billions of pounds’ for long term productive investments including green assets. So, increasing the amount of real capital held by insurers may not be the outcome the government wants to see.

But, looking at the balance sheets of certain individual insurers, there is a compelling case for robust interventions to strengthen financial resilience given the reliance on the MA to artificially boost regulatory capital. The proposed reforms to Solvency II involve a reduction in the RM, offset by a tightening of the MA application. As mentioned, we think the use of the MA *per se* is fundamentally flawed. However, if the government and BoE/ PRA insists on allowing insurers to retain some value from using the MA, then new regulations should ensure that the combined effect of the RM/ MA measures does not result in any release of capital by those insurers heavily reliant on the MA. Indeed, there is a strong case for ensuring the combined effect to result in an increase in real capital held by those insurers.

Furthermore, the BoE/ PRA should require those insurers heavily dependent on the MA to develop ***financial resilience transition*** plans to reduce reliance on the MA over a reasonable period.

Aligning financial markets with climate goals

As well as having concerns about the impact on consumer protection, we conclude unfortunately that the government’s proposals on Solvency II will do little to align behaviours in the UK financial system and markets with climate goals.

As we set out in our submission to HM Government: Update to Green Finance Strategy Call for Evidence,[7] and in the Annex below, we do not think the legislative and regulatory framework, and specific regulations, rules, and guidance are fit-for-purpose and will not drive the necessary change in the financial system and markets. A different approach will be needed if the UK financial sector is to contribute to climate goals and if the UK is to be a leading effective, trusted, and reputable global centre of green finance.

[7] HM Government: Update to the Green Finance Strategy – Call for Evidence | The Financial Inclusion Centre

The key objectives of climate related financial market reform should be to:

- Effectively align the behaviours and activities of the financial system,[8] markets, and institutions with climate goals; and
- Efficiently direct resources ***to*** climate positive economic activities and ***away*** *from* climate damaging activities. For this to happen, financial policy and regulation must be as efficient as possible at: i. causing financial institutions to disinvest and divest from their existing ***stock***[9] of climate damaging assets; and ii. ensuring the ***flow*** of new funding (public and private)[10] is allocated to climate positive economic activities and directed away from climate damaging activities.

Greening the financial system and underlying real economy will require sustained efforts over the long term. Therefore, it is important that any redirection of resources is sustainable and available funding is aligned with the long term in nature of climate goals. This will be a challenge given the short termism prevalent in UK financial markets.

In our view, the proposals made by government for reforming Solvency II would not encourage significant *flows* of resources to climate positive activities, and away from climate damaging activities. At best, the proposals might make a marginal contribution to channelling flows of assets but at a cost to the consumer protection available to insurance policyholders. Moreover, the proposals do not appear to contain robust measures that would cause insurance companies to meaningfully divest or disinvest from their existing stock of climate damaging assets.

The insurance industry has been vocal in asserting that the current design and implementation of Solvency II stops them from investing in green technology/ infrastructure and that reform is needed to enable such investment. These arguments are disingenuous. It is not at all clear why government believes that, with reforms, insurers might choose to invest in green assets (or levelling up) rather than create further windfalls for shareholders by investing in high return, speculative assets.

Solvency II does ***not*** prevent insurers from investing in green assets or levelling up. What insurers actually mean is that unless they are able to make greater use of the MA, they will not be able to provide shareholders with windfalls.

Moreover, there is the important point that private finance (including insurance and pension funds) is a much more costly way to finance environmental and economic policy goals (green assets and levelling up/ social infrastructure) compared to state financing mechanisms.

Furthermore, we also note that the finance industry is lobbying for the state to 'de-risk' green assets (such as new green technologies or green infrastructure) by underwriting the associated early stage risks. This is what is known as 'socialising the risks, privatising the rewards'. Again, it does not seem to be an economically sensible approach.

We would understand the dilemma facing policymakers and regulators if weakening prudential regulation was the only option to encourage investment in green assets/ levelling up. But, this is not the case. There are more effective ways of directing the financial resources of financial institutions

[8] When we refer to the financial system, we include institutions of the state and the Bank of England, not just private sector institutions
[9] Held in the form of loans provided to and shares and bonds held in listed/ tradeable companies or larger privately owned companies
[10] When we refer to climate related funding or financial resources we include state/ public funding not just market based private finance (eg. banks, insurers, pension funds, asset managers, private equity and so on)

to productive uses without compromising consumer protection and undermining long term trust and confidence in the insurance industry and pensions.

A much more effective means to 'incentivise' insurers to invest in productive assets would be to penalise the holding of, or directing new funds to, unproductive or climate damaging assets. This would provide the necessary incentive by making productive assets more attractive (in economic and regulatory terms) and a better way of achieving the twin goals of dealing with the flow and stock of assets.

To redirect resources from climate damaging assets, financial regulators should require insurers (and banks and asset managers) to have credible and demanding ***climate de-risking transition plans*** in place, with clear targets and timeframes.

Once transition plans have been approved, specific policy tools will be needed to implement these plans. We very much support the idea that policymakers and prudential regulators should adopt the "One for One" Rule. That is, for each £ of resource that finances ***new*** climate damaging activities, insurers should hold a £ of their own-funds held liable for potential losses.[11] An alternative would be to adjust the 'own-funds requirement' by reference to an independent assessment of the climate damage caused by an economic activity.[12]

If government and BoE/ PRA insists on retaining the use of the MA (see above), then assets which contribute to climate damage should be excluded from assets eligible for MA portfolios.

That would address the ***flow*** of new funds. We would still need to deal with the ***stock*** of existing climate damaging assets. This could be done by requiring insurers to hold a proportion of own-funds against existing holdings – this proportion would be ratcheted up over an appropriate time frame to incentivise insurers to divest these assets in line with the transition plans described above. This should apply to assets already held in MA portfolios.

[11] https://www.finance-watch.org/the-one-for-one-rule-a-way-for-cop26-ambitions-to-manifest-in-policy/

[12] So, if an economic activity was rated as 4 out of 5 in terms of its climate impact, insurers would hold 80p in the £ and so on. But, this would require a robust foundational taxonomy which we do not yet have.

Response to specific questions

Question 2.1 How would a reduction in the risk margin for long-term life insurers toward the bottom or top of the 60%-70% range impact on: policyholders and their level of protection; and insurers and their reinsurance, investment and product pricing decisions.

We recognise the drawbacks in the current application of the risk margin in terms of the volatility created.

But the important point is that, as explained above, the risk margin (RM) and the matching adjustment (MA) must be considered together. If the RM was reduced for insurers without offsetting this by tightening the MA, this would by definition result in a weakening of policyholders' protection. There would be less regulatory capital overall held against future risks.

HMT says that '*a high risk margin increases the costs to insurers of writing new business and leads to a suboptimal allocation of capital resources*'.

A reduction in the RM may well indeed reduce the cost of writing new business. But, if the overall effect of proposed reforms is to weaken financial resilience, that business would be written on artificially low terms, that does not properly reflect the risks involved. This might allow insurers to sell more business and satisfy shareholders. But, under-pricing risk would not be a good outcome for consumers and should not be encouraged.

It is not clear why HMT thinks that the current RM leads to a suboptimal allocation of resources. Nor is it clear what HMT defines as 'optimal'. We define optimal allocation of assets (in the case of long term life insurers selling annuities/ pensions) as assets whose risk profile and duration match the future liabilities – that is, the expected payouts to policyholders. In the case of people's retirement incomes, this is best done using portfolios of objectively rated low risk bonds.

The insurance lobby is arguing that reducing the RM and allowing insurers to make greater use of the MA facility would enable greater investment in alternatives such as infrastructure and other yield-generating financial activities. Indeed, the insurance lobby is claiming that their proposed reforms would allow the sector to support national policy goals such as investing in green assets (green technology and infrastructure) and levelling up.

But, there are considerable risks attached to alternatives such as early stage technologies and infrastructure (particularly novel, untested technologies and infrastructure).[13] These are not appropriate for critical products such as annuities. Moreover, funding provided by insurers would be costly compared to state funding.[14] Weakening prudential regulation/ consumer protection to 'incentivise' insurers to provide costly financing does not seem to be an optimal allocation of resources.

[13] Of course, the finance lobby has been pushing for the state to underwrite early stage risks of novel technologies and infrastructure. This might mitigate some of the risks policyholders would be exposed to. A question of socialising the risks, privatising the rewards. We question whether it would be appropriate for the state to support costly private finance in this way through subsidies.

[14] The private finance insurers would supply would be expensive compared to state funding (the returns demanded would be higher than the risk free rate ie. gilts which represent the cost of the state funding infrastructure through borrowing). Remember, shareholders would be already receiving a windfall through the application of the matching adjustment which also transfers risk to policyholders.

Furthermore, if the RM was reduced, we think it is unlikely insurers would use these 'freedoms' to invest in productive assets. It is surely sensible to assume that shareholders would pressure insurance company boards/ executives to use this deregulation to invest in assets which appear to generate the highest returns so creating the biggest gain for shareholders.

HMT says that reducing the RM would reduce incentives to reinsure longevity risk outside the UK in a jurisdiction that does not require a RM. That may well be the case. But, this is missing the point. We must avoid regulatory arbitrage. A UK version of Solvency II should only allow insurance companies to reinsure in non-UK jurisdictions that meet robust regulatory standards at least equivalent to the UK's. Similarly, UK policyholders should ensure that the UK insurance market does not become a destination for regulatory arbitrage to support the government's goal of promoting 'competitiveness'.

Question 2.2 How would a reduction in the risk margin for general insurers of 30% impact on: policyholders and their level of protection; and insurers and their reinsurance, investment and product pricing decisions.

See above Question 2.2. The same issues are relevant for general insurers. But, clearly the risks to policyholders are not as acute.

Question 2.3 Do you agree that a modified cost of capital methodology should be used to calculate the risk margin?

The government prefers the modified cost of capital approach the Margin over Current Estimate (MOCE) model used in the Insurance Capital Standard set by the International Association of Insurance Supervisors on the grounds that: it is sensitive to the significant differences in risk profile and liability duration across the population of UK insurance firms; there is less disruption for firms as current systems would only need slight adaptation, rather than the more significant changes that would be needed to accommodate a Margin over Current Estimate approach; and there is comparability with the revised RM methodology being proposed for use in the EU, which benefits insurers with a presence in both the UK and EU.

We are still considering these two approaches in light of where developments at EU and international level are going. So, for now have no particular preference. The reasons set out for supporting the modified cost of capital approach may well be valid. But, it is worth noting that the MOCE model could be more helpful in aligning the UK with international standards. The choice will be influenced by whether the future of the UK insurance sector is likely to align more with international markets or EU markets.

However, the choice of model here is not the main consideration. Both models would result in a reduction in the RM. As explained, this should be offset by basically removing the potential for creating artificial capital through the MA.

It is interesting that the government refers to the significant differences in risk profiles across the population of UK insurance firms. Looking at the data on the degree to which individual insurers rely on the artificial capital created by the MA, it raises concerns that some insurers are less sound than others. Rather than weaken financial resilience, we would argue there is a compelling case for the regulators to require insurers relying heavily on the MA to boost their real capital.

Question 2.4 Is there any further information about actual transfer values of insurance risk that should be taken into account when finalising the calibration of the risk margin reforms?

No comment.

Question 2.5 How could the Government be assured that resource that becomes available following a reduction in the risk margin would not be distributed to shareholders or used to increase remuneration to parties within the insurance firm?

The first step is for government and regulators to **presume** that boards and senior management would seek to use this deregulation to provide a further windfall to shareholders or boost remuneration for senior executives.

There are ways to prevent this. The most obvious is for regulators to make a rule prohibiting the windfall being distributed to shareholders and requiring that it be used for the benefit of policyholders for example by providing a bonus to policyholders or used to bolster annuity payments. Any plans for using this windfall should be overseen by Independent Governance Committees (IGC) and approved by regulators.

Of course, boards and senior management could still produce windfalls for shareholders using more indirect means. For example, this could be done by investing the windfall in high return speculative assets and creating a gain through the MA. This avenue should be closed off by the proposals we outline above which would basically remove the potential for artificial gain through the MA.

Question 3.1 Taking into account the fundamental spread methodology needing to be sufficiently responsive to changes in investment decisions and reflect long-term exposure to credit risks, do you agree with the above assessment that the current methodology does not: sufficiently address the risks associated with assets with the same credit rating but different market measures of retained risks; or take account of all the risks associated with holding internally rated or illiquid assets?

Yes, we do agree that the current methodology does not sufficiently address the risks described. But, as we explain below, we do not believe that the government's proposals fully address these risks.

Question 3.2 What is the impact of the fundamental spread including a credit risk premium of 25, 35 or 45% of spreads on life insurers': key balance sheet metrics including best estimate liabilities, own funds and the solvency capital requirements; incentives to provide annuities; annuity prices; investment in economic infrastructure, such as clean energy, transport, digital, water and waste; investment to support the transition to net zero, either allocation of capital to support the development of new green technologies or to support adoption of green solutions; and relative incentives to invest in different types of assets, including assets of different credit ratings and different risks, assets with different liquidity, assets that are internally or externally rated, and assets in different sectors?

As explained above in the summary of our response, we think the MA is fundamentally flawed *per se* and that the use of the credit risk premium (CRP) will not fully address these flaws. Moreover, applying a blanket CRP of whatever amount – even the most restrictive – does not address the specific balance sheet weaknesses in individual insurers.

We share the views of others that insurers should be required to recognise credit risk in portfolios by accounting for *all* the market perception of those risks. It follows that the fundamental spread (FS) should be equal to the market spread and that the MA should be zero.

The current approach used in Solvency II, we believe, allows for artificially low pricing of annuities and other pension products. A more realistic approach to the FS, CRP, and MA would of course affect life insurers attitudes to providing annuities and annuity pricing by requiring more realistic, sustainable pricing. This would be a good outcome.

With regards to investment in infrastructure, as we explain above, we do not need to weaken consumer protection (particularly given the state of insurers balance sheets) to encourage this. We urge the government and regulators to call the bluff of the insurance lobby on this issue. There are more effective ways to achieve this such as penalising the holding of climate damaging activities. This would make productive assets more attractive and provide the necessary incentive – see above.

Moreover, any deregulation would more likely be used to generate further windfalls for shareholders rather than invest in green infrastructure and so on.

Question 3.3 What is the threshold for any increase in the fundamental spread above which adverse effects become significant, such as excessive balance sheet volatility or increased reinsurance of risks off-shore?

No comment.

Question 3.4 What is the impact on policyholder protection of a credit risk premium of 25, 35 and 45% of spreads, when accompanied by a risk margin reduction for long-term life insurers of 60-70%?

We are concerned that the insurance lobby's demands for reforms to Solvency II would result in a significant reduction in consumer protection for policyholders and pension savers from an already weak position.[15] We take the view that the insurance lobby's demands are driven more by the desire to benefit shareholders rather than unlock capital for productive uses such as financing the green transition or levelling up.

It is encouraging that the government and BoE/ PRA's proposals would indeed mitigate the impact of the industry's demands. The BoE/ PRA would be content to reduce the RM but to offset this would tighten up on the use of the MA.

But, it is also worth noting that the combined effect of the proposed reforms to the RM and MA would still reduce overall capital levels from their starting position and will inevitably lead to some reduction in financial resilience amongst insurers.[16] By loosening the requirements on the RM and tightening the MA, the combined effect of the BoE/ PRA's proposals would be to release capital equivalent to 10-15% of the current capital held by life insurers.

We would argue that the current state of the insurance sector does not warrant ***any*** across-the-board weakening of prudential regulation standards – indeed, the current state would justify a

[15] There are concerns that the use of the Matching Adjustment already artificially inflates the strength of the balance sheets of a number of major UK insurers. See: Regulation is masking the true condition of insurers | Financial Times (ft.com)
[16] PRA, DP2/22 – Potential Reforms to Risk Margin and Matching Adjustment within Solvency II, para 49

tightening of regulation particularly for certain insurers relying heavily on artificially created MA capital.

As outlined above, we think insurers should be required to recognise credit risk in portfolios by accounting for *all* the market perception of those risks meaning the fundamental spread (FS) should be equal to the market spread and that the MA should be zero.

If the government and BoE/ PRA insists on allowing insurers to retain some value from using the MA, then new regulations should ensure that the combined effect of the RM/ MA measures does not result in any release of capital by those insurers heavily reliant on the MA. Indeed, there is a strong case for the combined effect to result in an increase in real capital held by those insurers.

Furthermore, the BoE/ PRA should require those insurers heavily dependent on the MA to develop ***financial resilience transition*** plans to reduce reliance on the MA over a reasonable period.

Question 3.5 What is the impact of selecting an averaging period (n) of 0.5, 1, 2, 5, 10 and 30 years?

No comment.

Question 3.6 Are there other ways to achieve the same impact that changes to the fundamental spread would have?

See above our response to Question 3.2. We think the MA is fundamentally flawed *per se*. Insurers should be required to recognise credit risk in portfolios by accounting for *all* the market perception of those risks. It follows that the fundamental spread (FS) should be equal to the market spread and that the MA should be zero.

Question 4.1 What would be the impact of these reforms on insurers' use of the matching adjustment and investment: in economic infrastructure, such as clean energy, transport, digital, water and waste; to support the transition to net zero, either allocation of capital to support the development of new green technologies or to support adoption of green solutions; and in any other asset classes.

Again, we are concerned that the government appears to think that weakening consumer protection, this time through 'increasing investment flexibility', is a worthwhile trade off to encourage investment in 'innovative assets'.

Innovative assets by definition are associated with greater risk. The government says that if an insurer has already received approval for a particular innovative asset class in their MA portfolio, then the PRA may consider this when assessing applications by other insurers to invest in such assets. This does not follow. The appropriateness of an 'innovative' asset class should depend on the specific risk profile of individual insurers.

With regards to the impact of these specific reforms on encouraging investment in productive assets, we reiterate the points made above. Insurers are more likely to use this deregulation to identify opportunities to benefit shareholders rather than support productive investment. Productive investment is better incentivised by deterring investment in climate damaging or speculative assets rather than weakening consumer protection.

Question 4.2 What are the additional risks that these reforms may pose to policyholder protection?

See above. The overall combination of the government's proposals would be to reduce consumer protection – albeit by not as much as implied in the insurance lobby's demands. These particular proposals would expose policyholders to even greater risk by incentivising investment in 'innovative' speculative assets.

Moreover, we are very concerned to read that the government wants to extend the range of liabilities eligible for the MA such as income protection or social care insurance. We already have concerns about the terms on which existing products are written given the state of certain insurance company balance sheets. There is no logic to extending a fundamentally flawed approach to other products. Encouraging inappropriately priced products is not a sensible way to promote a sustainable, safe market in which consumers can have justified confidence and trust.

Question 4.3 What safeguards are appropriate to protect policyholders from the risks posed by allowing a wider range of assets into matching adjustment portfolios?

As outlined above, the obvious safeguard is that insurers should be required to recognise credit risk in portfolios by accounting for *all* the market perception of those risks. It follows that the fundamental spread (FS) should be equal to the market spread and that the MA should be zero.

Question 4.4 What impact will these reforms have on insurers providing a greater range and more affordable pricing of products?

See above. The deregulation implied in these specific reforms might allow insurers to manufacture seemingly keener priced products. But, we conclude that this would just lead to badly priced products which do not properly reflect the risks involved. This would not be a good outcome for consumers particularly given the concerns we have about the terms on which existing products are written.

Question 4.5 What changes to the matching adjustment approval process are necessary to ensure that applications to use the matching adjustment are approved more quickly?

Given the current state of certain insurers' balance sheets, speed is not of the essence here.

Question 5.1 What is the impact of these reforms on regulatory costs incurred by insurers?

No comment. We have no information on this

Question 5.2 What would be the impact of removing capital requirements for branches of foreign insurers operating in the UK, both on existing branches and on the decision to establish new branches?

We are concerned that the government is considering this measure to boost 'competitiveness' and competition. Weakening regulation and consumer protection to try to support the competitiveness of the UK, and promote competition within in the UK, is not sensible.

The risk is that foreign insurers regulated under less robust regulatory regimes would set up in the UK and have a competitive advantage over domestic insurers. This would cause domestic insurers to

demand the same treatment risking regulatory arbitrage. Moreover, if an increase in *competition* and choice did happen, this would be as a result of an increase in less well-regulated firms in the market.

Question 5.3 What would be the impact of a new mobilisation regime for insurers and changes to thresholds at which Solvency II applies on: businesses currently considering whether to become an authorised insurer; and small insurers' ability to expand before Solvency II applies?

We have no particular comment on this expect to say that speed of authorisations should not be the priority here. What matters is a robust authorisation process.

This marks the end of The Financial Inclusion Centre's submission

ANNEX I: ALIGNING THE FINANCIAL SYSTEM WITH CLIMATE GOALS

To align financial markets with climate goals we need the following:

- An appropriate high level policy framework
- An effective legislative and regulatory framework
- Detailed regulations, rules, and guidance
- Effective conduct of business regulation, information disclosure
- The right regulatory culture and approach

The high level policy framework

With regards to funding the necessary green transition, there have been a number of attempts to model the level of funding needed for the UK to meet its net zero goals.[17] Moreover, The Committee on Climate Change (CCC) has undertaken detailed analysis of the level of funding needed within specific economic sectors.[18]

So, we have reasonable estimates about how ***much*** is needed. But, we do not have the political structures and high level policy mechanisms to ensure the necessary level of funding occurs. The UK, despite the stated commitments of government, is falling behind in terms of the level of funding needed.[19]

There has been little detailed analysis (and even less informed transparent public debate) on how ***best*** to fund the transition. That is: what is the most sustainable and economically efficient means of funding the transition; how to achieve a just and fair transition; and how, where, and when to best deploy available funding to different sectors of the economy (public and private).

There are big decisions to be made such as on the balance between: public and private sources of funding; and direct charges, current taxation, and borrowing. There are difficult choices to be made about intergenerational fairness. The timing of funding decisions is also important. There are decisions to be made on which type of funding is most appropriate for specific sectors of economy (public and private); and the balance between central and local government funding.

We must also consider the impact of *economic* policy decisions made by policymakers on green transition policies. For example, decisions by the MPC to raise interest rates to tackle inflation has consequences for funding green tech which becomes comparatively more expensive.[20]

We do not have the appropriate policy framework in place to allow us to answer those critical questions in the national interest. So far, the government's attention seems to have been focused on incentivising private finance in its various forms (eg. pension funds, insurance funds, private equity and so on) even though private finance is a more costly form of funding than collective funding through the state. These decisions are important. Defaulting to more costly forms of funding has real world consequences. It feeds through to higher costs for households.[21]

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[17] The OBR estimated that £1.4 trillion in additional investment would be needed between 2020 and 2050 for the UK to meet its domestic net zero emissions targets How much will it cost the UK to reach net zero? | Financial Times (ft.com) The-Sixth-Carbon-Budget-The-UKs-path-to-Net-Zero.pdf (theccc.org.uk)

[18] Sixth Carbon Budget - Climate Change Committee (theccc.org.uk)

[19] Climate: WWF warns UK spending is lagging behind targets - BBC News

[20] Can we avoid green collateral damage from rising interest rates? | by UCL Institute for Innovation and Public Purpose | UCL IIPP Blog | Jun, 2022 | Medium

[21] Private finance demands a return above the 'risk free rate' namely government bonds (gilts). Higher charges need to be extracted from households to pay for the higher returns expected.

An effective legislative and regulatory framework

It is not at all clear that policymakers and regulators recognise in the policies they propose the financial risks associated with climate change – particularly the impact on households. The UK, with its heavily financialised economic system is particularly exposed to climate-related financial risks. [22]

Dealing with these financial risks requires a sustained, robust approach to financial market regulation. But, for regulation to be effective also requires the appropriate legislative framework.

With regards to the overarching legislative and regulatory framework, we highlighted in our report, Time for Action, that the absence of clear, primary statutory objectives for financial regulators in relation to climate change is a major barrier to greening the financial sector - and therefore greening the economy.[23]

The current high level post Brexit reform of financial regulation (The Future Regulatory Framework Review and now the Financial Services and Markets Bill), and specific reforms such as that of Solvency II, are a missed once-in-a-generation opportunity to reform UK financial regulation so that it causes the necessary behavioural change in the UK financial system and markets.

The appropriate high level policy framework for determining how best to fund the green transition (specific legislation and regulation relating to green finance has to flow from the high level policy framework). The latest proposal in the Financial Services and Markets Bill is very limited in its ambitions for climate related financial regulation. It does not provide The Bank of England and financial regulators with clear, powerful statutory objectives to promote financial market behaviours that contribute to climate goals. Instead, the role of regulators is relegated to having regard to a regulatory principle defined as 'the need to contribute towards achieving compliance with section 1 of the Climate Change Act 2008 (UK net zero emissions target)'.[24]

Therefore, we argue that the Bank of England should be given new statutory objectives to promote financial market behaviours that contribute to economic and environmental sustainability; and, specifically, to ensure the activities of the UK's financial sector are aligned with the goal of 1.5 degrees of warming. The FCA, PRA, TPR, and FRC should be given new obligations to support and have regard to the impact of their policies on the Bank of England's sustainability objectives.

The FCA should be given responsibility for overseeing how financial institutions, listed companies and larger private companies disclose compliance with sustainable, responsible, and social impact (SRI) criteria. The FRC should retain responsibility for ensuring the auditing of underlying economic activities meet regulatory requirements. Reporting on SRI compliance should be made a statutory requirement rather than voluntary, with appropriate sanctions for non-compliance with reporting standards.

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[22] See: People in US and UK face huge financial hit if fossil fuels lose value, study shows | Fossil fuels | The Guardian
Stranded fossil-fuel assets translate to major losses for investors in advanced economies | Nature Climate Change

[23] Time for Action – Greening the Financial System | The Financial Inclusion Centre

[24] Financial Services and Markets Bill, s25 newbook.book (parliament.uk)

There needs to be greater focus on supply chains in the economy.[25] The FRC and FCA should collaborate on improving the standards of auditing in and reporting on compliance with climate goals in supply chains.

Government and Bank of England should establish a Financial Sustainability Committee (FSC) along the lines of the Monetary Policy Committee (MPC). The FSC should take responsibility for the Bank's new statutory objective described above and coordinate the work of all the regulators involved in managing climate related risks – the Bank of England, PRA, FCA, and The Pensions Regulator (TPR).

The FSC should publish an annual report on its activities plus a wider triennial review on progress against its objectives. The FCA, PRA, and TPR should also publish an assessment in their annual reports on how their activities have contributed to the objective of the FSC.

Detailed regulations, rules, and guidance

We also have concerns about the detailed regulations, rules, and guidance currently proposed by the main regulators. These are not as well developed as other jurisdictions. A good example relates to how the UK is falling behind the EU in developing a robust green finance taxonomy.

We do not have the space to cover all the current legislative and regulatory reforms in train. But, we would highlight the reforms to Solvency II, aligning bank behaviours, and the FCA's proposals on disclosure and investment labelling.

Government, post Brexit, is currently consulting on reforms to Solvency II.[26] The government appears to believe that, by reforming Solvency II, the insurance industry will be incentivised to direct more resources to green assets. Specifically, it wants to change the way a technical provision called the Matching Adjustment is calculated. The Matching Adjustment is a perverse mechanism that allows insurers to discount liabilities to the benefit of shareholders. The government's proposals are not an economically efficient way to direct resources to green assets.

Moreover, we are very concerned that government's intentions will lead to a reduction in consumer protection for policyholders and pension savers[27] while providing a further windfall for shareholders.

In a nutshell, government's approach on Solvency II can be summarised as reducing consumer protection, offering shareholders the chance of a windfall, and risking taxpayers money - all just to encourage a costly way to fund the green transition.

Moreover, this approach does not actually recognise the scale and nature of climate related financial risks. It would be much more effective for Bank of England/ Prudential Regulation Authority to ***direct*** insurance and pension resources to climate positive activities (green assets) by deterring funding of climate damaging activities (brown assets).

To do this, regulators will have to deal with the ***stock*** of existing climate damaging assets and the ***flow*** of new funding and resources. And if this redirection of resources is to happen efficiently and

[25] The supply chain accounts for more than 90% of most consumer goods companies' environmental impact. For more detail see: Podcast: The Devil is in the policy detail – the role of disclosure and reporting, standards setting bodies, and audit and accountancy professions | The Financial Inclusion Centre

[26] The PRA is also consulting on the details but there is no question this reform is being driven by the Government.

[27] There are concerns that the use of the Matching Adjustment already artificially inflates the strength of the balance sheets of a number of major UK insurers. See: Regulation is masking the true condition of insurers | Financial Times (ft.com)

effectively, financial regulators will need to ensure that insurers (and banks and asset managers) have credible and demanding transition plans in place with clear targets and timeframes.

Once transition plans have been approved, specific policy tools will be needed to implement these plans. We very much support the idea that policymakers and insurance prudential regulators should adopt the "One for One" Rule. That is, for each £ of resource that finances ***new*** climate damaging activities, insurers should hold a £ of their own-funds held liable for potential losses.[28] An alternative would be to adjust the 'own-funds requirement' by reference to an independent assessment of the climate damage caused by an economic activity.[29]

That would address the ***flow*** of new funds. We would still need to deal with the ***stock*** of existing climate damaging assets. This could be done by requiring insurers to hold a proportion of own-funds against existing holdings – this proportion would be increased over an appropriate time frame to incentivise insurers to divest these assets in line with the transition plans described above.

Similarly, there have been arguments put forward by industry lobbies that charge caps on pension schemes could be relaxed to 'facilitate' investment in green finance infrastructure and levelling up. Again, we believe that the real aim here is allow private finance to generate higher returns and higher fees (greater value extraction). Undermining an important consumer protection measure to facilitate a more costly form of funding does not make sense.

As mentioned above, private finance (including via insurance funds and pension funds) is a costly way to fund green infrastructure. Diluting critical pieces of legislation and regulation, which would reduce consumer protection, just to encourage more costly forms of funding green infrastructure does not make sense in policy terms.

Moreover, we also note that the finance industry is lobbying for the state to 'de-risk' green assets (such as new green technologies or green infrastructure) by underwriting the associated early stage risks. This is what is known as 'socialising the risks, privatising the rewards'. Again, it does not seem to be an economically sensible approach.

Similar issues arise with regards to prudential regulation of banks (although it is worth noting that banks do not benefit from the perverse matching adjustment incentive available to insurers). We would argue that the One-for-One Rule outlined above should also be adopted for calculating Pillar 1 capital requirements for banks.

Conduct of business regulation, information disclosure

With regards to conduct of business regulation, the FCA is relying heavily on improving disclosure and transparency. The FCA wants to introduce a tiered approach to disclosing information. This is appropriate as different external users of relevant data and information (such as investors, pension funds, civil society) will need to have access to (or be interested in) different levels of component data.

But, we have serious concerns about the classification system proposed by the FCA.[30] The classification system proposed is not robust and could result in confusion. In particular, the low level

[28] https://www.finance-watch.org/the-one-for-one-rule-a-way-for-cop26-ambitions-to-manifest-in-policy/

[29] But, this would require a robust foundational taxonomy which we do not have
[30] Financial-Inclusion-Centre-submission-to-FCA-dp21-4-final.pdf (inclusioncentre.co.uk)

criteria that financial institutions would have to meet to be allowed to market and promote their funds and products as 'Responsible' and 'Sustainable' could lead to greenwashing, misselling, misrepresentation, and investors inadvertently making poor financial decisions.

We are also very concerned about the lack of detail on how the FCA will supervise compliance with its rules and how claims made by financial institutions are to be independently audited to ensure that any label or rating system is not built on misleading foundations.

In addition, we have concerns about the proposals for auditing real economy firms' compliance with climate disclosures.[31]

The absence of a robust foundational taxonomy must be urgently addressed if financial stability, prudential, conduct of business, and reporting and disclosure regulation is to be effective.

Regulatory culture and approach

The dominant culture and attitudes within the UK regulatory system is a cause for concern. UK regulators are relying far too much on disclosure, transparency, and 'encouraging' the market to achieve the necessary realignment of market behaviours and activities.

UK financial regulators do not appear to be as willing to take action against financial firms suspected of 'greenwashing' as their US counterparts.

Historically, UK financial regulators have tended to follow a permissive approach to regulation, intervening only when there is evidence of harm that cannot be ignored. This is not the appropriate approach to climate risks. We cannot afford to wait. Therefore, we urge the financial regulators to adopt a precautionary approach to climate related financial regulation.

Financial market behaviours will only align with climate goals if financial institutions are made to fully appreciate and recognise the cost of failing to do so. The experience of repeated financial scandals and crises tells us that we cannot rely on the market dynamics to reveal and 'signal' the true cost of market failure or compel financial institutions to respond.

It will require ***direction*** from policymakers through the appropriate legislative framework, statutory objectives provided to regulators, and robust pre-emptive and precautionary interventions on the part of regulators that ***deter*** climate damaging financial activities.

[31] Podcast: The Devil is in the policy detail – the role of disclosure and reporting, standards setting bodies, and audit and accountancy professions | The Financial Inclusion Centre