Written evidence submitted by the Association of British Insurers

About the Association of British Insurers

- The Association of British Insurers (ABI) is the voice of the UK's world-leading insurance and long-term savings industry. A productive and inclusive sector, our industry supports towns and cities across Britain in building back a balanced and innovative economy, employing over 300,000 individuals in high-skilled, lifelong careers, two-thirds of which are outside of London.

- The UK insurance industry manages investments of over £1.9trillion, pays nearly £16.6billion in taxes to the Government and supports communities across the UK by enabling trade, risk-taking, investment and innovation. We are also a global success story, the largest in Europe and the fourth largest in the world.

- The ABI represents over 200 member companies, including most household names and specialist providers, giving peace of mind to customers across the UK.

Executive Summary

1. We welcome the opportunity to respond to the Treasury Select Committee's consultation on the Future of Financial Services. Our response sets out the key arguments from the ABI on the future regulatory framework and how reforms to Solvency II regulation can deliver significant benefits for the UK economy. The response does not attempt to answer each of the committee's questions in the terms of reference, and we would be happy to provide further information where this would be of benefit. We look forward to continuing to work with the Select Committee throughout this important inquiry.

2. Now that the UK has left the EU, this is an important moment for our world leading financial services sector and it is essential that we take advantage of the opportunities presented to benefit customers, policyholders and the wider economy. We have welcomed the Government's progress with the Financial Services Bill and the Chancellor's November 2019 Statement on the Future of Financial Services, which set out an ambitious plan for the UK to establish itself as a global leader in Green Finance ahead of COP26 in autumn 2021.

3. The industry has welcomed the Trade and Co-operation Agreement reached between the UK and EU. While the agreement doesn't directly cover the insurance and wider financial services industry, it does provide a good foundation for positive future co-operation with our European neighbours. We note the intention from the UK Government and the EU to secure a Memorandum of Understanding on financial services by March 2021, and the ambition for regulatory alignment where appropriate. We look forward to continuing to engage with the Government, the EU and the wider financial services industry throughout ongoing discussions.

4. We have responded to HM Treasury's Financial Services Future Regulatory Framework and Solvency II Reviews, which are key to ensuring regulations are fit for purpose for UK based firms. Getting Solvency II reform right will be vital to enable insurers and long-term savings providers to make further investments in green assets and infrastructure and play their full part in the recovery from Covid-19 and the

transition to a net zero economy. HM Treasury's model for the Financial Services Framework proposes change from a rules-based towards a principles-based framework, with a substantial transfer of power and responsibilities to regulators. What we want to achieve as a country must be enshrined in the new system to ensure regulators stay focused on these goals. Therefore, we are calling for a framework that balances this substantial transfer of responsibilities to regulators with enhanced accountability and scrutiny, empowering Parliament, alongside additional transparency and a new statutory objective on economic growth for the regulators.

5. Independent research carried out for the ABI by KPMG has highlighted that the ABI's proposals for Solvency II, including reforms to the matching adjustment and a reduction in the risk margin, could result in £95billion being unlocked for investment in socially useful assets, whilst not undermining policyholder protection. This capital would contribute to accelerate the economic recovery and the Government's ambitions for a Green Industrial Revolution.

6. The review of Solvency II and the regulatory framework provides an excellent opportunity for the UK to boost the economic recovery post-covid, and drive investment to level-up and create long-term economic advantages in communities across the country. We can keep consumers safe and eradicate the idiosyncrasies of a system which too often are not fit for purpose. With a new statutory objective on economic growth for the regulators, we can also press our already significant advantage in financial services on the world-stage – maintaining the UK's position as a leader in a modern, global economy. These are the objectives which should drive the Government's approach as we reclaim and reform the rules and regulations governing financial services post-Brexit.

7. Parliament must play a key role in holding regulators to account and scrutinise their work, in order to ensure they are acting within their statutory objectives and their actions are in line with policy objectives set out in primary legislation. Parliament must be given additional resources in order to fulfil these new functions. Both the House of Commons and House of Lords have important roles to play. Ultimately it is up to Parliament to decide on the most effective means of scrutiny however, the ABI supports the establishment of an Advisory Council to provide scrutiny and democratic accountability under the new framework.

8. We recognise that the outcome of the framework review will require changes in legislation that will take time to implement. It is important this does not delay the implementation of the Solvency II review. Otherwise, we would be unnecessarily delaying important benefits to policyholders, as well as to the wider economy, at a time when HM Treasury, and the country, is looking ahead to post-Covid economic recovery and to making the UK more internationally competitive post-Brexit. We have the opportunity to ensure that we have a robust regulatory environment that is able to adapt to changing economic circumstances, protects consumers and meets the needs of our economy. We look forward to continuing to work with Parliament, Government and the regulators to realise the opportunities presented by the UK's departure from the European Union.

ABI consultation response

How can the UK financial services sector take advantage of the UK's new trading environment with the rest of the world?

Unlock investment through Solvency II reform

9. The Solvency II regulatory framework was agreed with the EU and built on the previous UK regime. Solvency II is the EU's prudential regulatory framework and was implemented by the UK as a member state. The framework built on the previous UK regime, and has now been onshored into UK legislation and regulation. It ensures that the insurance market understands its risks and accurately assesses its liabilities, so that we meet our obligations to customers now and over decades to come. The Government have launched a consultation on how the framework can be reformed and it is an opportunity to tailor the framework to the UK market. We believe that sensible, targeted changes to the Solvency II framework have the potential to unlock significant investment from the insurance and long-term savings industry to support the economic recovery from COVID-19 and the new Green Industrial Revolution. These changes can also deliver benefits for consumers, without risking the security of investments.

10. In our response to the Government's Solvency II call for evidence the ABI is calling for the following reforms to Solvency II to be prioritised:

Reforming the Risk Margin with at least a 75% reduction and associated capital release

- As the PRA's Deputy Governor, Sam Woods, has previously stated to the Treasury Select Committee, the design of the risk margin is 'too sensitive to the level of interest rates, and it is therefore too high at current levels of low interest rates'. This is particularly true for long-term investments and annuities. ABI analysis indicates the UK aggregate Risk Margin doubles in size for every 200-basis point drop-in interest rates, an unacceptable degree of volatility. The ABI proposal would free up more capital for the industry to invest in socially useful and productive assets. Such a change would reduce the cost of re-insurance in the UK, ensuring business continues to be done here whilst ensuring a high level of policyholder protection and a robust regulatory regime.
- The ABI is prioritising Risk Margin reform with associated capital release, to increase availability and affordability of insurance. The current Risk Margin is excessive in size, too sensitive to interest rates and inappropriate for long-term business. Our analysis shows it can be reduced without a material impact on policyholder protection.

Broadening access to a wider range of long-term assets, through refinement to the Matching Adjustment

- The current rules around the Matching Adjustment (the mechanism designed to recognise the match between asset and liability cashflows) and on where insurers and long-term savings providers can invest their assets currently make it difficult to invest in green or social assets. The restrictions on asset classes currently incentivises insurers to invest in traditional corporate bonds, often issued by more polluting and carbon intensive industries. It is much easier invest in a corporate bond in a mining company than it is for a 30-year investment in a wind farm. Our proposals to the Matching Adjustment are a start to address this.

- The ABI support broadening access to a wider range of long-term assets, through refinement of the Matching Adjustment, to increase the role that insurers can play as investors in addressing climate change, leading the world as a hub for green finance, and other long-term productive assets such as social housing and digital infrastructure.

Simplifying and streamlining reporting and approvals, increasing proportionality and transparency

- We estimate that, depending on their size and lines of business, UK insurers are reporting between 4 and 8 times more information to the PRA than was the case prior to Solvency II implementation, and that it is often smaller firms that find themselves at the higher end of this range. The PRA has reached a similar conclusion, estimating that it receives between 4 and 5 times more information reported to it than before. Industry would favour changes that remove unnecessary reporting templates in their entirety, rather than making incremental changes to existing templates This would help to better capture the risk profile of firms, ensuring the upholding of high standards of policyholder protection and promoting the safety and soundness of firms. The ABI support simplifying and streamlining reporting and approvals, increasing proportionality and transparency, to reduce the cost and delay in regulatory engagement, liberate time to focus on key issues, and increase innovation and international competitiveness.

Benefits of proposed Solvency II reform

The ABI commissioned independent research which has established that our proposals would deliver the following significant benefits for the UK economy:

Release of capital for productive investment, with no loss of regulatory prudence

£60bn of the £290bn funds held in Matching Adjustment portfolios could be re-invested if rules allow pension funds to invest in a broader and greener range of assets. It is currently much easier to invest in a highly rated mining company than it is to invest for 30 years in a wind farm. The Matching Adjustment exists to ensure that long-term investments designed to pay long-term liabilities such as annuities are not valued on a short-term basis. The current framework, designed in the aftermath of the financial crisis, forces insurers and long-term savings providers to invest heavily in highly rated corporate debt and in sovereign bonds. This skews investment towards non-green investments and makes it harder to invest in renewable energy, infrastructure and companies that will be vital to a successful transition to net zero. Amending the Matching Adjustment rules will ensure it reflects the types of investment that are safer and more productive in a world that will be changing rapidly to meet the challenges of climate change.

£35bn of capital currently backing the Risk Margin, solvency capital requirement (SCR) and firms' capital buffers could be redeployed either to increase investment in the sector, support the annuity market, or be returned to shareholders for investment elsewhere in the economy.

The Risk Margin is an additional layer of capital, introduced by the EU, that insurers are required to hold over and above what they need to meet their obligations to customers and their capital requirement buffer. It is calculated by a formula that is overly-sensitive to very low interest rates, forcing insurers to hold billions of excess capital for no purpose and contributing to low levels of supply and competition in the annuity market.

Boost to the UK economy
£16.6bn would be generated in additional annual GDP in the UK by 2051 at no cost to the Government. Every £1 productivity enhancement in 2021 will lead to a nearly £4 improvement in GDP in 2051. This is equivalent to a net present value economic benefit of c.£190bn in additional GDP over the next 30 years.

Increased revenue to the Exchequer
Finally, the impact of increasing economic growth directly in the insurance sector, but also other sectors through productivity improvements, is likely to increase taxation receipts. Improvements in Exchequer receipts from the Optimised scenario are modelled to be £1.4billion by 2030

What changes should be made to the UK's financial services regulations and regulatory framework once the UK is independent of the European Union?
Establishing a future regulatory framework that meets the needs of the UK

11. HM Treasury's model (that is currently being consulted on) proposes a radical change, moving away from the EU rules-based model that the industry is used to, towards a principles-based, less oversight framework with a substantial transfer of powers and responsibilities to regulators. The aim would be to build flexibility and agility into the framework. A principles-based approach can deliver these objectives, including the boost of our economy recovery and substantial increase in long-term investment. But what we want to achieve as a country must be enshrined in the new system to ensure every regulator stays focused on these shared goals and the framework provides stability to ensure that financial services firms can take the decisions to invest for the longer term. That is why we are calling for:
    - Regulators to be given a new statutory objective of supporting economic growth in line with other jurisdictions commonly recognised as having a thriving global financial services industry , including Hong-Kong, the U.S., Singapore and Australia.
    - A regulatory framework that balances this substantial transfer of responsibilities to regulators with enhanced accountability and scrutiny as well as transparency, empowering Parliament and Treasury as well as industry.
    - Striking the right balance between legislation and regulation, recognising the benefits of a principles-based framework but recognising the need to include certain elements in legislation, going beyond the level of detail suggested in HM Treasury's proposal.

12. The absence of these elements could still deliver a more flexible framework. However, it would jeopardise a number of objectives for the Government's review such as (1) appropriate policy input by democratic institutions; (2) effective accountability; (3) a coherent and user-friendly framework; (4) international confidence; and (5) a framework that facilitates stakeholder engagement. This flexibility, without appropriate measures in place, could turn into uncertainty and unpredictability and eventually unwanted consequences, including an unbalanced regulatory output that would jeopardise industry's chances to better serve policyholders, support the real economy, remain competitive and thrive while supporting UK's position as a global financial centre.

Should the mandate and statutory objectives of the financial services regulators change to include wider public policy issues?

13. The aims of the current regulatory framework can be broadly summarised as the totality of the statutory objectives of the two main financial services and markets regulators, the FCA and the PRA, as given by FSMA. The regulators' objectives were established when the UK was part of the EU. Changed circumstances due to Brexit should require a reassessment of those objectives and decisions on whether they remain 'fit for purpose' or require some revision. In particular, they need to ensure that a healthy financial services industry continues to play a major role in the post-Brexit economy.

14. Under the new framework, with regulators' decision-making responsibilities significantly expanded, regulators need a primary objective that supports economic growth to provide an explicit balance to their other statutory objectives. The lack of such an economic growth objective would mean that, for instance, the PRA's main objectives would continue to be focused on removing risk from the system. Other jurisdictions such as Hong Kong, the US, Australia and Singapore already include wider objectives for their regulators, including to "facilitate the sustainable market development of the insurance industry', "enable American companies to be competitive with foreign firms", "the efficiency and development of the economy" and "develop Singapore as an international financial centre", respectively. In Canada, the Office of the Superintendent of Financial Institutions' (OSFI) mandate, as directed by parliament, states "the need to allow financial institutions to compete effectively and take reasonable risks."

15. Introducing a statutory objective for economic growth will act as an effective mechanism, on equal footing to the other operational objectives, that would guarantee public policy inputs and would allow regulators to:
    - Become bigger contributors of stronger, more successful and better-managed UK financial services;
    - Let firms to have the opportunity to contribute further to achieving economic recovery and growth, UK's carbon-neutral objective and transition to a green economy as well as supporting further socially valuable investments, including social housing and infrastructure
    - Support the international competitiveness of the UK and its firms, contributing to attract international capital as well as the success of UK firms overseas;
    - Promote competition even further, contributing to increase efficiency for consumers as well as its effectiveness for the markets while promoting innovative solutions, including on range, affordability and access.

What role does Parliament have to play in influencing new financial services regulations? How should new UK financial regulations be scrutinised?

16. Strong accountability will be essential within the new framework. Both Parliament and HM Treasury should be provided with explicit additional powers and resources to allow for a higher degree of oversight of the regulators. Enhanced accountability should also be to stakeholders, who are impacted by the decisions of the regulators. This, in combination with the inclusion of an objective for regulators to take account of economic growth, should significantly help achieve a more coherent, agile regulatory framework that is better equipped to meet the specific regulatory needs of UK firms, markets and consumers.

17. Besides passing legislation, Parliament must play a key role in holding regulators to account, scrutinising their work and ensuring they are acting within their statutory objectives and in line with policy objectives set out in legislation.

18. We propose a Joint Committee of both Houses of Parliament to scrutinise financial services SIs. This Committee could not only scrutinise legislation and rules regarding financial service but could also look in depth at areas of strategy and policy that it felt would help support a more effective Financial Services sector. They could also hold the regulators to account in terms of ensuring that processes such as consultation and cost benefit analysis had been robustly undertaken. The membership of the Joint Committee could include those with experience of financial services, and in addition it would be supported by a panel of experts who have experience in financial services law, policy and consumer advocacy. This would also help achieve detailed scrutiny of regulators' strategy and policy decisions from a continually informed basis.

19. Ultimately, it is for Parliament to decide how to adapt scrutiny measures. What we would like to recommend is the outcomes that process should achieve. These mainly being (i) whether regulator policy met intended policy objectives); (ii) performance against the statutory objectives / principles; and (iii) supervisory effectiveness.

20. Parliament also has a role to play in ensuring coordination between different regulatory authorities, with a focus on identifying areas of alignment and tensions in regulatory proposals, in order to ensure they are enacted in a coordinated and efficient manner.

21. There is also an important oversight role for Parliament in the preparation, negotiation and implementation of Free Trade Agreements, and other bilateral agreements with third countries. While this clearly goes beyond just regulation, 'trade' agreements can have regulatory implications. For example, in the form of setting a framework for ongoing regulatory cooperation, agreeing mutual market access, and/or (as in the case of the Bilateral Agreement between the United States of America and the United Kingdom on Prudential Measures Regarding Insurance and Reinsurance – the UK-US Covered Agreement) address specific prudential matters on a reciprocal basis.

22. Carrying out this level of enhanced accountability and scrutiny of the regulators, Financial Services regulation and legislation, as well as Free Trade Agreements, will require Parliament to have access to greater resources than it currently has at its disposal. Staffing with independent technical expertise would be necessary. Sufficient funding to carry out these enhanced functions as well as sufficient time to ensure that the financial services market works effectively would also be required.

How important is the independence of regulators and how might this best be protected?

23. We support the concept of regulatory independence as this is important to foster a stable regulatory and supervisory environment.

24. The ABI recognises that finding the right balance between public policy input and regulatory independence can sometimes be complex and challenging, especially in a framework where FSMA does not include any statutory objectives that guarantee public policy input. The ABI sees the addition of a new statutory objective to support economic growth as an effective mechanism to balance the regulatory framework and protect the independence of the regulators.

25. Another necessary element to protect the independence of regulators is securing an appropriate level of accountability and scrutiny. For instance, appropriate transparency over the effectiveness and efficiency of the regulatory system supports credibility and trust in regulatory decisions and processes, as noted in the OECD's guidance *The Governance of Regulators Creating a Culture of Independence*[1].

26. We also believe that the Board of the FCA and the Prudential Regulation Committee, and supporting committees, should become more accountable and transparent to external members of those bodies and their role expanded to better promote the views of regulated firms via external members, especially if regulators are granted a new statutory objective to support economic growth.

27. Another relevant example would be connected with the important international role of the UK regulators. Regulation should follow international standards where appropriate and regulators should continue to play a role in developing global standards. Whether that is taking a constructive role in the formal development of coordinated global efforts, the sharing of experience and best practice in multinational forums, and/or bilaterally through regular dialogue with regulators in other jurisdictions. The approach taken in each must be informed by a conscious decision as to what is appropriately tackled globally or domestically.

28. There are clearly a number of global challenges that are best tackled by working together with other jurisdictions – economic recovery is an obvious example. Similarly, there is merit in looking at how there can be international cooperation on prudential regulation especially where there are shared interests in supporting financial stability, as well as looking to minimise fragmentation which unnecessarily brings costs and burdens for firms.

29. This can also be achieved bilaterally with other jurisdictions and there is real value in having formal bilateral frameworks for regulators to cooperate on financial services and develop mutual understanding of their markets' regulation. In our experience, this builds trust and familiarity which in turns assists in resolving any potential bilateral concerns.

30. It is, however, also important to recognise the limits. When it comes to retail regulation and conduct issues, challenges are best addressed nationally with regard to the UK's consumers needs and expectations. The sharing of ideas and best practices is of course valuable, but it is difficult to identify an example of where coordinated action for retail would be appropriate beyond the UK's borders.

31. It is important that there is some oversight of the approach of the regulators when they are engaging internationally to ensure that it fits the overall policy objectives/strategy of government.

February 2021

1 https://www.oecd.org/gov/creating-a-culture-of-independence-9789264274198-en.htm