Institute and Faculty of Actuaries

19 February 2021

IFoA response to HM Treasury's Financial Services Future Regulatory Framework Review

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

Key points

The Future Regulatory Framework Review presents a once in a generation opportunity to design and shape the regulation of the UK's world-leading financial services sector so that it can remain competitive, innovative and fit-for-purpose.

The IFoA sets out three key recommendations to achieve this. Taken together, they reflect the need for a principles-based approach that is free from industry capture and recognises the public interest priorities of long-term systemic resilience, adaptability and appropriate risk-bearing capacity and investment:

1. The legislation that governs the regulatory framework needs to set out a clear set of enduring purposes and objectives. Recognising that the financial sector acts as a series of complex adaptive systems that evolves over time in a way that is not always predictable, it is important that the detailed implementation of the regulatory framework is able to adapt as needed.

2. There needs to be a genuinely independent scrutiny function that is able to openly advise Ministers, Parliament and regulators about the ongoing successes and failures of the framework as the system evolves over time, and which is able to take a long term view in relation to the purposes set out in the governing legislation. Great care will be needed to design the brief given to the scrutiny function and in the selection of a suitably diverse, knowledgeable, skilled and experienced group of people to collectively lead that function as the financial sector evolves through the difficult to predict, yet inevitable, cycles that lie ahead.

3. One of the objectives that we suggest be included within the governing legislation is that the life and pension sectors, having regard to the long-term nature of their liabilities, are suitably able to invest in risk-bearing assets across cycles, with the regulator having appropriate flexibility to control such activity without undermining the long-term success of these sectors.

All stakeholders should reflect on the lessons of COVID-19 when designing the new system, including acknowledging the fault lines it has revealed in how the sector serves groups across society. We should harness the growing desire to build back better and fairer, to ensure the system effectively supports much greater financial inclusion and wellbeing across society.

Should you wish to discuss any of the points raised, please contact Henry Thompson, Head of Public Affairs (henry.thompson@actuaries.org.uk) in the first instance.

John Glen MP
Economic Secretary to the Treasury (City Minister)
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

19 February 2021

Dear Mr Glen,

Changing the Conversation on Financial Regulation: IFoA response to HM Treasury's Financial Services Future Regulatory Framework Review

The Institute and Faculty of Actuaries (IFoA) is pleased to submit feedback for Phase II of the Consultation on the Financial Services Future Regulatory Framework Review. We applaud HM Treasury in leading stakeholders in an important discussion about the future of the UK financial sector. Within the actuarial profession we have experts in the technical detail, we have executives in small and large financial institutions, and we have experts working with the financial system itself. Our outlook is rooted in our Royal Charter (dating back to 1884) and our long history of working with policymakers to effect change, and it is focused forwards on how actuaries will contribute to solving the problems of the 21st century.

We support the goals of HM Treasury with this consultation, and our response addresses many specific points within it. We would also like to suggest the adoption of further and broader objectives for the financial sector, its agents, its stakeholders, its purposes and for society.

In reviewing this request for consultation and our answers to it, there has been a growing realisation that we need to have a wider conversation about what the financial sector is for. All of us are agreed that the UK does want a vibrant financial sector which is attractive to investors and financial players. But we also want a financial sector which serves society and the public interest – i.e. the people.

Too many things have gone wrong in our generation. The culture and assumptions underpinning our financial system, regulations and arrangements have contributed to the following:

1. Climate Risk. Biodiversity Loss. The impacts of the COVID-19 Crisis. The entrenched inequality and plight of the marginalised in society. The marginalisation of society in deference to the financial system.

2. Accounting Scandals. Financial scandals and mis-selling. Opaque and complicated financial products. Limited insurance products on offer leaving individuals and business exposed to financial risks.

3. Lack of economic, income and health security. The poverty of the regions versus the metropolitan centres. Financial exclusion.

In our public discourse, the IFoA's unifying themes are our desire for greater fairness, greater transparency, and better ethics and behaviour. With the FRF Review, you have created the opportunity for a discussion beyond rules and technical standards, beyond codes of conduct and penalties, to include a discussion of behaviour and culture.

Often through misaligned interests of various stakeholders, agents seek to maximise their interests and their shareholders' interests. There are too many conflicts of interest. Our financial systems have developed to reward self-interest and look the other way. Short termism comes at a cost to longer-term growth, inclusion and benefit to society. We have a tragedy of the commons and a tragedy of the time horizons. These are systemic problems which we must call out and rectify.

We cannot disengage overnight from where we are today. We acknowledge the problem and we must create the context for change. We can take steps in regulations to shift what is expected of boards and professions. We can make interventions in the investment system. We can give pragmatic solutions and examples of good behaviours and ethics - cultural change. We would welcome more conversation about what responsible capitalism is and how our regulatory and professional systems can support it. HM Treasury, and HM Government, have important roles in leading this important discussion.

The IFoA doesn't have all the solutions but we are working hard to progress thinking and ideas to support the transformative change that is needed. We look forward to working with you as these changes take shape; we have identified component parts of the solution that we believe are important, covering a broad range of aspects, for example, systems thinking, biodiversity, the time value of carbon, and cementing sustainability into the actuarial mindset. We would be delighted to discuss any of these further with you.

Yours sincerely,

Tan Suee Chieh
President

Louise Pryor
President-elect

Stephen Mann
Chief Executive

The purpose of insurance and pensions

1. Before looking into the problems of the past, it is important to anchor our thoughts to the essential services – both societal and economic - of the insurance and pensions sectors[1]. That is, what insurance and pensions *should* do and the services they *should* provide from the perspectives of all stakeholders. Ultimately, the system needs to be designed in a way that enables insurance and pensions to act like insurance and pensions.

2. Insurance needs to support the taking of new risks by agents in the real economy. This is essential for economic progress and development. While it has come into question whether the essential need is for economic growth, we do note that economic growth and economic progress are not one and the same. Economic progress and development are essential to the progress and development of society and humankind. Growth is only one aspect and is well defined. Progress and development are vague and broad and should not be reduced to and equated with only growth.

3. At their core, the insurance and pension industries manage risk and provide society with a safety net:

   - Providing products to households and businesses to help them manage financial risk;
   - Helping businesses in the real economy manage their real-world business risks;
   - Helping businesses within the financial sector really, truly manage their risks, not just use capital rules to arbitrage real-world risk;
   - Helping households manage their real-world risks, not just telling households what their real-life risks are implicitly through the products providers sell;
   - Helping households manage their wealth over their lifetimes, and actively managing and protecting against excessive extraction from the value chain (though there is a difficult question of how to manage this and who should manage it);
   - Risk pooling, risk diversification, smoothing of risk and events over population groups and over time (and extending this smoothing to customers). IFRS 17 and recent capital frameworks seek to, and are succeeding in smoothing risks and results over time for providers. This pushes risk and uncertainty onto customers, society and Government. We are capable of focusing the smoothing of risk, events, and timing for the benefit of members and customers;
   - Restricting products which in themselves could create a future systemic risk.

4. In assessing the insurance and pensions systems in the present and the past, we see evidence of shortcomings in achieving some of the various economic purposes listed above. More detail is included in our answers to the specific consultation questions.

5. Looking to the future, we want capital to serve its purpose. In long-term products, capital must be adequate over the long term. Insurance and savings products must align with customers' needs and society's needs over the short, medium and long term. From a provider's perspective, products should serve customers' needs and have stable long-term profits. Providers may face moral hazard due to misaligned accounting rules and the desire to take profit today from the future, thus reducing invested capital and future returns.

6. We want providers to align purposes of capital with interests of customers and society as a whole. Providers need to help customers protect, understand and manage their wealth and protect themselves and their financial resilience with the use of protection insurance.

7. We do not want a system that increases total risk within the system as a whole where those risks are, strictly speaking, unnecessary for the prudent management of risk. Nor do we want the accumulation of aggregate total system risk—intentional or incidental—within a sub-system, sub-

[1] Traditionally, IFoA members have tended to work in the insurance and pensions sectors and therefore the scope of our remarks are largely based on our experiences in these areas. However actuaries are increasingly deploying their skills in wider domains such as banking – a major part of FSMA. Similarly, we note that the regulation of DB pensions for instance falls outside the scope of FSMA. In our response to Question 6, we ponder whether the Pensions Regulator (and by extension DB pension regulation) should be brought into the same regulatory framework.

component, or sector where this risk cannot realistically be managed. We would like the system to oppose the opacity of risk: risk creation, risk transfer, accumulation, and the over-complexity of products or of insurance-reinsurance-retrocession chains.

Question 1: 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?

8. Our overall assessment of the FSMA model is mixed. In some instances, it has functioned as intended, enabling the system as a whole to largely weather the impacts of the global financial crisis of 2007-08 and the COVID-19 pandemic (although in practice this may be a result of the prudential and conduct regulation in place below FSMA). We also see value in the democratic accountability upon which the current model is based. Ensuring this level of transparency and independence – which has protected certain macro-economic and policy decisions from being used as 'political football' – is replicated within the future model is key.

9. At a macro-level, it could be argued that FSMA has not worked as intended, in that it has not identified systemic problems, whilst simultaneously stifling innovation and constraining investment[2]. Further, the model was not designed to underpin the achievement of governmental goals, such as of provision of long-term capital to support sustainable growth that benefits the whole of society, which has led to an array of unintended consequences[2]. The problems here presented arise at different levels in the financial system and affect stakeholders differently. Most commonly, a problem will involve one group of stakeholders disadvantaged to the benefit of another group. In some of the worst cases, all stakeholders are disadvantaged[2].

10. When looking at the current regulatory and solvency regime when applied to the insurance and long-term investment sectors[3] as a whole, there are gaps in the alignment of regulatory capital, customer needs and commercially-viable capital that has inadvertently led to a series of consequences and incentivisations, including but not limited to:

    - an under-investment in green-finance, infrastructure and investment to support societal needs;
    - a failure to focus on systemic risks and uncertainties[7], creating enhanced risk of wide-scale industry failure;
    - capital optimising incentives which have led to 'Enron-isation' of companies and an early recognition of profits and capital optimization, leading to the selling of established business lines or offshoring to exploit regulatory arbitrage. This reduces the capital backing liabilities and magnifies failure risks;
    - a failure of incentives for the sustainability of long-term markets, resulting in the potential for increased transfer of risk underwriting to Government. This is already seen in the UK household flood insurance market, where an absence of incentivisation for longer-term mitigations and adaptations may lead to unaffordable and unsustainable premiums and, similar to Flood Re, could require Government to provide safety net solutions to bridge a gap in private sector provision;
    - a failure of incentives to support a just transition to a low carbon economy through product design e.g. a lack of incentives for "low-emissions" replacements and refund like-for-like purchases rather than buy back better/smarter;
    - a failure to sufficiently consider multi-year, business model, time horizons, with risks of widespread medium-term 'zombification' and long-term failure;

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[2]ATC Bulletin 1: The Unintended Consequences of Regulation: https://www.linkedin.com/posts/ifoa-actuaries-for-transformation-change_atc-the-unintended-consequences-of-regulation-activity-6721713878427942912-DOPv

[3] The primary source of UK investment is the £8.2trillion financial wealth of individuals; approximately three-quarters of which is to provide for retirement. These monies are channelled through life companies, pension funds and wealth managers to fund managers and investee companies, providing 80% of all long-term investment capital.

- failure to ensure that consumers and policyholders have a clear understanding of the charges to which their products or investment choices are exposed and to enable them adequately to compare product offerings;
- failure to innovate in order to meet customer needs, particularly on long-term contracts and meeting the needs of society as a result of the ageing population;
- a collective failure of the industry and wider society to appropriately educate the public on financial matters. The constant focus on price as the be all and end all – coupled with often complex and poor communications – means that customers rarely fully understand what they should purchase or have actually bought.

11. Regulatory bodies seek to ensure that risks undertaken by commercial financial institutions are adequately capitalised. Commercial financial institutions, like insurers, seek to ensure they deliver to their shareholders an adequate return on capital and that this capital is used efficiently. Insurer risk appetites inevitably target those risks which achieve both insurer and regulatory objectives; this leads to a growth in and concentration of those risks and a limited appetite for risks falling outside this intersection. This focus can contribute to a build-up of systemic risk, as the insurance sector as a whole chases particularly 'attractive' risks and focuses their capital on providing products, generating these risks.

12. Risks deemed attractive to both regulators and product providers may fail to overlap with the risks that customers wish to have underwritten by commercial organisations. This can result in the industry failing to provide consumers and society with the ability to manage risks at an affordable cost. Individual consumers, or society, can ultimately end up bearing the costs and we have seen this happen in several UK markets, including flood insurance, long-term care and investment guarantees. Information asymmetry between insurers, customers and Government can help to conceal who ultimately is bearing risk, both at a micro and macro level. Also, many consumers lack the capacity and capability to effectively bear and manage many risks, without easy and affordable access to risk pooling and / or adequate safety nets.

13. The IFoA's Great Risk Transfer campaign examines this trend in more detail[4]. Many financial risks that used to be borne by Governments, financial services providers and employers are being transferred to individuals. This change is giving many people the freedom to manage their own finances as they see fit, but making these choices and managing these risks can often be extremely complex. Evidence of this shift exists in a number of areas of public policy and actuarial work, and amounts to a profound change in the way that individuals organise their life and finances. Meanwhile, levels of numeracy, financial literacy and understanding of risk are low, meaning large parts of the population are not well equipped to deal with the risks they now face. Our forthcoming report will set out the regulatory and public policy recommendations that could help protect people against some of the more negative impacts of these risk transfers.

14. An example of risk behaviour distortion is the market in longevity risk. The attractive 'profit recognition' characteristics of annuities, combined with an ageing society and transfer of risk from pension funds to insurers, has led to a concentration of longevity risk for insurers, which is then often off-shored to release capital. It is unclear who is ultimately bearing such longevity risk and the extent to which the Government is effectively 'underwriting' such risk.

15. The bulk annuity market is an example which has the potential for systemic risk in the future, where the pensions industry is gradually moving scheme liabilities across to the insurance industry. As a result of the decreasing number of annuity providers, over time it will lead to thousands of employers' covenants being replaced across the UK with the covenant of these insurers, thus leading to a potential concentration of risk.

16. Much discussion has taken place on the inexorable rises in the financial burden of long-term and social care. Yet the pooling of the risks associated with that, which should be possible within an

[4] IFoA Great Risk Transfer Campaign: https://www.actuaries.org.uk/documents/great-risk-transfer-interim-report

insured environment has not developed in a way which enables society to spread and mitigate those risks. Solutions to the long-term financial challenges remain uncertain.

17. Having a regulatory definition of risk and measurement of risk is key. Currently risk is measured too narrowly and on a short-term basis. Current regulatory practice is to measure and manage risk on a 1-year basis. Many risks underwritten by the insurance sector are 20, 30, 40 year liabilities. A 20-year risk is fundamentally different from a 1-year risk written over 20 consecutive years. In practice a 20-year risk is dominated by unquantifiable uncertainty. As a result the regulatory system today fails to distinguish between risk and uncertainty. It encourages the building of over-elaborate risk models that provide false comfort, encourage Groupthink and constrain effective solutions.

18. Even within the general insurance sector, annually renewable policies are not necessarily the right way to cover long-term risks from the consumer's point of view. Annual insurance policies are not well aligned with long-term risk management in that they do not support incentivising adaptation to climate change, which plays out over a period much longer than 12 months. The system needs to incentivise adapting and abating behaviours to manage longer-term climate change risks and real world impacts; one year policies do not motivate necessary adaptive behaviours.

19. These effects extend into insurer investment strategies and constrain their ability as providers of long-term, risk bearing capital able to support investment in sustainable infrastructure and development of 'green' technologies. Regulatory practices of quantifying investment risk based upon short term movement in market prices, i.e. market volatility or 1-year VAR, is misaligned with the inherent liability risk, especially where investments are backing long-term, illiquid liabilities. This leads to inefficient use of capital, stifles insurer investment strategies and encourages short-term 'profit maximisation' behaviour by insurers. This is inconsistent with insurer sustainability and limits their natural ability to support a move to 'greening' the economy.

20. Risks not neatly captured or easily measurable by and within the regulatory framework (or practices considered regulatory outliers) are considered undesirable and become commercially unviable. This stifles innovation within the insurance sector. For example, the supply of equity release products has reduced significantly following a change in regulatory practice[5]. Providers and customers need to be able to meet in markets to find mutually agreeable products, such that experimentation and failure around new risks is supported. The regulators (PRA and FCA) and the IFoA have a responsibility to continue to support innovation via an on-going trilogue comprising (i) the assessment of economic viability and macro-economic consequences (PRA as micro- and macro-prudential authority), (ii) consumer protection, fairness and legality of product offerings (FCA), and (iii) long-term addressing of consumers risks and needs fairly. This trilogue is important to support and challenge innovation.

21. A core issue contributing to the problems with certain products such as equity release are Day 1 profits arising due to the accounting rules. Maximising short-term profits is itself an enemy to a long-term institution such as an insurer of pension scheme. The regulator has been unable to state that for long-term insurance products and investments, accounting profits should emerge in-line with economic profits, or that prudence in profit recognition in long-term investments or insurance products is beneficial. Instead of dealing with the issue in principle (accounting profits being disconnected from economic reality), an exception had to be made to halt the consumer market. One of the main issues with the current system is that such a discussion has not been had by the regulators.

[5] In relation to innovation and Day 1 profits, equity release provides a useful example. The overall consideration of equity release within society, investment markets, and insurance products is complex. For the homeowner purchasing an equity release product serves real needs; be they long-term care or accessing residential equity. As society and the economy have changed over the past decades, the real need to access one's real equity has increased. There are undesirable aspects of the potential longer-run effects, not least increased rigidity of future house prices and familial inheritance. While it may be appropriate for households' home equity to provide for other households' retirement benefits, the emergence of large Day 1 profits creates an issue of fairness and of long-term viability. A product with prudent, stable long-term profit emergence would be better suited to customers and the long-term viability of providers.

22. Combined, each of the above contributes to system fragility. System resilience requires an avoidance of risk concentrations, appropriate diversification and an ability for organisations to innovate and fail safely. Diversity of thinking and practices reduces systemic risk. Manageable, individual firm failure is a necessary cost to achieving system resilience. The current regulatory system encourages industry 'herding', increasing systemic risk, in the belief that organisational failure represents a regulatory failure: 'safe' failure should be the regulatory objective.

23. Separately, there are two specific examples where we feel the interaction between FSMA and Solvency II could benefit from further clarity. Solvency II explicitly prohibits the payment of dividends where doing so would lead to an insurer's post-dividend coverage ratio falling below Solvency Capital Requirements (SCR). However, S192C & S55M of FSMA gives the PRA the power to block dividends from the Insurance Group to shareholders and remittances from a UK subsidiary to the Group respectively. The circumstances when the power to block dividends using FSMA power(s) may be used for a reason(s) other than the situation set out in Solvency II (i.e. to prevent a solvency breach (net of dividends)) is unclear.

24. More generally, it's unclear when the use of one or more of the regulator's powers of Direction under FSMA might be used. The actions that insurers and regulators need to take in the event that an insurer is no longer able to comply with the SCR [and MCR] is set out in the SII Directive / PRA Rulebook. The non-compliance of the SCR is generally interpreted to occur when an insurer's solvency coverage falls below 100%.

25. However, the Threshold Conditions set out in FSMA includes text that could result in a firm that is "likely to fail" (i.e. when it's a solvency coverage > 100%) breaching Threshold Conditions. Further clarity setting out the relationship between SII solvency coverage, Threshold Conditions and the regulator's Powers of Direction would be welcome.

Question 2: What is your view of the proposed post-EU framework blueprint for adapting the FSMA model? In particular: what are your views on the proposed division of responsibilities between Parliament, HM Treasury and the financial services regulators?; what is your view of the proposal for high-level policy framework legislation for government and Parliament to set the overall policy approach in key areas of regulation?; and 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?

26. As practitioners in insurance, pensions, regulation and consumer protection in many areas of the financial sector and beyond, members of the IFoA have been witness to the failings and undesired outcomes within the financial sector. We have struggled with and sought to understand and remedy these problems from the past affecting pension schemes, insurance products, customers, investments and investment markets, and more.

27. We believe it is important to discuss and build common understanding of the problems of the past in order to design the insurance and pensions systems and wider financial system that we want for the future. Despite the above assessment of FSMA's operation over the last 20 years, we do not see value in rebuilding the entire framework from scratch, but instead, taking this opportunity to refine and tweak the framework to ensure it is fit for purpose for the challenges of the future. We advocate a similar approach in our response to HM Treasury's Review of Solvency II.

28. The IFoA agrees with the premise that the current onshoring approach is right for the immediate period after EU exit but that it is not designed to provide an optimal, long-term approach for UK regulation of financial services. The key policy challenge for Government will be adapting the FSMA model to make the most of the UK regulators' expertise and flexibility in setting regulatory standards, while at the same time ensuring regulators take full account of broader societal and public policy issues and priorities when designing and implementing those standards. The proposed approach represents a considerable change in the way in which regulatory requirements for firms are developed, with proposals delegating many of the powers currently held at the EU level to the UK regulators. Consequently, the interaction and relationship between regulators and firms will become even more important.

29. Having regulatory requirements in legislation can make it difficult to flex requirements and is not conducive to a dynamic and efficient regime[6]. However, whilst there is an argument to suggest that 'good' financial services regulation needs to be able to flex in a way that allows it to respond to changing market conditions and emerging regulatory challenges (e.g. COVID-19) so that the regulatory regime continues to operate effectively, we would urge caution in this regard as flexibility in regulation is a slippery slope. If flexibility in regulations is truly required then a strong set of objectives is critical to avoid moral hazard. The system as managed by HMT and its regulators should be designed to be flexible in ways which (i) recognise the economic nature of services being provided, (ii) recognise agents' success and shortcomings in providing those services, and (iii) do not allow for the unnecessary accumulation of risk or inappropriate or implicit risk transfer at a systemic level.

30. A key aspect of flexibility is regulatory forbearance, which should be to relieve short-horizon pressures arising from discrepancies in the system as a whole, for example, where the 1-year volatility-based Solvency II capital measure places inappropriate stresses upon the long-term products and business models of insurers. However, forbearance should not accommodate economically unviable insurance products, unviable business models or unviable parts of the overall system. There is an irresolvable tension in forbearance: there is temporary forgiveness for sub-optimal products or business models, but after a crisis, the incentive diminishes for designing better products and business models. This cost of forbearance has been dealt with by the regulators historically, but we feel that the overall assessment of the overall reasons for unviable products has focused only on products and should extend to providers and the system as a whole.

31. From insurance and pensions as a part of the UK and global economy, society needs customers' long-term savings to provide for their future wealth and well-being, but also to act as a buffer for the real economy during crises. Insurance and pensions should stabilise financial instability arising from other sectors or unforeseen events (e.g. COVID) and *not* to destabilise an emerging crisis (pro-cyclicality)[7]. We want insurance and pensions products and providers to largely be indifferent to financial cycles and crises. In order to achieve this, the overall insurance and pensions system—accounting, regulation, products types, providers' legal form and interconnectedness with other sectors (e.g. pension schemes and their sponsors)—should be designed to with these goals in mind. When this is in place, the purpose of forbearance clearly becomes to relieve short-term, acute pressures which are unlikely to crystallise as real losses to either customers or providers.

32. The move to reverse the fragmentation of regulatory requirements seems also sensible given the complex and byzantine nature of the financial services regulatory regime.

Question 3: Do you have views on whether and how the existing general regulatory principles in FSMA should be updated?

33. In our view, the existing principles remain relevant. In addition, we propose further consideration and integration of long-term issues such a climate sustainability and intergenerational fairness, which could either feature as standalone principles or woven in to existing wording.

Question 4. Do you have views on whether the existing statutory objectives for the regulators should be changed or added to? What do you see as the benefits and risks of changing the existing objectives? How would changing the objectives compare with the proposal for new activity- specific regulatory principles?

34. We recognise the challenge in that Government (and indeed different parts within Government), the regulators and stakeholders will approach the design and regulation of the financial system as a

[6] We note the typically annual opportunity the Finance Bill provides HMT in terms of making swift adjustments in primary legislation. Any difficulty in terms of flexibility would not apply to secondary legislation through the availability of statutory instruments. However, in this instance, it is certainly arguable that changes in the regulatory requirements which could have very significant macro-economic and societal effects should be open to scrutiny by Parliament before taking effect.
[7] Bank of England: Procyclicality and structural trends in investment allocation by insurance companies and pension funds: https://www.bankofengland.co.uk/-/media/boe/files/paper/2014/procyclicality-and-structural-trends-in-investment

complex set of objectives which do not always align given with the diverse range of interests and goals. Historically this has posed difficult problems and even more difficult choices.

35. There is no simple solution. But a well-balanced set of objectives and outcomes for society and the economy over the medium to long term is crucial. Given the goal of designing regulation and the FRF for UK financial services, as we attempt to approach this using classical analysis of the system via its parts, the subsequent synthesis does not yield a singular, simple solution. Instead, it produces many open ends, many unanswered or unanswerable questions, many critical areas for ongoing focus and monitoring, and the need to re-evaluate now and again in pursuit of well-balanced objectives and outcomes for all stakeholders.

36. Finance and the economy are self-referential and dynamic, changing over time, therefore regulation should be designed purposefully, and so it is important to set out clear objectives at various levels. These objectives should be supplemented by the intentions of the objectives, so that over time knowledge is not lost and the system can be re-evaluated against the intentions driving the current changes. It also enables our future selves to re-evaluate the objectives and the intentions against the impacts and outcomes they deliver.

37. This necessitates that Government defines high-level objectives to balance the interests of all stakeholders. These high-level objectives can be used to guide legislation, inform enforcement, and act as a starting point for scrutiny and holding parties accountable. The better and more comprehensive the objectives, the more useful for assessing complex situations, but the more likely not all objectives can be equally satisfied.

38. More broadly, the FRF presents an opportunity to integrate a number of other considerations into the existing statutory objectives, including ‘have regards’ for the regulators.

39. The IFoA sees a number of areas for consideration as part of this review. Firstly, there should be greater consideration of how regulation can reduce intergenerational unfairness across financial services policy – and in particular, the transfer of risk to individuals, which is likely to be exacerbated by COVID-19 and other societal trends. Again, the IFoA’s Great Risk Transfer outlines how these risks have manifested themselves across financial services and wider society.

40. Secondly, a greater consideration of climate risk and how financial services regulation can mitigate it is required. To give an example, the embedding of the objectives of the UK Green Finance Strategy within the statutory objectives of the regulators would allow the UK to become a leader within this sector. This creates significant opportunities post Brexit, particularly as the world looks to build back better post-COVID-19. Furthermore, it could be helpful to extend the "have regards" to other objectives for Government set out in legislation elsewhere, for instance the zero emissions binding target.

41. Finally, this could be expanded to ensure all statutory objectives facilitate a more general consideration of long-term risks, rather than incentivising short-termism.

Question 5: Do you think there are alternative models that the government should consider? Are there international examples of alternative models that should be examined?

42. In our view, the UK’s regulatory framework is, in many regards, ahead of its international peers. The International Monetary Fund (IMF) undertakes a review of macro-prudential risk every five years, citing the strengths of national economies and financial systems. There may be some learnings that could be applied from our international partners in a UK context.

Question 6: Do you think the focus for review and adaptation of key accountability, scrutiny and public engagement mechanisms for the regulators, as set out in the consultation, is the right one? Are there other issues that should be reviewed?

43. A robust and transparent system of checks and balances is of paramount importance and therefore the general thrust of the proposals appear sensible and proportionate. As a result of Brexit, the

regulators will eventually acquire significantly more power. Scrutiny and accountability of their activities will therefore be more important. Parliament remains the right mechanism to do this.

44. We would add that it is important to recognise when reviewing the framework that matters of regulatory principles are political decisions, with regulators then implementing that decision e.g. where there is a trade-off between policyholder security and policyholder value for money, it is one for Parliament to choose on behalf of society, not the regulator (in this case, the PRA).

45. There are sad examples of areas where the public would have thought that regulation should have been extended to products which are outside of regulatory control, such as high income bonds. Instances such as these suggest the need for greater clarity for consumers around the regulatory perimeter, including where certain consumer protections start and end.

46. Referring to a specific point, paragraph 3.33 of the consultation references HMT's role in setting the regulatory perimeter for financial services. There is an argument to make for HMT retaining control over all Level 1 text (including the Level 1 text transposed into the PRA Rulebook) with the regulator(s) gaining control of the on-shored, more detailed Level 2 requirements in end state.

47. The Level 1 text contains the high-level principles and this sitting with HMT would appear to be consistent with HMT's role as the regulatory perimeter setter. It would also replace the current disparate approach where some of the L1 text is set out in HMT Statutory Instruments, whilst others are in the (e.g. PRA) Rulebook. The approach would also build-in an automatic control mechanism i.e. the Level 2 text must be compliant and consistent with the overarching principles set out in the Level 1.

48. Finally, we suggest using this opportunity to consider whether there is a more effective and efficient long-term approach to pension and retirement product regulation than the current split of regulation responsibilities. There are some instances where certain products or regulations are designated to the Pensions Regulator that might be more at home under the remit of the FCA. A greater consideration of any changes that the extend role of financial regulation into what is effectively employment regulation is one example and represents a wider opportunity to avoid regulatory arbitrage.

Question 7: How do you think the role of Parliament in scrutinising financial services policy and regulation might be adapted?

49. We welcome the proposals to give Parliament a heightened, strategic role in the scrutiny of financial services policy and regulation. The current select committee system plays a crucial role and should be evolved to encompass the new framework. It is likely that the Treasury Committee will remain the prominent mechanism for scrutinising financial policy, but Parliament could look to utilise other committees for joint inquiries where there is overlap and expertise elsewhere, for example on cross-cutting issues such as climate change. One further proposal to consider is more frequent evidence sessions combining ministers and the heads of regulators, so that Parliament can holistically assess the functioning of the policymaking process and framework in full. If the present select committee scrutiny is to be the focus, then it would help if Government were to be clear that it would allow responsible ministers and regulators to appear and give evidence before any of the departmental select committees which have a locus.

50. Conversely, there are some instances where Parliament does not have access to the bodies capable of equipping it with the ability to provide independent oversight on financial systems. Further, the very nature of our parliamentary democracy hinders a truly long-term outlook to policymaking, with Parliament unable to look beyond the traditional five year election cycle. As a result, long-term risks and challenges are not identified and acted upon.

51. Too often parliamentary scrutiny takes place after failure has occurred, rather than scrutiny of the policies in place in advance. Both Government and regulators should look for ways to adopt more proactive assessments of markets, even in 'good' times, so that swift action can be taken to mitigate risk before it happens.

52. Paragraph 3.51 questions the establishment of a new independent scrutiny function to scutinise regulators' rule proposals. We would support this and believe its remit should extend to report on system effectiveness, outcomes, inappropriate agency and systemic risk. Entities responsible for micro-supervision are conflicted in providing financial systems oversight, as their need to protect and retain confidence in the regulatory system makes them defensive to criticism and ineffective in challenging unintended consequences of regulation and system failings.

53. In Norway, the Ministry of Finance is the macro-prudential authority[8]. In Sweden, it is Parliament[9]. In Denmark, the Central Bank is an example of an entity which limits its activities to system and macro-prudential oversight without responsibility for supervision of individual organisations[10]. In the US, macro-prudential responsibilities are split among Congress, FSOC, OFR and the FRB[11]. There are abundant examples of different ways in which supervision, legislation, enforcement and scrutiny can be achieved[12].

54. In terms of the UK, the nature of the proposed scrutiny function should make sense within the UK context. Its responsibilities and interactions with regulators and legislators should be devised in order to enable the achievement of its objectives. Best efforts should support its initial formation, but may risk ineffectiveness further in the future if not flexible and adaptive to its raison d'être.

55. The proposed new function could provide a better understanding of financial sectors as complex, adaptive systems and would help to assess and report on the effectiveness of how particular aspects of financial systems are meeting their purposes. It will additionally help to identify when agents are extracting inappropriate levels or patterns of profit, inappropriate consequences such as short-termism, build-up of systemic risk, etc.

56. The success of this is predicated on the function being protected from capture by commercial organisations, political conflict or special interests. It must also be structured so that it remains above the financial system and avoids becoming an agent itself within the system. Such a model could be based on that of the Comptroller and Auditor General, who is appointed by the monarch through letters patent and is an officer of the House of Commons, and therefore not answerable to the government of the day.

Question 8: What are your views on how the policy work of HM Treasury and the regulators should be coordinated, particularly in the early stages of policy making?

57. The new approach to the coordination of policy work between HM Treasury and the regulators is logical and should allow Government more time and scope to consider the wider public policy and regulatory implications of potential rule changes. The option for the regulators to move quickly in urgent circumstances is also sensible.

58. As above, we would question the extent to which the proposed framework would foster true, long-term policymaking. The direction of financial services policy will be guided by ministers and parliamentarians who can change roles frequently, in addition to governments, which can change every 5 years (or less), thus strengthening the argument for long-termism to be embedded in regulatory principles/objectives, and scrutiny of their application and outcomes, as we have highlighted above.

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[8] Norway FSAP 2020: https://www.imf.org/en/Publications/CR/Issues/2020/08/07/Norway-Financial-Sector-Assessment-Program-Technical-Note-Systemic-Risk-Oversight-and-49676
[9] Sweden FSAP 2017: https://www.imf.org/en/Publications/CR/Issues/2017/10/05/Sweden-Financial-Sector-Assessment-Program-Technical-Note-Systemic-Risk-Oversight-Framework-45305
[10] Denmark FSAP 2020: https://www.imf.org/en/Publications/CR/Issues/2020/08/07/Denmark-Financial-Sector-Assessment-Program-Technical-Note-Systemic-Risk-Oversight-and-49663
[11] IMF: https://www.imf.org/en/Publications/CR/Issues/2020/08/07/United-States-Financial-Sector-Assessment-Program-Technical-Note-Systemic-Risk-Oversight-and-49655
[12] IMF: https://www.elibrary-areaer.imf.org/Macroprudential/Pages/Home.aspx

Question 9: 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?

59. One voice that we feel is not sufficiently represented with equal weight in the policymaking and stakeholder engagement process is the voice of the customer, particularly the 'macro' view of society as a whole, and also groups of consumers who tend to experience less positive/more negative impacts from the financial system e.g. younger generations, vulnerable customers, excluded customers, customers with disabilities and those in lower socio-economic circumstances[13]. Further thought is required to ensure that the experiences and outcomes of all groups in society are given greater consideration.

60. More generally there needs to be a clearer articulation in policy development about the trade-offs being made to achieve the best outcome for the many and then ensuring that all the underlying individual elements operate in support of, and not separately to (or undermine) the bigger outcome. The mass market withdrawal of products and distribution to mid-income families with more regulation to save than required to take out a pay day loan demonstrates where the narrative and direction of travel, can at times feel uncoordinated.

61. The Welsh Government appointed a dedicated independent Future Generations Commissioner in 2016 whose role it is to ensure public bodies and those who make policy in Wales think about the long-term impact their decisions have. We would welcome the consideration of a similar role being created on a UK-wide basis.

62. Finally, in keeping with the Government's levelling up agenda, we see a symbolic opportunity for HM Treasury to re-badge the role of the 'City Minister', which at present implies a London-centric bias to financial services. Whilst not strictly the subject of this consultation, the review of the entire framework presents an opportunity to widen the definition of the Minister's title in order to showcase the regional value and impact of financial services across the UK.

[13] The IFoA's forthcoming report: *The Poverty Premium in Insurance* (in conjunction with Fair By Design) explores these issues in greater detail.