Institute and Faculty of Actuaries

4 July 2023

HMT Financial Services Regulation: Measuring Success

IFoA Response

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.

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to HM Treasury (HMT)'s proposals for *Financial Services Regulation – Measuring Success*. In particular, we support HMT's efforts in advancing the competitiveness and growth of the UK financial services sector from a public interest perspective.

2. In developing our response, we have drawn upon input from a range of IFoA members working in both life and general insurance, together with specialists in institutional investment. We have also reflected on our experiences of regulatory interaction in recent years, including points raised in earlier HMT consultations on the financial services Future Regulatory Framework (FRF).

3. It is important to note that, as for any IFoA response, we have considered HMT's proposals from an independent, public interest perspective. In particular, we have focussed on the potential impacts of HMT's proposals on consumers and society as a whole.

4. We support HMT's proposals to add new growth and international competitiveness secondary objectives for both the PRA and the FCA. We believe this would be in the wider public interest and would help support HMT's vision for the UK financial sector.

Question: Do you agree with the government's approach to the exercise of the power of direction in Clause 37 of the FSM Bill?

5. We support the involvement of a wide range of stakeholders in the government's approach, and hence support the use of the proposed Clause 37 (i.e. the power for HMT to direct the regulators to publish information). The Treasury Committee, and other relevant House of Commons committees, are cross-party so can provide a long-term view that is less influenced by the 5-year election cycle and 24-hour media cycle.

6. There may be asymmetries of information between stakeholders, for example between consumers and providers of financial products (with consumer groups less able to devote the same level resources to public policy engagement as compared to financial services firms and trade associations). Professional bodies such as the IFoA can provide a public interest perspective backed by the expertise of its members, helping to fill this gap.

Beijing	14F China World Office 1 · 1 Jianwai Avenue · Beijing · China 100004 · **Tel**: +86 (10) 6535 0248
Edinburgh	Level 2 · Exchange Crescent · 7 Conference Square · Edinburgh · EH3 8RA · **Tel**: +44 (0) 131 240 1300
Hong Kong	1803 Tower One · Lippo Centre · 89 Queensway · Hong Kong · **Tel:** +852 2147 9418
London (registered office)	7th Floor · Holborn Gate · 326-330 High Holborn · London · WC1V 7PP · **Tel**: +44 (0) 20 7632 2100
Oxford	1st Floor · Park Central · 40/41 Park End Street · Oxford · OX1 1JD · **Tel**: +44 (0) 1865 268 200
Singapore	163 Tras Street · #07-05 Lian Huat Building · Singapore 079024 · **Tel**: +65 6906 0889

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Question: What are the key metrics that the FCA and the PRA should publish in relation to their new secondary growth and competitiveness objectives?

7. We believe there are several forms of metric that could be published; metrics on: (i) regulatory approvals; (ii) macro-economic stability; and (iii) micro-economic default rates.

Regulatory approvals

8. The contribution of the regulator to the competitiveness of the UK's financial services sector may be assessed by the monetary value of approvals afforded. In the insurance industry, this could include the difference in capital requirements between firms' Internal Models and the Standard Formula. When multiplied by a cost of capital assumption derived from required rates of return observed in the debt and equity markets, this presents an annual benefit to the UK economy of the regulator's (and insurance industry's) work to develop and maintain these sophisticated Internal Models.

9. The legislation governing Internal Models is deliberately principles-based so that models can be tailored to the risk profiles of the individual firms. This means that significant judgement is required when the legislation is implemented both in the firms making applications and with the regulator in determining approvals.

10. Similarly there is the difference in Technical Provisions with and without the use of the Matching Adjustment that is also approved by the PRA, with an annual benefit to the UK economy that can be measured in a similar way. The Fundamental Spreads that underpin the Matching Adjustment have been the subject of significant debate post-Brexit. There is an expectation that a wider range of asset classes will be brought within scope of the Matching Adjustment framework, and a senior manager attestation process will be introduced. This is therefore another area where judgement is required at firms and at the regulator.

Macro-economic stability

11. The contribution of the regulator to the growth of the UK economy will be more keenly felt during economic crises than in the 'business as usual' intervening periods of stability. Economic growth tends to occur in business cycles, with more benign periods of stable growth, punctuated by extreme downside events. These downside periods tend to be shorter and more volatile periods of potential regime change, before a 'new normal' emerges.

12. The ability of strong regulation to help the UK economy weather these storms by dampening their effect can significantly contribute to the average growth over the full business cycle. In the next global financial crisis, will the UK's regulatory framework lead to better outcomes for the UK economy, compared to other comparable geographies? A key metric will be the depth of the next recession and the speed at which the UK recovers, and this should be assessed relative to other G7 countries facing the same external shock.

13. As well as external shocks, internal (domestic) shocks such as the financial turmoil seen in September 2022 affect growth. Strong regulation should also minimise the effects of idiosyncratic financial crises that affect the UK in isolation. A key metric here will be the short-term volatility of foreign exchange rates, as falls in the value of sterling are often the earliest indicator within financial markets of an internal UK shock. As foreign exchange rates represent mark to market prices in a liquid market, sudden falls in sterling may signify reduced confidence in the UK economy.

14. Analysis should be performed by the FCA and the PRA to disentangle any impacts of public or fiscal policy from impacts driven by the regulatory decisions within the scope of their remit. What might the

impact have been if different or less timely decisions had been taken? This will necessarily involve some judgement. Similarly long-term trends in foreign exchange rates may be driven by wider demographic, political and economic factors.

Micro-economic default rates

15. Growth in the UK economy is supported by the availability of credit from banks to support new business ventures, and confidence in the protection afforded by the insurance industry that allows businesses to focus their attention on the relevant risks in which owners have expertise.

16. For example, in assessing the regulatory performance during the 2007-9 Global Financial Crisis, the impact on the UK economy of the need to intervene with respect to Northern Rock, Lloyds Banking Group and Royal Bank of Scotland Group in the UK could be compared to similar interventions overseas.

17. The Bank of England's role as lender of last resort could lead to moral hazard if regulated firms expect intervention as a backstop. Historical case studies where intervention has proved difficult include the UK's exit from the European Exchange Rate mechanism in 1992.

18. When assessing regulatory performance in more benign years, the rates of default of UK banks and insurers, as compared to those in other G7 countries with similar credit ratings, can be used to assess the ability of the FCA and the PRA to facilitate this support. The issues seen with Silvergate Bank, Signature Bank and Silicon Valley Bank in the USA and Credit Suisse in Switzerland in March 2023 can, for example, be compared to the financial services sector in the UK at that time.

Should you want to discuss any of the points raised please contact me, Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk) in the first instance.

Yours Sincerely,

Steven Graham
On behalf of Institute and Faculty of Actuaries