Institute and Faculty of Actuaries

12 December 2024

HMT - Call for Evidence:

Financial Services Growth and Competitiveness Strategy

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 the HMT's Call for Evidence into its Financial Services Growth and Competitiveness Strategy. We agree with HMT that the financial services sector will likely play a fundamental role in delivering the Government's overall growth strategy. We recognise that, although financial services already play a vital role in supporting growth across the UK economy, there is scope to build on this growth.

2. It is important to note that, as for any IFoA response, we have considered HMT's Call for Evidence from an independent, public interest perspective.

3. We note that HMT is developing a Financial Services Growth & Competitiveness Strategy with a medium-term focus i.e. setting out HMT's approach to the sector for the next 10 years. This longer-term strategy ties-in with the longer-term view taken in a policy prospectus the IFoA launched in autumn last year: Beyond the next Parliament: The case for long-term policymaking. Our policy prospectus suggests ways Government can ensure a longer-time horizon is considered in policymaking. Although launched last year, the themes considered in the prospectus are still relevant and we touch on relevant aspects within our response below. The prospectus also considers a range of other long term policy issues relevant to Government, but outside the strict scope of the growth/ competitiveness strategy.

4. Actuaries are expert problem solvers and strategic thinkers who use their skills to help measure the impact of future events - and to provide suitable solutions or new ways of looking at what many assume are intractable problems. Actuaries, with their specific skill set, are well-placed to assess future risk and advocate for long-term policymaking. They also take a rigorous, dispassionate and meticulous approach.

5. We would be delighted to meet with HMT to discuss both our response below, or indeed our perspective on long-term policymaking.

6. We have answered a subset of the Call for Evidence questions, restricting our responses to those questions where we have specific points, in the public interest, to raise.

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7. The IFoA Header above includes background information on the IFoA. This gives answers to some of the ‘biographical’ questions 1-7; the other such questions are not applicable to us.

Chapter 3 - Objectives and Approach

Objectives and Approach:

Question 3.1: Do you agree with the proposed objectives set out in paragraph 3.6?

8. As we mention in our introductory comments above, we agree with HMT that financial services will likely play a fundamental role delivering the UK Government’s growth and competitiveness strategy. Although the IFoA is a global organisation, we support HMT’s aims in delivering long term, sustainable and inclusive growth in the UK’s financial services sector. We touch on a range of these themes within our longer-term policy prospectus referred to above. From a ‘big picture’ perspective, the proposed objectives of HMT’s strategy seem appropriate.

Future of Financial Services:

Question 3.3: What do you consider to be the most important trends or changes likely to affect the financial services industry over the next 10 years?

Rise of Digitalisation/ AI

9. In the financial services sector, the opportunities presented by the proliferation of data and digitalisation, and the rise of Artificial Intelligence (AI) are exciting, both for customers and for the industry as a whole. The rise of digitalisation/ AI offers improved access to information, innovation, personalisation and automation, to name just a few strands. Practical examples include the rise in the number of home gadgets connected through networks to each other, technology transforming fitness regimes with the increasing popularity of wearable devices that monitor exercise regimes and provide data on wellbeing. Insurers are already seeing opportunities from these particular examples applied to home and health insurance.

10. There are also challenges however with the rise of AI, particularly around questions of regulation and ethics. Recent advances in AI and its potential power further emphasise the need for these debates. Although the use of AI may offer a range of societal benefits, it can also generate or exacerbate a range of challenges, which are very relevant to the wider public interest.

Infrastructure Investment – Supporting Growth

11. Infrastructure investment is critical in driving growth and integral to supporting the UK economy. With the UK’s existing infrastructure becoming older - some of it well over a hundred years old - we are at risk of not being able to support our growing, and ageing, population.

12. Over the longer term, the effects of climate change could also have a major impact on the availability of energy and natural resources, particularly water. The potential impacts of climate change make adaptations of existing infrastructure essential to delivering national resilience. The availability of housing, especially in the UK, is a longstanding issue. Against this background, investing in infrastructure represents an opportunity to re-engineer the UK’s delivery and consumption of these and other essential resources and services, putting the adoption of new technologies at the heart of the debate. However, in light of recent economic pressures, the capital to support such infrastructure investment is in short supply.

13. Although infrastructure projects help to generate economic growth and job creation, there is often a shortage of available capital to get them off the ground because that growth is only in the future.

Cuts to capital expenditure are easier to make than cuts that will affect existing resources or services.

Infrastructure Investment – Insurers and Pension Fund Investment

14. Insurers and pension funds can play a pivotal role in stimulating economic growth and development by investing in essential infrastructure assets. However, the rules that dictate how much capital insurers must hold to meet claims had often been seen as a barrier to greater investment.

15. Solvency II is an EU directive, which had been retained in UK law, that regulates the insurance industry. It outlines the amount of capital that insurance firms must hold to reduce the risk of insolvency. Following the UK's departure from the European Union, the UK is now transitioning from Solvency II to 'Solvency UK', hopefully providing a once-in-a-generation opportunity to turbocharge much-needed investment in key infrastructure projects, in such a way that it will support the UK's bid to be net zero by 2050. The regulatory reforms currently now finalised adapt the previously pan-European regime to a bespoke UK model will allow insurance firms the ability to invest in said projects with greater ease and with greater capital.

16. From a pension perspective, we welcome initiatives to increase pension scheme investment to support more growth in the UK economy, particularly where it is also likely to improve long term outcomes for savers. However, it is important to recognise that pension funds already own and contribute to UK assets in a range of ways such as Government bonds, equities, and infrastructure. The assets most appropriate for investment will always depend on the pension fund and its structure whether defined benefit (DB) or defined contribution (DC), open or closed. Any investment decisions need to be taken in this context.

Open Finance

17. The development of open finance i.e. the potential offered by extending open banking more widely across financial products is also worth considering. Open finance could potentially offer a range of benefits to consumers: it could give the consumer a holistic view of their finances, but also improve consumer engagement and outcomes. The need to harness technology and support innovation has become all the more important given development of consumers digital capability in recent years: a wider group of consumers may potentially be able to derive benefit from open finance.

18. Financial inclusion is a potential/ real issue across financial services, and we suggest that improving inclusion should be one of the intended aims of open finance. In any consideration of open finance, it is also sensible to learn lessons from open banking and build on its success.

Chapter 4 - Policy Pillars

Question 4.1: Do you agree with the list of policy pillars that the government intends to focus on? Are there other areas that should be included?

19. We note that the Call for Evidence makes reference to the Government's focus on other priorities within financial services policy, including addressing barriers to financial inclusion. We agree that it is in the public interest that everyone has access to useful and affordable financial service products that improve their financial resilience and allow them to fully participate in the economy.

20. Efforts to increase financial inclusion, such as closing insurance coverage gaps should also be beneficial to the financial services sector as a whole. We wonder then whether improving financial inclusion should be an explicit policy pillar.

Question 4.5: Which technologies do you think have the most potential to transform financial services over the next 10 years? And in which financial services sectors or functions do you see these being applied most effectively?

21. As noted above, the rise of AI has significant potential to transform financial services; the impact of AI is already being felt across the financial services sector. Although the use of AI may offer a range of societal benefits, it can also generate or exacerbate a range of challenges, which are very relevant to the wider public interest.

22. Although AI's potential upside is wide-ranging, we highlight the following benefits in an insurance context:

    - greater accuracy in risk assessment;
    - insurance becoming more of an holistic service;
    - greater data cleansing and hence quality/ transparency;
    - automation of routine tasks;
    - AI could also help provide wide-ranging societal benefits, such as climate change risk modelling and analysis.

23. One key general risk is that firms use AI outside their 'zone of competence' and inadvertently open themselves up to a range of unintended consequences. This is plausible given the rate of technological progress in AI, or where there is a dependency on external parties in procuring AI infrastructure. Further key risks include:

    - an increase in financial/ insurance exclusion - this is a potential downside of the greater accuracy in risk assessment;
    - conduct risk – i.e. unfair treatment of customers by an algorithm because there is a bias within it;
    - modelling risk - i.e. a model is so complex it becomes opaque to model users/ owners;
    - AI could be associated with discriminatory decisions, including in respect of individuals with protected characteristics;
        - although such discrimination could be inadvertent, this does not lessen any consumer harm.

Regulatory Environment:

Question 4.6: What is your assessment of the UK's current regulatory environment?

24. The regulatory regime for actuaries in the UK will be subject to reform when the Government brings forward the Draft Audit and Corporate Governance Reform Bill, as announced at the 2024 King's Speech. Namely, legislating to give the Financial Reporting Council's proposed successor - ARGA (the Audit Reporting Governance Authority) - statutory powers to oversee and regulate the actuarial profession, focused primarily on individuals, by reference to actuarial activities of public interest; although the details of this are ambiguous.

25. The Draft Bill will contain measures which will have implications for actuaries, employers of actuaries (including many of the UK's largest insurers and pension funds) and, importantly, the public interest which our members serve.

26. Generally, the IFoA supports the Government's core proposals here. Placing the IFoA under statutory oversight and targeting statutory regulation on public interest work will represent a significant and proportionate strengthening of the current regime. However, we have some serious concerns that some elements of the proposals will have the opposite effect.

27. The first is the risk of regulatory arbitrage. The 2022 White Paper contained proposals that would see the proposed legislation focus regulation on membership of a profession or a nebulous definition of ‘actuarial work’. These definitions are vague, risking casting the regulatory net so wide that it will disincentivise actuaries from designating their work as being actuarial and/ or from being subject to any regulatory framework (as members of IFoA).

28. Instead, we have proposed a solution to Government where the legislation should clearly define the scope of actuarial regulation by reference to specific public interest activities (jobs/ roles), not to a general definition of ‘actuarial work’ or solely to IFoA membership. If membership of a professional body is to be used to define scope, membership must be required. This would ensure that all individuals (or entities) undertaking it were within the scope of statutory regulation and would not be able to ‘opt-out’ of it.

29. Secondly, we are concerned about a disproportionate regulatory burden being placed on actuaries undertaking low-risk work. Again, in the 2022 White Paper, the Government proposed that ARGA will regulate public interest actuarial work. In the same document, it also proposes ARGA will have the statutory power to set technical actuarial standards for IFoA members in relation to their non-public interest work. Statutory regulation of non-public interest work is likely to create an excessive burden on low-risk work and create a perverse situation where IFoA members might be subject to it but non-IFoA members would not, raising legitimate questions as to why the former would retain their IFoA membership.

30. Our solution is to remove the proposal for ARGA to have the statutory power to set technical actuarial standards for all IFoA members in relation to non-public interest work. If not, there is a credible risk of a ‘shadow’ profession of actuaries emerging, who are not bound by the ethical and technical standards that IFoA members adhere to, thus posing potential risk in actuarial and public interest work.

31. We share this Government’s ambition for a regulatory environment that ensures ‘there is a robust and transparent regulatory framework that supports growth while also maintaining financial stability, ensuring that markets function well, protecting consumers…’. The proposals as they stand risk undermining these objectives, as well as making IFoA qualifications and membership - which are a world-leading export - less desirable.

32. We continue to work with officials at HMT and the Department for Business and Trade (as the department sponsoring the Bill) to ensure these risks are mitigated before draft legislation is brought forward.

Question 4.7: How can regulation support responsible and informed risk-taking?

33. In 2023 we supported HMT’s then proposals to add new growth and international competitiveness secondary objectives for both the PRA and the FCA, believing this was in the wider public interest. These secondary objectives should help support HMT’s strategy for growth in the UK financial sector.

34. The contribution of the regulators 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.

35. The ability of strong but proportionate 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.

36. 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. Growth is also supported by insurers and pension funds investing in infrastructure and other productive assets.

Chapter 5 - Priority Growth Opportunities

Question 5.1: Do you agree with the priority opportunities that have been identified?

37. Although we agree with the priority opportunities listed, we note that although insurance is mentioned explicitly, pensions is not. However, it may be that DB and DC pensions are implicit within/ across the five priority areas listed, and note pensions are included in the business areas set out in question 5.2.

Sustainable Finance:

Question 5.7: What are the opportunities and barriers for the financial services sector in developing the products and/or services necessary to facilitate investment into the net zero transition? For each opportunity, please provide an indication of the type of intervention required, for example developing guidance, or supporting the development of further capabilities.

Influence

38. Asset owners and asset managers can exercise considerable influence on the level of financed emissions in their investment portfolios (within any limits set by their investment objectives). This includes actions such as:

- choice of which asset classes and individual investments to:
  - include in portfolios: increasing investment in countries, sectors, companies (and with asset managers) who are Net Zero aligned and who promote a just transition to a Net Zero world;
  - exclude from portfolios: divesting from or excluding holdings in countries, sectors and companies which continue to fall short of having credible pathways to reduce emissions and are not willing to engage in any suitable manner;
- engaging with policy makers, asset managers, banks, companies and other stakeholders within their spheres of influence, to promote Net Zero aligned initiatives at all levels.

39. It is important to note that divestment and exclusion is not a credible strategy to achieve real world emissions reduction. This is for the practical reason that ‘relative’ reductions in emissions of one investor’s portfolio do not remove them from the aggregate emissions of all portfolios. Divesting also results in the investor losing the opportunity to further engage and influence.

40. The role of governments is critical to address the impact of climate change given their ability to set policy and to drive outcomes through legislation and enforcement.

Portfolio Alignment Metrics

41. Carbon foot-printing, while useful as a tool to understand current day emissions, provides little information regarding where emissions are heading. Therefore, there is a need for forward-looking

metrics. Portfolio alignment metrics aim to capture whether individual companies within the investment portfolio are expected to align with net zero in the future. This depends on factors such as the level of decarbonisation commitments made by the particular underlying companies, or the sectors and geographies in which they lie. As they are looking into the future, forward-looking metrics tend to use more complex assumptions or calculations.

42. There are four broad types of portfolio alignment metrics: binary metrics, maturity scale alignment metrics, benchmark divergence metrics and implied temperature rise. No single portfolio alignment metric is perfect, so a combination of metrics can be used to complement one another and provide a more complete picture.

43. Regulatory reviews of early examples of climate disclosures (The Pensions Regulator, 2023) suggest that there are still significant gaps in the metrics being reported and that they are often not being integrated into companies' overall strategy and the investment decision-making process.

Verifying if Company Targets are Aligned to Net Zero

44. It is becoming increasingly common for companies to seek independent approval of their targets, such as Net Zero Tracker or Science Based Targets Initiative (SBTi). Data providers such as MSCI and CDP maintain databases on the extent to which they believe company targets are aligned with the Paris Agreement.

45. However, some companies have decided not to submit their targets to independent bodies for assessment, either because they have not made sufficient progress or lack the data for the assessment. This leads to gaps in available data, giving an incomplete view to investors. There is also a lack of consensus on net zero scenarios, with different third parties choosing different pathways for assessing whether the targets are aligned with net zero. Therefore, a target assessed as net zero in one database may not be in another, making it difficult to compare datasets.

Incorporation into Investment Products

46. Portfolio alignment metrics are starting to be used in the design of investment products. This was mostly in equities initially, but now products exist across a range of asset classes.

47. Types of funds or investments using portfolio alignment metrics include:

- binary metrics in exclusion policies;
    - some investment managers only include securities in high carbon intensity industries within funds if the underlying company has an SBTi-verified target in place (or a similar binary metric);
- overall fund temperature alignment target or emissions benchmark or index;
    - some funds seek a certain temperature alignment score or level of emissions for the portfolio as a whole, often with reference to an index, but do not necessarily place restrictions on the securities within the fund;
- temperature alignment or binary metric for individual counterparties;
    - some funds will only include securities if the underlying company is aligned to the temperature goals of the Paris Agreement or has a carbon reduction target in place.

48. These data-driven metrics and rules are straightforward to calculate for asset managers compared to more subjective active management and may be easier for investors to understand. However, these funds are reliant on the actions of the invested companies to meet their net zero fund

objectives and so may not impact the net zero transition without the asset manager also engaging with companies.

Global Split

49. Outside the UK and EU, there is less use of portfolio alignment metrics. Where such metrics are optional, companies are often choosing not to use them because the complex assumptions and data requirements underlying the metrics make them difficult to calculate and understand. Without global usage, portfolio alignment metrics will not do enough to encourage investment portfolios which enable the net zero transition, other than at a more regional level. They are more likely to become a technical tool for asset managers with only a limited impact on the transition.

50. If portfolio alignment metrics are a key approach to facilitate the transition, then more education and better data is needed to encourage take-up globally, possibly backed up with stronger regulatory requirements.

Scenarios

51. Climate change scenarios may be useful to stress test how portfolios of investments might perform in different climate change scenarios. However, their assumptions and limitations need to be better understood. Real-world impacts such as tipping points, sea-level rise and involuntary mass migration are largely excluded.1 The benign results shown by some scenarios potentially delay decisions to support decarbonisation. A new approach is needed to ensure scenarios add value, are actionable and more accurately represent the level of scientific risk we face if we do not decarbonise.

Governance, Monitoring and Disclosures

52. Governance plays a key role in implementing a Net Zero investment approach, and the frameworks require a high level of commitment from organisations adopting this ambition including:

    - Board/ CEO level commitment to a Net Zero goal, including acceptance of responsibility for implementation (including setting and reporting on achievement of targets) and allocating appropriate resources;
    - clear oversight of Net Zero activities and incentive schemes (including executive remuneration) linked to delivering targets.

Capital Markets (including retail investment):

Question 5.8: Are there any barriers to growth in capital markets that are not being targeted by existing government reforms? How can private and public markets be grown so that they best support UK growth?

53. We welcome that the UK Infrastructure Bank has become the National Wealth Fund, with more capital and a broader scope to attract private sector funding for infrastructure projects. However, we are concerned that there is currently no standard mechanism in the UK for investing in infrastructure through public-private partnerships (PPPs). We believe it is practical to develop a new system of PPPs that would be simpler than previous versions like the Private Finance Initiative, and that would enable strong collaborations that harness the different strengths of the public and private sector partners. A recent article by the chair of our Infrastructure Working Party sets out how this would work in more detail.

[1] The Emperor's New Climate Scenarios (IFoA 2023)

Insurance & Reinsurance Markets:

Question 5.10: What are the barriers to insurers and reinsurers to growing their businesses and share of international markets?

54. The PRA (and indeed all UK regulators) have established a sophisticated and robust regulatory framework. However, there does appear to be an endemic default to 'gold-plating' aspects of their regulation to remove every aspect of risk, including normal and every-day commercial risks.

55. A good example of the above is the 2017 version of the PRA's regulation of UK Insurance Special Purpose Vehicles (ISPVs). At the time the UK insurance sector voiced strong reservations at the PRA's approach, and such feedback did not appear to have been taken on board. However, we note that the PRA may now be softening its approach with ISPVs given a current (at the time of writing) consultation exercise; there does however seem to have been a real missed opportunity here.

56. Regulation must also be placed in a global context. Having regulation that significantly exceeds international norms benefits no-one, and strangles growth. Orientating regulation to directly and specifically take that consideration into context is critical. Much of the financial services industry operates on a global basis, and developments such as the rise of AI do not 'respect' international borders.

57. In relation to Solvency II/ Solvency UK regulation, we welcome the introduction of measures to give insurers greater investment freedom as part of the Matching Adjustment reforms. This is an important step towards supporting insurers to be able to be invest more freely in productive finance and support the growth of the UK economy. From a policyholder protection perspective, we also recognise the importance of ensuring that, where firms take on additional risks, they are able to understand, measure and manage these risks.

58. In our view, however, the Matching Adjustment reform may focus overly on the PRA's primary objectives. Whilst it is important that policyholder security is maintained, a balance needs to be struck as a Matching Adjustment regime that it too restrictive could stifle/ slow down investment.

Question 5.11: What are the barriers to innovation in the UK's insurance markets?

59. In addition to the response to Question 5.10, a further observation is that the Government and UK regulators need to avoid being too prescriptive; a good example is Captive Insurance, which sees limited interest from the insurance industry.

60. Creating a regulation-appropriate and globally consistent environment will permit all manner of innovation. The UK already has a commanding position in the global insurance sector. Innovation in insurance will naturally gravitate to the UK, if the UK gets this right.

61. We mention AI in an insurance context above, and there is significant scope for further innovation in insurance through the use of AI. Although we have not identified any current regulatory barriers, it is important that any regulatory framework for AI balances proportionate management of risk with encouragement of innovation. One potential form of regulatory barrier would be conflicting or duplicate regulatory requirements. Again, a non-prescriptive, principles-based and global approach to AI regulation may be more effective than a rules-based framework. *Note that these comments on AI regulation are also applicable more widely across financial services.*

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

Yours Sincerely,

Steven Graham
On behalf of Institute and Faculty of Actuaries