Financial Services Consumer Panel
AN INDEPENDENT VOICE FOR CONSUMERS OF FINANCIAL SERVICES

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By email: SolvencyIIReview@hmtreasury.gov.uk

Dear Sir / Madam,

Financial Services Consumer Panel response HMT's Review of Solvency II Consultation

The Financial Services Consumer Panel (the Panel) is an independent statutory body. We represent the interests of individual and small business consumers in the development of policy and regulation of financial services in the UK. Our focus is predominately on the work of the FCA, however, we also look at the impact on consumers of other bodies' activities and policy where relevant to the FCA's remit.

The Consumer Panel welcomes the opportunity to respond to the HM Treasury Review of Solvency II Consultation Call on the better tailoring of prudential regulatory regime with the objectives of:

1) spurring a vibrant, innovative, and internationally competitive insurance sector.

2) protecting policyholders and ensuring the safety and soundness of firms; and

3) supporting insurance firms to provide long-term capital to underpin growth.

We have not structured our response around the questions posed in the consultation as we believe they are primarily aimed at industry respondents. However, we feel the consumer voice should be considered as it is financial services consumers and insurance policyholders who ultimately stand to benefit from, or be harmed by, prudential regulatory reform. We therefore set out our overarching views and considerations from a consumer perspective in this letter.

The Panel considers that the second objective, "consumer and policyholder protection, safety, and soundness", should be the foundation stone for reform that any steps to deliver the other two objectives must be aligned to.

Policyholder protection and reducing the risks and uncertainties that policy holders face in their lives and businesses is the core role of insurers. This transfer and pooling of risk, provision of certainty, and financial security empowers and enables both individuals to plan for the future and for firms to innovate and grow. Policyholders need the confidence that the promises made by insurers will be met, and this assurance is fundamental to the insurance industry working and developing. The Panel considers that, having left the EU, the approach to policymaking and regulation should continue to have the protection of consumers and policyholders, together with robust prudential standards, at its heart.

It is essential that we recognise the long-term nature of the promise of insurance upon which consumers depend and trust. Some types of cover, such as Employer's Liability, may only be called upon years after the original policy was written. Having cover is essential to allow certain businesses to operate and such cover has, in the past, provided vital compensation to beneficiaries who have been affected by asbestos and other harms that may take decades to fully become known. It is very important, for everyone involved, that insurers will still be there, and in a position to pay these claims when they arise.

Life insurances and annuities represent another type of long-term and important promise. Policyholders may entrust the financial protection of their family and/or proceeds of a lifetime of work and careful saving to a life insurer and/or annuity provider. These policyholders do this knowing that there are no refunds, and no opportunity to switch provider once they are committed. They are placing significant trust in their insurer's promise to make payments to them for years in the future. For many customers, these payments are very likely to form a substantial portion of their retirement income.

The trust that policyholders place in their insurers has several significant benefits to the wider economy. As mentioned above, risk transfer allows innovation and growth but in addition, the pooling of savings within life insurance companies and the willingness of policyholders to commit their savings for the long term also allows those savings to be channelled into new types of investment – ones that would be difficult or impossible for individuals to access directly, but which will play an essential part in the recovery and in meeting the challenges that we face as individuals and as a society.

Whilst investment innovation is to be welcomed, there is however a flip side, which is the lack of a long history to guide the selection and risk-management of these assets, or to show how they may perform under various possible stress scenarios. This includes uncertainty around the liquidity of potential investment options in certain scenarios, which may undermine insurers' ability to meet their obligations. So, there are new sources of uncertainty to contend with, alongside those that insurers have been managing as their bread and butter for hundreds of years. Insurers, and their regulators, have a responsibility to understand, plan for and respond to new uncertainties, some of which may play out over a very long horizon, to ensure that policyholders' trust is safeguarded and repaid.

It is also important that potential investment innovations are properly aligned to consumers' expectations. When considering climate change, for example, the Panel are aware that many consumers are looking for more sustainable investment philosophies and products. This brings benefits and risks of philosophies and products being mis-described as "green "or "sustainable" to attract and/or retain customers. The Panel would like to express our support of the FCA's ESG strategy and work of the DLAG to encourage the benefits and address the risks in this area.

Policyholders are consumers of a financial product, which may be very significant to them and their families, and they deserve to be protected. But it goes further. Securing policyholder protection upholds policyholders' confidence and trust in the face of uncertainty. With this confidence and trust, policyholders will continue to be willing to use insurance as a means of managing their risks and investments, with all the additional benefits this brings to the wider economy.

In terms of international competition, it is essential we accept that UK insurers can only be internationally competitive, or invest for the long term, if they are financially sound. Policyholders will only buy innovative products, if they are comfortable that they are adequately protected. Therefore, the Panel see the second Solvency II review objective as the foundation on which measures to pursue the other objectives can and should be developed.

Whilst the Panel broadly agrees with the points proposed in the consultation, specific points we would like to highlight are:

<u>Consumer Protection Mechanisms and Interlinkage:</u>

There are several ways in which the prudential regulatory regime seeks to ensure policyholders are protected.

Firms must hold capital to meet at least a '1 in 200 event' in the bad times, and they must hold reserves not only to meet their likely commitments, but to allow the business to be transferred to a third party if required. Ultimately there is also the backstop of FSCS coverage for many policyholders.

These mechanisms are all linked: if the capital and reserves firms hold are not adequate, and in the absence of any reinsurance or indemnity cover (or in excess of these), the FSCS backstop will need to be used. This means that if capital and reserves are inadequate, the residual cost would be paid for by surviving firms, who in turn would need to pass the cost on to their policyholders or shareholders.

The Panel therefore encourages thinking that looks across the mechanisms, reflects the interlinking of these, and places the protection of the consumer at its core.

<u>Risk Margin:</u>

The risk margin exists to provide a margin above the 'best estimate' of liabilities on the regulatory balance sheet, so that the total technical provisions represent an estimated transfer value.

Whilst the principle for the risk margin is sound, widely accepted and protects policyholders the Panel agree with the developing consensus in the UK market that the risk margin as currently designed is larger than expected, very sensitive to interest rate movements resulting in potential volatility in insurer balance sheets. This in turn raises the cost of capital which is passed on to consumers in the form of higher premiums.

<u>Matching Adjustment:</u>

The Matching Adjustment (MA) lets a firm recognise an immediate benefit today, from future returns above the risk-free rate that have not yet been earned. So, getting the MA right is critical for ensuring the right level of policyholder protection in the UK, and getting it wrong could have very severe consequences.

The Panel therefore views any reforms to the MA as being a key determinant of success against all three of the government's objectives for the Solvency II Review and for policyholder protection in particular.

<u>Stress Testing:</u>

The Solvency II review is a chance to build a regime that is strong, robust and meets the needs of policyholders, the UK market, and the broader economy.

Prudential regulators must ensure that whatever is built will be able to withstand the challenges and shocks that may hit the regime in the year(s) ahead – energy firm failure is a clear and timely reminder of the dangers of prioritising a competition objective ahead of prudent regulation.

The Panel believe that a key way of ensuring the rigour of the regime is through regular stress testing together with independent checks on balance sheets and business models, the Panel view this as central to the development of the regime, supervisory approach plus, and importantly, helping firms understand the effect on their balance sheets of real-world events.

<u>Released Capital Control:</u>

In his Consultation Foreword, the Economic Secretary to the Treasury comments that

"The reforms could result in a material release of possibly as much as 10% to 15% of the capital currently held by life insurers and unlock tens of billions of pounds for long term productive investments, including infrastructure "

The Panel believe that irrespective of the maturity and/or nationality of the insurer, control mechanisms are required to ensure that any released capital is used for this purpose and/or improving policyholder value, product affordability and accessibility and not simply used to improve shareholder returns.

We look forward to future engagement with the regulators on the development of the reforms to the prudential regulatory regime.

Yours sincerely,

Helen Charlton

Chair, Financial Services Consumer Panel