Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

9 January 2019

AFM Response to PRA CP23/18, Enhancing banks' and insurers' approaches to managing the financial risks from climate change

1. I am writing in response to this consultation paper, on behalf of the Association of Financial Mutuals. The objectives we seek from our response are to:

    - Comment on the proposals as they affect AFM members and their customers.

2. The Association of Financial Mutuals (AFM) represents insurance and healthcare providers that are owned by their customers, or which are established to serve a defined community (on a not for profit basis). Between them, mutual insurers manage the savings, pensions, protection and healthcare needs of over 30 million people in the UK and Ireland, collect annual premium income of £19.6 billion, and employ nearly 30,000 staff[1].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically results, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. In particular, FCA and PRA are required to analyse whether new rules impose any significantly different consequences for mutual businesses[2] and to take account of corporate diversity[3].

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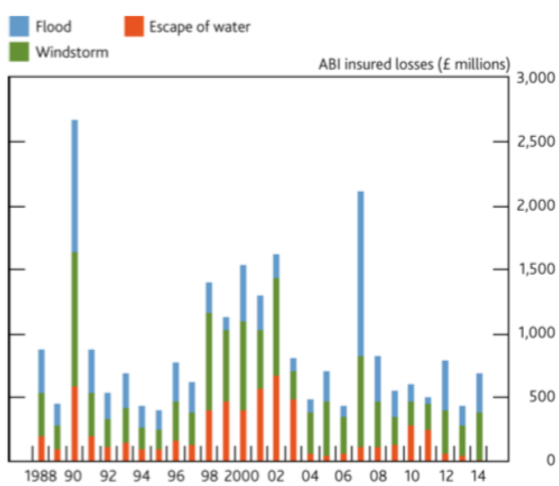
[1] ICMIF, https://www.icmif.org/publications/market-insights/market-insights-uk-2016
[2] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted
[3] http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

4. We support PRA's desire to see firms "take a strategic approach to managing the financial risk from climate change", and we consider the focus in the supervisory statement on governance, risk management, scenario analysis and disclosure, are appropriate issues for banks and insurers to be properly considering and effectively acting on at this time.

5. We agree that the effects of climate change on banks and insurers are likely in many cases to be far-reaching, and to stretch over long time horizons. We also see that governments, in the UK and overseas, are already acting on many of the transition risks associated with climate change and that firms, including those in financial services, are responding to new legislative requirements.

6. A small number of AFM members directly underwrite the sort of business that the consultation focuses most specifically on, where the physical risks from climate change are most evidently a factor. This includes climate factors that increase the incidence and severity of natural catastrophes, as well as an increase in global temperatures. As AFM members tend to write these business lines on a domestic rather than international basis, the evidence base for changing significantly the planning assumptions for the UK and Ireland is relatively limited at present. This is illustrated in Chart 3i in PRA's 2015 paper on insurance and climate change[4] which, whilst it does not offer a clear upward trend in the occurrence of flood, windstorm or escape of water claims, shows how specific large events have a significant short-term impact on claims.

Chart 3i: Annual UK insured losses by flood, windstorm and escape of water for domestic properties from 1988–2014



Source: Association of British Insurers (ABI)(2015).

[4] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/publication/impact-of-climate-change-on-the-uk-insurance-sector.pdf?la=en&hash=EF9FE0FF9AEC940A2BA722324902FFBA49A5A29A

7. A larger proportion of AFM members focus on life and health insurance products, where the secondary impacts of climate change, such as increasing morbidity and mortality, are factors to consider. However, as PRA indicated in Appendix B to its 2015 paper on the impact of climate change on the UK insurance sector, the understanding of the potential future impact is at an early stage, and much of the PRA's analysis has tended to focus on the impacts on annuities and pensions, which AFM members do not sell. We agree with the conclusion that *"PRA does not expect the impact of climate change on mortality and morbidity rates in the short term to be significant"*, though we would anticipate the board of an insurer to explore this for themselves, and to in any event assess the relevant transition risks of moving to a lower-carbon economy.

8. AFM members in aggregate have combined assets of over £7 billion, and decisions on how these are invested can make a material difference. All AFM members outsource fund and investment management, and we have seen an increase in engagement between insurers and fund managers on ESC issues. We note that in paragraph 3.11 of the draft supervisory statement, PRA suggests that: "*Solvency II insurers should therefore consider whether there is an excessive accumulation of financial risks from climate change (particularly those likely to crystallise via the transition risk factor) in their investment portfolio, and consider mitigants when this is the case."* As PRA states this might include diversifying assets, which implies that insurers should take a more active approach to reviewing the content of their investment portfolios, and where fund management is outsourced, to seeking assurance from managers (or by "*working together with external experts to collect (asset-level) data*") that their portfolio avoids a significant concentration of climate-related risks.

9. These are valid concepts, and in our discussions with fund managers we can see that significant effort is being devoted to improving transparency, as well as in developing investment solutions with greater attention to ESG issues. For smaller insurers in particular, we would welcome more insight from PRA on how these issues can be approached in proportion to the size of firm and the degree of risks they are exposed to.

10. As FCA states in its Discussion Paper on Climate Change and Green Finance, the lack of asset-level data on climate-related value creation or erosion, "*makes it difficult for financial institutions to identify assets that are likely to become stranded*"[5]. As such we see more scope for a co-ordination between the PRA and the FCA, to ensure that future expectations of risk management and disclosure requirements are aligned effectively.

[5] https://www.fca.org.uk/publication/discussion/dp18-08.pdf

11. PRA's consultation coincides with a paper from EIOPA on the integration of sustainability risks and factors[6]. The EIOPA consultation proposes possible amendments to the delegated acts under Solvency 2 and to the Insurance Distribution Directive. The EIOPA paper considers the wider ESG preferences of policyholders as well as the potential long-term impact of investment decisions on sustainability factors. We expect that PRA will wish to consider incorporating the outcomes of the EIOPA review into the post-Brexit rulebook.

12. The revised AFM Corporate Governance Code came into effect for AFM members from 1 January 2019[7]. The AFM Code applies to all AFM members, and takes account of the governance expectations of both the PRA and the Financial Reporting Council, and specifically seeks to carry across relevant requirements from PRA's SS5/16 on board responsibilities, as well as the guidance provided in FRC's UK Corporate Governance Code (for premium listed companies) and The Wates Principles (for large privately-owned companies). As such, the Code includes reference to the issues covered in the PRA consultation, including:

    - *developing appropriate risk management systems that identify emerging and established risks facing the organisation and its stakeholders. Such systems should enable the board to make informed and robust decisions, including those associated with material environmental, social and governance matters, such as climate change, employee relationships, supply chains and ethical considerations; and*
    - *reporting on environmental, social and governance standards should take account of the priorities of customers and members.*

13. We anticipate that the guidance above will give a broad framework for firms to comment on in their report and accounts. The degree to which they will need to do that will depend on their business model, and the expectations of their members. We would expect the board of an organisation to consider these issues carefully and use this to determine how they manage relevant risks, whether and what scenario tests are relevant, and how to disclose. In doing so, some of our members may wish to take up the recommendations for reporting from the FSB's Task Force on Climate-related Financial Disclosures[8], though we have not

[6] https://eiopa.europa.eu/Pages/News/EIOPA-consults-on-the-integration-of-sustainability-risks-and-factors-.aspx
[7] http://www.financialmutuals.org/mutual-governance/our-governance-code
[8] https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf

mandated this due to the different scales and business models of our members.

14. We would welcome the opportunity to discuss further the issues raised by our response.

Yours sincerely,

Martin Shaw
Chief Executive
Association of Financial Mutuals