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CP10/25, Central Climate Team
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30 July 2025

AFM Response to CP10/25 – Enhancing banks' and insurers' approaches to managing climate-related risks

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:

    - Describe challenges mutual insurance firms anticipate in implementing these proposals;
    - Encourage PRA to provide more guidance and examples of good practice to illustrate the proportionality of these proposals; and
    - Emphasise the importance of prioritising good outcomes over box-ticking exercises.

About AFM and its members

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). The mutual insurance sector manages the savings, pensions, protection and healthcare needs of over 26 million people in the UK and Ireland, collects annual premium income of over £23 billion, and employs nearly 23,000 staff[1].

3. The nature of their ownership and the consequently lower prices, higher returns or better service that typically result, make mutuals accessible and attractive to consumers, and have been recognised by Parliament as worthy of continued support and promotion. FCA and PRA are required to analyse whether new rules impose any significantly different

[1] ICMIF and AFM, 2023: https://financialmutuals.org/wp-content/uploads/2023/10/UK-Market-Insights-2023.pdf

consequences for mutual businesses[2] and to take account of corporate diversity[3]. Further, the Government have committed to double the size of the mutual sector as part of their agenda to grow the UK economy. FCA and PRA have been issued secondary competitiveness and growth objectives which should inform how they examine the impacts of regulation on mutual firms.

Introductory comments

4. AFM and its members recognise the increasing impact of climate-related risks on businesses, and we understand the need to increase expectations of firms over time to keep pace with a developing area of risk management. We support the PRA in seeking to consolidate existing guidance into one supervisory statement, making it simpler for firms to understand what is expected of them and ensure proportionate compliance.

5. However, our members have expressed several concerns with implementing the proposals as written in the paper. Several expectations are not realistic or practical for firms to implement, particularly where they have already taken strides to improve their approach in line with SS3/19. We also find that they are somewhat disconnected from the reality of managing risk within insurance firms.

6. We also wish to reiterate the importance of regulations prioritising good outcomes. Some of the proposals are overly prescriptive and do not consider how they would be implemented at firms whose nature and business differ from traditional insurance companies. Many of our members are concerned that efforts to comply with regulations will become box-ticking exercises which do not meaningfully contribute towards their firm's ability to manage risk.

7. We urge the PRA to consider revising some aspects of the proposals to give firms more autonomy to manage risk in the way that is best suited to their business, resulting in better outcomes for customers. We would also ask the PRA to produce further guidance around what good looks like across the full proportionality of the proposals, illustrated with good practice examples from different types of firms.

Challenges to the proposals

8. The consultation paper notes that many firms do not account for climate-related risk as a standalone risk and as a result, do not have a climate-

[2] Financial Services Act 2012, section 138 K: http://www.legislation.gov.uk/ukpga/2012/21/section/24/enacted
[3] Bank of England and Financial Services Act 2016, section 20 http://www.legislation.gov.uk/ukpga/2016/14/section/20/enacted

related risk appetite statement or threshold. Our members express a strong preference for their considerations of climate-related risk to be integrated within existing risk management frameworks. Mutual insurers are keenly aware of the potential impacts of both physical climate risk and transitional climate risk, but they see these primarily as drivers of existing risks (e.g. insurance risk, upmarket risk.) As such, they do not feel there is value is creating a separate risk appetite statement which would simply restate how they have factored climate change into existing risk appetites. Requiring firms to do so ignores the effort they have already put into integrating climate-related risk considerations within their existing risk procedures.

9. Additionally, it is unclear what an appropriate risk appetite statement would include for our members who offer more niche products. Take, for example, health cash plan providers. A general insurer may have a risk appetite statement for insuring properties which states that if the risk of flooding exceeds a certain threshold, they will refuse to insure the property. It is less clear how a health cash plan provider would produce a similar standalone statement accounting for the effects of a changing climate on population health. Work on climate-related risk is still developing in these areas and the PRA's expectations must accommodate for this variation.

10. Members have also expressed uncertainty around how they can account for climate change as a standalone risk within the calculation of their Solvency Capital Requirement (SCR) given that this is based on a modular formula. Beyond the practicalities of this, we are also concerned that where firms rely on incomplete or inaccurate data and unrealistic assumptions within their CSA, its consideration within the Standard Formula could undermine the formula itself. We ask the PRA to provide more clarity on this in the final statement in order to preserve the value that existing requirements add to firms' business considerations.

11. Another challenge that members have shared is that it is difficult to synthesize long-term models for climate change (20 – 50 years) with business plans (3 – 5 years), and investment time horizons (4 – 8 years). Although businesses can model how different scenarios for climate change would impact them, they will be limited in what tangible steps they can take within the timeframe of their business plan to mitigate the corresponding risks.

<u>Guidance</u>

12. We support UK regulators' efforts to move towards a principles-based regulatory regime as we feel that in theory, this allows for proportional compliance which is well tailored to a firm's business model. However,

principles-based regulation can push firms towards excessive reporting to alleviate concerns of non-compliance. This puts pressure on other firms to do the same and eventually shifts the market perception of what "good" looks like. In these situations, small firms especially suffer due to a lack of guidance around what proportionality looks like for businesses like theirs.

13. Further, we would point out that while approaches to climate-related risk management have evolved in the market, this is predominantly among larger insurers with more traditional business models. There are less examples of what good practice looks like for small and medium mutual insurers who offer more bespoke products.

14. We ask the PRA to publish more guidance illustrating what compliance with these proposals looks like for firms of all types and sizes. Good practice examples which showcase a variety of compliance approaches across small and medium mutual firms would provide helpful supplementary advice to firms looking to improve their approaches.

15. We also ask the PRA to provide more specific feedback to firms on their approaches to managing climate-related risk, including where their existing activity is already considered compliant, proportionate to their firm size and type. Several of our members feel that they have already made significant progress to implement the existing guidance on managing climate-related risk, but they are still concerned that PRA supervisors will not agree. More regulatory support would go some way to achieve the stated objectives of this consultation, helping small firms improve their approach without driving unnecessary tick-boxing.

<u>Concluding remarks</u>

16. We support the objectives of this consultation paper and understand the importance of firms' readiness to address systemic risks such as climate change. We support proposals which will complement firms' existing work on climate risk and raise expectations proportionately.

17. However, we are concerned that some aspects of the proposals as written could lead to box-ticking exercises to meet regulatory expectations which result in no better outcomes for consumers. We urge the PRA to consider the points we have raised above in order to improve the proposals.

18. We would welcome the opportunity to discuss further the issues raised by our response and are happy to be included in the published list of respondents.

Yours sincerely,

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