Quarterly insurance update

Q2 2023

ROYAL LONDON
ASSET MANAGEMENT

Summary

Welcome to the Quarter 2 2023 investment update designed for insurers and produced by Royal London Asset Management. The year started optimistically with a strong January rally for equities and fixed income markets reacting positively to the decline in inflation and the prospect of easier monetary policy. However, expectations shifted with stronger than expected US job market data, leading to fears that interest rates would have to continue higher. The increased volatility this caused was then exacerbated towards the end of the quarter, with concerns over the health of the global banking sector.

In addition, reviews of the regulatory frameworks within both Europe and the UK have continued to progress. In the UK, the PRA (Prudential Regulation Authority) gave a speech to the ABI (Association of British Insurers) covering fundamental spreads and the risk margin under the Solvency UK regime and gave a separate speech identifying the need for insurers to reassess existing risk models and conduct stress testing that also better considers management actions. In addition, the Bank of England published a report outlining its concerns that climate related risks are not accurately reflected in the existing capital framework for insurers.

In wider Europe, EIOPA (European Insurance and Occupational Pensions Authority) published its opinion on the European Financial Reporting Advisory Group's technical advice concerning European Sustainability Reporting. Insurance Europe provided feedback to EIOPA on its discussion paper on the prudential treatment of sustainability assets and activities and to the ESAs (European Supervisory Authorities) on greenwashing issues.

Within this quarterly update, we cover developments to the two main areas most prevalent to the asset side of insurers' balance sheets – investment markets and regulations. In addition, we highlight two investment themes we believe should be considered by many insurers at the present time.

Market update:

- Markets started the year with a strong January rally for equities. Fixed income markets also reacted positively to the decline in inflation and the prospect of easier monetary policy but towards the end of the quarter the collapse of Silicon Valley Bank and broader concerns around the financial sector hit bank shares hard.
- Government bond markets posted solid returns in the quarter but did not escape the period without suffering a bout of volatility as investors wrestled with guesses on when central banks would find their peak in the current rate hiking cycle.
- For corporate bonds, as with the previous quarter, US dollar and sterling markets both showed markedly better returns than the euro market, predominantly due to stronger performance from underlying US treasury and gilt markets over bunds.
- The fall in bond yields also led to a rally in growth stocks away from value. This dramatic rotation came in the aftermath of the fallout of Silicon Valley Bank and expectations that central banks globally may be less aggressive in hikes, leading to longer duration assets performing well.

Regulatory update:

The regulatory environment for insurers continued to develop rapidly. Over the quarter:

Europe

- EIOPA published its opinion on the European Financial Reporting Advisory Group's (EFRAG) technical advice concerning European Sustainability Reporting Standards (ESRS) following the request of the European Commission.
- Insurance Europe has responded to a discussion paper by EIOPA on the prudential treatment of sustainability assets and activities.
- In addition, Insurance Europe also responded to a call from the ESAs for evidence on greenwashing.
- Elsewhere, the ESAs including EIOPA, together with the European Central Bank (ECB), published a Joint Statement on climate-related disclosure for structured finance products.
- Finally, EIOPA has published a staff paper on nature-related risks and their relevance to the insurance sector.

UK

- In February, the PRA gave a speech to the ABI covering fundamental spreads and the risk margin under the Solvency UK (SUK) regime.
- The PRA also gave a speech to the Westminster Business Forum identifying the need for insurers to reassess existing risk models, conduct stress testing that also considers the actions of management, and consider at what point to exit the market to best protect policyholders.
- Elsewhere, the FCA provided a progress update on its proposals for Sustainability Disclosure Requirements (SDR) and investment labels. It announced that it is currently reviewing the feedback provided and will be publishing a Policy Statement in Q3 this year.
- The FCA also published a discussion paper in February 2023 focusing on sustainability governance, incentives, and competencies to assess the viability of introducing new regulation to enhance the requirements of regulated entities in these areas.
- The Bank of England published a report outlining its concerns that climate related risks are not accurately reflected in the existing capital framework for insurers. As such, it is considering how to address capability and regulatory gaps.
- The UK Government published its 'Powering Up Britain' and the '2023 Green Finance Strategy' reports in March. These stated the UK Government's commitment to its net zero goals and the importance of facilitating private investments to achieve the objectives.
- Finally, the PRA provided a speech to the April 2023 Bulk Annuities conference on the increasing importance of the bulk annuities market and how the PRA is looking to strengthen senior management accountability and enhance market discipline through the implementation of the SUK package.

We explore these areas in more detail, also highlighting what these could mean for insurers going forwards.

Insurance investment themes:

We set out two investment ideas and themes for insurers that we believe are well placed and relevant relative to the future economic and regulatory environment. For this quarter's publication we include:

- **Absolute Return Bonds:** Absolute Return Bonds are an area that is intuitively attractive, with the intention to generate higher returns through manager skill in a low yield environment, and with reduced correlations to wider market exposures – particularly credit. However, many of these strategies have failed to deliver for various reasons. In this theme we explore how an Absolute Return Bond strategy can be constructed that is truly diversifying whilst also being highly capital efficient for insurers.
- **Integration of Climate Risks within a Strategic Asset Allocation (SAA) framework**: It is becoming increasingly important for insurers to set a robust climate risk management and disclosure framework given the regulatory pressure that insurers are facing currently as well as other external influences. Whilst there are various ways in which this can be implemented, the natural extension of these is to incorporate it more formally within asset allocation processes. We explore the challenges of this and ways in which insurers can integrate this robustly.

Market update

	Yield (%)*		Total 3 month return*	
	31 December 2022	31 March 2023		
Euro Treasuries†	3.18	3.00	2.87% (GBP)	2.47% (EUR)
UK Gilts†	3.83	3.70	2.05% (GBP)	
US Treasuries†	4.18	3.83	2.64% (GBP)	2.24% (EUR)

	Spread (bps)*		Total 3 month return*	
	31 December 2022	31 March 2023		
Global IG Corporates†	147	153	2.77% (GBP)	2.37% (EUR)
Euro IG Corporates†	161	163	1.54% (EUR)	
UK IG Corporates†	167	167	2.39% (GBP)	
Emerging Market Debt†	452	484	1.50% (GBP)	1.12% (EUR)
Global High Yield†	433	414	2.96% (GBP)	2.58% (EUR)

	Price index*		Total 3 month return*	
	31 December 2022	31 March 2023		
Global Equities†	383.13	405.45	4.81% (GBP)	5.83% (EUR)
Euro Equities†	3793.62	4315.05	13.74% (EUR)	
UK Equities†	4075.13	4157.88	3.08% (GBP)	
Emerging Market Equities†	427.58	436.64	1.13% (GBP)	2.12% (EUR)

	Index*	
	31 December 2022	31 March 2023
Volatility†	21.67	18.70

*Source: Bloomberg, IHS Markit.

†See appendix for details on index used and returns quoted.

Past performance is not a reliable indicator of future results. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

Overview

The year enjoyed an optimistic start, with sentiment calmer as it appeared that the major economies had avoided recession and consumer price inflation was moderating. However, expectations shifted with stronger than expected US job market data, leading to fears that interest rates would have to continue higher. The increased volatility this caused was then exacerbated towards the end of the quarter, with concerns over the health of the global banking sector.

Central banks continued their rate hiking path. The US Federal Reserve, the European Central Bank, and the Bank of England all pushed rates higher twice in the quarter – with the ECB increasing rates the most, by 0.75% – but with investors growing in confidence that central banks were nearing the end of their tightening cycle. Since the start of the current cycle the Fed has increased rates by 4.75% over the course of nine rises since March 2022. The BoE started the cycle at 0.1% but has moved rates higher 12 times since the end of 2021, now sitting at 4.50%, while the ECB on the other hand has only increased its main refinancing operation rate by six times to 3.50%.

In the final few weeks of the quarter, the collapse of Silicon Valley Bank (SVB) and Credit Suisse refocused attention on the strength of the banking sector and dragged returns for equity and bond markets sharply lower. By the end of the quarter, central bank action following the collapse of SVB and the rescue of Credit Suisse by larger Swiss peer UBS appeared to have calmed markets.

Government bonds

Government bond markets posted solid returns in the quarter but did not escape the period without suffering a bout of volatility as investors wrestled with guesses on when central banks would find their peak in the current rate hiking cycle. Stronger than expected economic data early in the year suggested most major economies would avoid a recession but the banking sector hitting turbulence at the end of the period reignited growth fears as lenders would look to tighten credit.

In the US, 10-year treasury yields fell to 3.47% from 3.87%, while in Germany the 10-year bund yield dropped to 2.29% from 2.57%. The UK gilt market delivered a 2.05% return (FTSE Actuaries) over the first quarter with the benchmark 10-year gilt yield slipping 18 basis points to 3.49% from 3.67% at the start of the quarter.

Credit

Total returns for global investment grade credit markets over the quarter were 2.62% in local currency terms, with US dollar and sterling markets both showing better returns than the euro market, predominantly due to stronger performance from underlying US treasury and gilt markets over bunds. For euro and US dollar markets, higher rated bonds tended to outperform, with the reverse true in the UK. Sector returns were widely dispersed, but in all three markets, banking was the worst-performing sector due to concerns following the collapse of SVB and the Credit Suisse rescue package.

Equities

Within equity markets, there was a dramatic rotation into 'growth' away from 'value'. This dramatic rotation towards growth stocks came in the aftermath of the fallout of Silicon Valley Bank and expectations that central banks globally may be less aggressive in hikes, leading to longer duration assets performing well. The MSCI World Growth Index produced strong returns, while the MSCI World Value Index was broadly flat in comparison. This is important because in 2022 and at the start of 2023, rising interest rates led to a significant rotation out of growth stocks and into value stocks.

Sector returns were dispersed for the MSCI World: information technology and communication services produced strong returns, while energy and healthcare saw negative returns for the quarter.

Regulatory updates

1. Insurance Europe feedback on ESAs call for evidence on greenwashing

- On 16th January 2023, Insurance Europe responded to a call from the European Supervisory Authorities (ESAs) for evidence on greenwashing.

The ESAs call for evidence focused on (i) collecting views on how to understand greenwashing and what the main drivers of greenwashing might be; (ii) examples of potential greenwashing practices across the EU financial sector; and (iii) any available data to help understand the scale of greenwashing and identify areas of high greenwashing risks.

In response, Insurance Europe's high-level feedback was that no new regulation on greenwashing was needed for the sustainable finance framework to deliver on its high ambitions while addressing greenwashing risks. It felt that insurers already operate in a highly regulated environment, and if designed correctly, ultimately, legislations under the EU sustainable finance framework have the potential to address greenwashing. However, a significant part of the framework intended to prevent greenwashing was not yet fully in place and further clarification was needed to deliver on sustainable objectives.

In particular, Insurance Europe felt that the following key issues in the EU sustainable finance regulatory framework may currently lead to unintentionally flawed information:

- The lack of clarity and inconsistencies in certain EU rules.
- The sometimes-contradicting definitions of what 'green' actually means.
- The lack of data (or lack of reliable third-party data).
- The lack of maturity of methodologies and metrics for measuring impacts on sustainability factors.

What does it mean for insurers?

Insurers will be consumers of information around the sustainability of their investments and hence are exposed to greenwashing concerns from asset managers and suppliers. In addition, some insurers will also be required to disclose sustainability information for the products they are issuing.

The consensus from industry as a whole seems to be that existing legislation, if designed correctly, should be sufficient to largely mitigate greenwashing risks. This is clearly a rapidly developing area and insurers should continue to pay close attention to emerging regulations and legislation to ensure that they are not exposed to greenwashing risks for their investments or products.

2. EIOPA paper on draft standards for corporate sustainability disclosures

- On 26th January 2023, EIOPA published its opinion on the European Financial Reporting Advisory Group's (EFRAG) technical advice concerning European Sustainability Reporting Standards (ESRS) following the request of the European Commission. This opinion covered the disclosures, consistency with other standards and whether this facilitated a consistent and proportionate application by insurers.

The ESRS will set out what sustainability-related information companies falling under the scope of the Corporate Sustainability Reporting Directive (CSRD) will be required to report. The CSRD will apply progressively from 2024 and will require all large and listed companies – including many insurers – to disclose information on the ESG risks that their business is exposed to and on how their business impacts people and the environment.

According to EIOPA, the draft ESRS, developed by the EFRAG, broadly meet their objectives, but some aspects could be enhanced upon.

EIOPA welcomed the general approach on the materiality assessment and the mandatory disclosure requirements that it said were crucial to calculate and report the Principle Adverse Impact (PAI) indicators under the SFDR. However, EIOPA believed that further clarity was needed so the relevant material sustainability impacts could be reported in a "proportionate and risk-based manner".

On the ESRS' consistency with EU standards, EIOPA said that further guidance may be required to improve comparability with certain SFDR-related indicators. On international standards, EIOPA emphasised the importance of avoiding the fragmentation of sustainability reporting requirements across jurisdictions (e.g. compatibility between ESRS and IFRS should be ensured).

What does this mean for insurers?

The CSRD will apply progressively from 2024 and insurers should check whether they are in-scope for the requirements, and if so, create an action plan for providing the required reporting. As this considers ESG risks across the entire business this will need close collaboration between different areas within an insurer (e.g. investment, underwriting, risk, operational).

3. Insurance Europe feedback on EIOPA paper on sustainable assets and activities

- On 2nd March 2023, Insurance Europe responded to a discussion paper by EIOPA on the prudential treatment of sustainability assets and activities, having already provided feedback (in December 2022) on the European Commission's proposals around the incorporation of sustainability risks in Solvency II.

The EIOPA paper had focused on three separate areas: (i) assets and transition risks exposure; (ii) underwriting risk and climate change adaption; and (iii) social risk and objectives.

Insurance Europe noted that European insurers strongly supported the drive towards sustainability and are ready to build on their current actions to contribute further to the transition to a more sustainable society, and was supportive of EIOPA's mandate in this area from the EC. It also noted the various challenges around pursuing a risk and evidence-based approach to fulfil the mandate, due to the scarce and not sufficiently standardised data available. In addition, the isolation of the sustainability element from other (non) economic parameters and influences was problematic for calibrating risks.

The more specific feedback provided by Insurance Europe, as focused on the three main areas in the EIOPA paper and relating to investments, was:

1. Asset and Transition Risk Exposures:

- The Solvency II SCR is determined on the basis of a one-year value-at-risk (VaR) measure. In the context of transition risk, the Own Risk and Solvency Assessment (ORSA) with the use of longer-term scenarios, at different confidence levels and allowance for mitigating actions seemed the best option for quantification.
- Any transition risk assessment should also reflect that insurers are not static, and investors, policyholders and competition will ensure that insurers transform/transition. In addition, mitigating circumstances, relevant for some sectors also need to be considered and the risk is expected to reduce eventually once the transition is completed.
- The EIOPA paper focused mainly on the energy infrastructure transition risk from fossil fuels to renewables. However, there are also other relevant factors such as biodiversity loss, pollution, land use and water use that often interrelated with climate change and carbon usage.

2. Underwriting and Climate Change Adaptation:

- Insurance Europe felt that publicly funded climate-related adaptation measures could have a significant role when it comes to adaptation to climate change and, in turn, in terms of risk reduction.

3. Social risk and objectives:

- It was felt that, for the time being, the analysis of social risks should remain at a prospective/identification stage. A meaningful quantification is not feasible, given the limited (standardised) data availability and studies on social risk and objectives.

What does this mean for insurers?

Insurance Europe signified its strong support for the insurance industry to play a leading role in the transition to a more sustainable society, it felt that this needed to be done in a way that recognised the data limitations and the risk and evidence-based nature of Solvency II.

It recommended recognising transition risk principally in the ORSA through scenarios and having wider regard to transition risks than just energy infrastructure risks. Insurers should pay close attention to further regulatory developments in this critical and high-profile area and recognise the likely importance of scenario analysis as part of the risk measurement and management framework.

4. ESAs paper on climate disclosures for structured finance

- On 13th March 2023, the European Supervisory Authorities (ESAs) including EIOPA, together with the European Central Bank (ECB), published a Joint Statement on climate-related disclosure for structured finance products. The Statement encourages the development of disclosure standards for securitised assets through harmonised climate-related data requirements.

It was noted that currently there is a lack of climate-related data on the assets underlying structured finance products. This poses an obstacle for the classification of products and services under the EU Taxonomy Regulation and SFDR and hinders the proper assessment and management of climate-related risks.

Securitisation transactions are often backed by assets that could be directly exposed to physical or transition climate-related risks, such as real estate mortgages or auto loans. Since the value of these underlying assets could be affected by climate-related events, there is view that the reporting on existing climate-related metrics needs to improve. Additional climate related data will allow investors to better identify climate change-related risks while avoiding overreliance on estimates from external sources.

ESMA is working towards enhancing disclosure standards for securitised assets by including new, proportionate, and targeted climate change-related information. The ESAs and the ECB also call on issuers, sponsors, and originators of such assets at EU level to proactively collect high-quality and comprehensive information on climate-related risks during the origination process.

What does this mean for insurers?

The European industry has a relatively low allocation to structured finance within investment portfolios, although this varies significantly between insurers. This is partly driven by the relatively more unfavourable SCR treatment applying for many securitisations under the Standard Formula. However, where there is an allocation the sourcing of credible climate related data has to date been highly challenging.

The actions taken by the various European bodies should improve the availability and quality of climate data for structured finance and insurers should therefore prepare to be able to integrate this within overall climate reporting frameworks. However, this is likely to be a longer-term project given the lack of data currently available especially as the focus is on collecting data at the origination stage.

5. EIOPA paper on nature-related risks

- On 29th March 2023, EIOPA published a staff paper on nature-related risks – such as biodiversity loss and damage to ecosystems – and their relevance to the insurance sector. This forms part of EIOPA's sustainable finance strategy in aiming to establish supervisory expectations for the management of nature-related risks and impacts.

Tackling climate change has typically taken centre stage but protecting nature's biodiversity and ecosystems has in recent years also emerged as an important aspect. The failure to account for, mitigate and adapt to the consequences of nature loss can have economic implications that may put overall financial stability at risk.

In this context, EIOPA believes it is important to gain a better understanding of how nature-related risks can affect (re)insurers and to examine ways in which the insurance sector can meaningfully contribute to the conservation and restoration of nature through investments and underwriting activity.

The staff paper describes how nature-related risks can translate into risks for (re)insurers' assets and liabilities. The paper sets out a framework to identify key areas in supervisory and regulatory activity that require attention when addressing nature-related risks and their impacts on the insurance sector.

What does this mean for insurers?

Most insurers are at an early stage in using tools to assess and disclose the biodiversity footprint for their investments, to identify where the investment portfolio exerts most pressure on nature, and hence where mitigation or adaptation measures could be appropriate. However, given EIOPA's stated objectives in this area insurers should be prepared to develop these further over time.

Investment activity could be directed to support activities that reduce the risk of loss of biodiversity. However, this should be considered as part of an insurer's broader ESG goals and framework.

1. The Solvency UK regime and Fundamental Spreads – PRA speech to ABI

- The PRA speech to the ABI confirmed the lack of significant reform for fundamental spreads underlying the Matching Adjustment (MA) for UK annuity writers. Instead, the main change impacting on many insurers' balance sheets would be due to reductions in the risk margin under the SUK regime. Broad changes were also outlined to support competitiveness and growth goals.

On 20 February 2023, the PRA gave a speech to the ABI covering fundamental spreads (impacting on the assessment of the MA relevant for UK annuity writers) and the risk margin under the Solvency UK (SUK) regime. This clarified that fundamental spreads will not undergo any major changes under the new regime. Instead, there will be cuts to the risk margin in addition to other wider reforms.

It was noted that the PRA are aware of industry concerns that it will implement more stringent requirements in its oversight of the use of the MA through the greater powers granted, and hence achieve its previously stated objectives around increasing the level and sensitivity of the fundamental spread levels through 'the back door'. However, it looked to reassure the industry that it would not use these powers unless strictly necessary.

In addition to this, 6 key points of the SUK regime were identified for change with a focus on competitiveness and growth:

1. **Reporting** – small and medium sized firms will see a 40% reduction in reporting, increasing proportionality. Additionally, some reporting requirements will be removed for all firms (e.g. variation analysis).
2. **Internal models** – significant streamlining of rules around internal model approvals. Nearly 70% of the roughly 200 internal model tests and standards will be removed.
3. **Matching adjustment assets** – widening the range of assets eligible for MA to include assets with prepayment options and construction phases and broader investments with predictable cash flows. It will also investigate removing the cap on sub-investment grade assets.
4. **Higher regime entry threshold** – smaller or newer insurers will benefit from a tripling of the threshold for gross written premiums (to £15m) and double the threshold for technical provisions (to £50m) for being formally subject to the SUK framework.
5. **Easing the flow of business** – removing capital requirements for branches of international insurers operating in the UK market.
6. **Simplify & clarify expectation** – regarding the UK Insurance Special Purpose Vehicle (ISPV) regime.

The Economic Secretary to the UK Treasury provided a further speech to the same ABI conference reconfirming its strong support for the UK insurance sector. The Secretary also restated expectations that the SUK changes will promote growth and competitiveness in the sector, particularly through unlocking 'unproductive capital' through the reform of the risk margin.

The PRA will engage with a set of Subject Expert Groups on some of the more contentious matters outlined above. The first consultation is expected to be published in June, with a second subsequently in September.

What does it mean for insurers?

The speech largely reiterated what had been communicated previously, in that the PRA would be implementing the specific SUK changes developed by the UK Government. The main area of interest was around the reassurance to industry around the PRA's use of its powers in overseeing the use of the MA.

In general, the speech provided further certainty around the direction of the SUK changes and UK insurers should continue to develop their specific plans in reaction to the changes.

2. FCA update to SDR & investment labels consultation

- The FCA's initial consultation period for feedback on its proposals for Sustainability Disclosure Requirements (SDR) and investment labels closed on 25 January. In a progress update of 29 March, it announced that it is currently reviewing this feedback and will be publishing a Policy Statement in Q3 this year.

The FCA had consulted on its proposals around SDR and investment labels for sustainable investment products. The consultation ended in January with 240 responses received. The FCA will incorporate this feedback in a Policy Statement published in Q3 this year, which will provide further information on labelling, marketing restrictions, qualifications, and verifications.

This will include the approach being taken to marketing restrictions as well as refining criteria for sustainability labels and clarifying the qualifying attributes. This will also clarify how different products, asset classes and strategies can qualify for a label, including multi-asset and blended strategies.

The FCA also confirmed that the regime will accommodate all in-scope products, including products not qualifying for labels but incorporate some sustainability characteristics.

What does it mean for insurers?

The previous expectation was for the FCA to be ready with its Policy Statement and final rules by the end of H1 2023, so the March update does delay the timescales for implementation.

Insurers may effectively be 'consumers' of the disclosures and labels if investing in sustainable investment products and potentially 'providers' of these if issuing such products. In any case, this is a highly important area and insurers should carefully review the initial consultation and monitor the release of the Policy Statement later in the year to understand what it will mean for their reporting and disclosure frameworks.

3. Risks, modelling and exists – Westminster Business Forum speech

- A PRA speech to the Westminster Business Forum speech identified the need for insurers to reassess existing risk models, conduct stress testing that also considers the actions of management, and consider at what point to exit the market to best protect policyholders.

On 27 March, the PRA gave a speech, focusing on the use of existing models in a new poly crisis risk environment, assessing management actions as a component of stress testing, and planning for market exit.

It was noted that insurers are currently operating in an environment unlike those seen before, where multiple different risk events compound one another and impact various aspects of insurers' operating models: credit, underwriting, operational, capital and liquidity. Given these risks, insurers should be considering unprecedented operating conditions, understanding key vulnerabilities, and being prepared for volatility in variables that have historically been treated as constant.

Insurers were urged to assess whether the factors integrated into models (e.g. longevity, inflation, climate change) have moved on since the model was first designed. Additionally, models should not only focus on the development of single event extreme scenarios but should also consider how different combinations of stress events can lead to different outcomes.

Following the PRA Insurance Stress Test 2022 it was found that many insurers would consider similar actions over the course of a stress event to manage risk, such as relying on the liquidity of sub-investment grade bonds. The BoE intends to run a system-wide exercise investigating behaviours to a severe market stress including the potential for amplification of shocks through similar management actions.

What does it mean for insurers?

The speech provided further evidence of the PRA's even greater focus on risk management and stress testing given the heighted risk environment that insurers are currently facing. In reaction to this, insurers should be prepared to review, develop and be able to justify the ongoing appropriateness of the risk models adopted. In the context of market risks, it will be important to consider the impact of management actions (also those taken by other insurers), having a holistic view of risks (including underwriting and liquidity) and considering holistic scenarios across the entire balance sheet.

4. FCA discussion paper – sustainability governance, incentives and competence

- The FCA published a discussion paper in February 2023 focusing on sustainability governance, incentives and competencies to assess the viability of introducing new regulation to enhance the requirements of regulated entities in these areas.

In February 2023, the FCA published a discussion paper which focused on the evolving area of sustainability, specifically the governance, incentives, and competence of regulated entities.

The FCA noted that good governance and a healthy culture – including around ESG criteria – were critical to financial services firms' delivering value to clients and consumers and supporting market integrity. It also stated the important role of the financial sector in contributing to the transition to a net zero economy and a more sustainable long-term future.

The FCA is seeking to identify good evolving practices to support the execution of positive sustainable change. The paper seeks to explore how firms embed sustainability-related considerations into their objectives and purpose, and how these are then reflected in its culture, business strategy, governance and incentives. The paper also included a collection of articles authored by external experts in different aspects of the topics considered in this paper.

The feedback gained from the discussion paper will be utilised to steer the future regulatory approach. Additionally, the FCA will consider firms' arrangements in these areas as part of their ongoing engagement, noting that proportionality will be applied.

What does it mean for insurers?

The FCA asked for feedback on its paper by 10 May and will then determine its next steps. We encourage all affected insurers to provide feedback if this has not already been submitted.

The paper further reinforces the increasing pressures expected from regulators around the governance and management of ESG risks. All regulated firms should continue to review their approaches in this area (noting proportionality) to ensure it remains fit for purpose, and pay close attention to the further feedback, papers and regulation that may be issued following this paper.

5. Bank of England report on climate related risks & regulatory capital frameworks

- The Bank of England (BoE) published a report outlining its concerns that climate related risks are not accurately reflected in the existing capital framework for insurers. As such, it is considering how to address capability and regulatory gaps.

On 13 March, the BoE published a new report on climate-related risks and regulatory capital frameworks. The report identified concerns posed by capability gaps (difficulties in estimating climate risks) and regime gaps (existing capital regimes may not fully capture risks). Specifically, these gaps can mean that insurers are not sufficiently capitalised for future adverse climate-related impacts. As a short-term priority, the BoE is focusing on ensuring firms make progress to address 'capability gaps' to improve their identification, measurement, and management of climate risks.

The BoE outlined some key next steps that it intends to take including:

- Monitor progress made by insurers to address capability gaps: identification, measurement and management of climate risks.
- Develop and enhance macroprudential tools to test the resilience of the wider financial system against climate related risks.
- Identify regime gaps in the existing capital frameworks. Analyse systematic risks and determine if changes to the macroprudential framework is necessary.
- Support initiatives, international and domestic, enhancing climate related disclosures.

By implementing more effective risk management controls, the BoE expect that insurers will be better capitalised in the event of future adverse climate-related events occurring. Scenario analysis and stress testing play a significant role in determining the appropriate level of capital that is required to be held. The Bank will undertake further analysis to explore whether changes to the regulatory capital frameworks may be required.

In addition, the BoE sponsored Climate Financial Risk forum (CFRF) provided further and updated guidance in March 2023 to financial market participants. The CFRF is an industry forum jointly convened by the PRA and FCA to build capacity and share best practice around climate-related risks.

The updated information available included updated climate disclosure dashboards, scenario analysis tools and guides, and learnings from the recent Climate Biennial Exploratory Scenario (CBES) exercise.

What does it mean for insurers?

The BoE paper does not set out any policy changes but sets out its thinking and identifies areas for future work. However, insurers should expect more pressure from the regulator to address perceived capability gaps, and possible changes to existing capital frameworks to reflect the updated systematic risks of climate change. In addition, the further build out of scenario and stress testing frameworks for climate-related risks will remain highly important.

The updated information and support from the CFRF should prove valuable for insurers as they further build out their disclosure and analytical frameworks around climate-related financial risks.

6. Powering Up Britain and 2023 Green Finance Strategy

- The UK Government published its 'Powering Up Britain' and the '2023 Green Finance Strategy' reports in March. These stated the UK Government's commitment to its net zero goals and the importance of facilitating private investments to achieve the objectives.

On 30 March the UK Government published its plans to strengthen energy security, independence and sustainability. These plans were set out in two reports.

I. Powering Up Britain

The first report focused on areas in which the UK Government is looking to invest to strengthen its energy infrastructure, largely in response to the ongoing conflict in Ukraine and the impacts this has had on the global supply of energy, but also in response to the ongoing climate mitigation goals.

II. 2023 Green Finance Strategy

The 2023 Green Finance Strategy outlined how, through various different initiatives, the UK will mobilise investment to meet climate and nature objectives. The strategy focused significantly on how the UK Government is seeking to unlock private investment into green initiatives to meet its ambitious goals. The strategy paper noted the Solvency UK review and the potential to mobilise over £100 billion of productive investments from insurers over the next ten years as a result of the intended changes.

The ABI released a statement which positively supported the initiatives outlined – also noting alignment with the ABI's Climate Change Roadmap. There was specific support for the speeding up of large-scale energy projects and to facilitating green initiatives (energy and otherwise) given insurers' significant investment capacity.

What does it mean for insurers?

The insurance sector, and particularly larger insurers with higher potential for scale investments in energy-related assets, are subject to increasing expectations around their role in supporting the green transition. Insurers should continue to review their allocation to investments that are targeting climate-related objectives to ensure these are aligned with both environmental and financial aims.

7. PRA speech to Annual Conference on Bulk Annuities

- The PRA provided a speech to the April 2023 Bulk Annuities conference on the increasing importance of the bulk annuities market and how the PRA is looking to strengthen senior management accountability and enhance market discipline through the implementation of the SUK package.

On 27 April, the PRA gave a speech to the Annual Conference on Bulk Annuities. It was noted that pension scheme funding levels have benefited from the recent rise in interest rates, and the UK insurance industry was preparing for the likely increase in demand for bulk purchase annuity transfers.

Insurers were expected to play an increasingly key role in delivering retirement income and as long-term investors in the UK real economy. However, it was noted that there was a need to balance the short term financial and reputational incentives to grow rapidly, with long term and enduring financial strength, to meet the long term needs of policyholders and the economy.

Three main areas of focus were identified in the speech:

1. **Expansion of risk appetites** – there was concern around whether risk management processes were keeping pace with growth ambitions and expanding risk appetites.
2. **Reliance on third party capacity** – the use of funded reinsurance to support large new business transactions. The PRA will be considering the opportunity cost of funded reinsurance (in terms of UK direct investments foregone) as well as the wider benefits and risks.
3. **Greater interconnectivity with the wider financial system** – the structural change in the control of long-term investments in the UK from pensions schemes to the insurance sector presented greater responsibility for insurers to manage macro-risks. Of note was for insurers to consider their own management actions under stress scenarios.

It was noted that the existing principles, including senior management responsibility and the Prudent Person Principle – were useful tools for helping manage the above three areas. These tools were being further strengthened and supplemented by the additional measures announced in the SUK package – for example regarding oversight powers for the use of the Matching Adjustment and the formalisation of regular stress testing exercises.

What does it mean for insurers?

The increasing prominence of UK annuity writers as providers of long-term retirement income and even more significant investors in the real economy means that the PRA will be paying even closer attention to their practices.

UK bulk annuity providers should therefore expect increased engagement and challenge from the PRA – particularly around the above three areas – and prepare accordingly.

Insurance investment themes

1. Fixed Income investing – the case for Absolute Return Bonds

Most fixed income strategies have struggled materially since 2022, with the significant increase in interest rates, government bond yields and credit spreads associated with the higher inflation position causing material mark-to-market losses.

Under such an environment, Absolute Return Bonds (ARB) are an area that is intuitively attractive, with the intention to generate higher returns through manager skill in a volatile rate environment, and with reduced correlations to wider market exposures – particularly credit. However, many of these strategies have failed to deliver for various reasons over recent periods. Do they still merit a place in insurers' fixed income portfolios?

Developing a more active fixed income approach

ARB are a form of fixed income investing that has much more reliance on the investment manager generating returns through skill rather than utilising common market drivers of return such as credit and illiquidity risk premia. We believe that the strategic case for incorporating ARB within a diversified fixed income portfolio is strong:

- Under the current volatile rate environment, having a more active approach to bonds is even more attractive – in particular actively managing the interest rate duration.
- The returns sourced through manager skill should be more lowly correlated with overall market returns (importantly credit), so provide positive diversification benefits with a wider more traditional fixed income portfolio.
- With careful active management of credit and interest rate risks, the strategy should exhibit low volatility.
- Many strategies are highly liquid (dependent on the exact approach and underlying securities / assets used)
- They can potentially have a high level of capital efficiency, depending on how the ARB mandate is structured. As an example, the chart in figure 1 shows the trade-off between expected return and SCR for the Royal London Asset Management ARB strategy relative to other fixed income assets, given it is focused mainly on positions within and between G10 government bond markets.

So why have many ARB strategies struggled?

Unfortunately, the construct of many Absolute Return Bond strategies means that recent performance has disappointed and not aligned with the strategic case identified above:

- Many ARB mandates have a higher correlation with market returns than expected and do not provide effective diversification, which, particularly during recent market events mean it has been difficult to outperform the broader market during that period.
- In particular, ARB mandates have tended to have a higher credit beta (i.e. exposure to changes in credit spreads), than investors were expecting. This is often evident during highly stressed conditions when funds have large drawdowns associated with the sell-off of credit assets.
- In general, ARB strategies have been designed for a wide range of investors and most are not optimised for use with insurers subject to regulatory constraints such as capital requirements. This means that they can contain several features which materially increase the SCR, such as less regulatory-friendly credit (e.g. non-STS securitisations); large unhedged currency positions (given the 25% SCR charge for most currency risk); and longer duration bonds.

Figure 1. Expected return vs Solvency II SCR (standard formula)

Source: RLAM based on EIOPA Solvency II Standard Formula at 14 October 2021.

Capital invested in the strategies is at risk and there is no guarantee that forecast returns or targets will be achieved over the 12 months rolling periods, or any other time period.

Designing a better ARB approach

We believe these design issues can be overcome by more careful construction and ongoing implementation of an ARB strategy to reflect the strategic objectives around diversification with other market exposures (especially credit), the focus on manager skill to generate returns, and to exhibit low volatility. In addition, for insurers there is the likely further preferences around capital consumption.

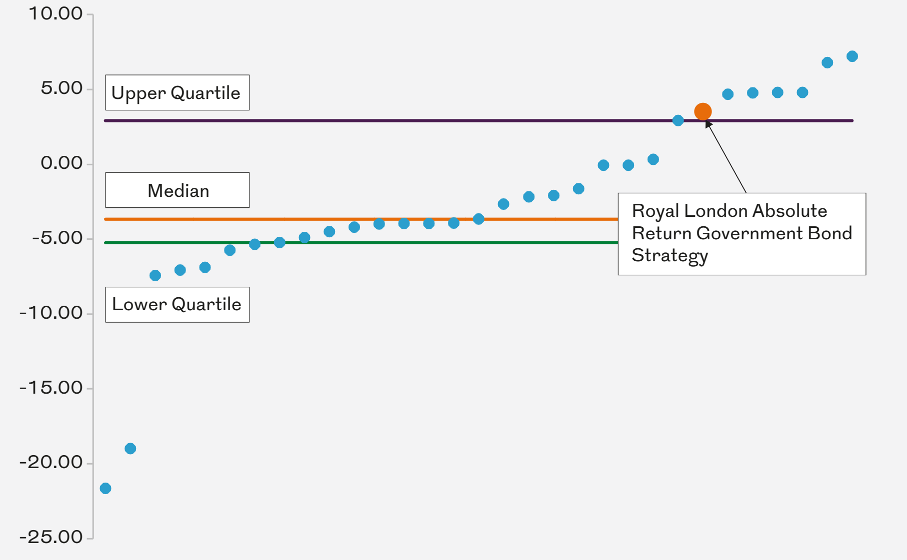
As an example, the Royal London Absolute Bond strategy invests in a diversified portfolio of global government bonds and short-dated investment grade credit utilising a derivative overlay focusing on our six key active strategies (e.g. cash, duration, curve, relative value, inflation, cross-market). In an attempt to deliver positive and uncorrelated returns the strategy looks to keep interest rate and credit risk to a minimum and focus on delivering outperformance from a range of non-correlated diversified market neutral strategies.

As proof of concept, the strategy delivered a positive return over 2022 (see figure 2) when most other Absolute Return Bonds in the peer group universe fell in value. In addition, the strategy has demonstrated low correlation against other asset classes (global inflation-linked bonds, global aggregate bonds, equities, and government bonds) over the last three years*.

* RL Absolute Return Government Bond Fund 3-year correlation Bloomberg Global Inflation-Linked (GBP Hedged) 0.0 Bloomberg Global Aggregate – Corporate (GBP Hedged) -0.1 MSCI World Index – Gross Return 0.1 Bloomberg Global Aggregate Government (GBP Hedged) 0.0 Source: RLAM, Bloomberg and MSCI as at 28 February 2023.

In addition, the Royal London Absolute Return Bond has a low SCR under the Solvency II Standard Formula. This is a result of the investment universe being mainly made up of G10 government bonds, there being no major unhedged currency positions, and for the credit assets these are mainly made up of very high-quality short duration covered bonds that are favourably treated under the Solvency II Standard Formula. This leads to a gross target return of cash plus 2.5% relative to an estimated Market Risk SCR of around 3% currently.

Figure 2: Royal London Absolute Return Government Bond strategy versus peers



Source: eVestment as at 31st December 2022.

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

2. Integration of Climate Risks within SAA framework

Warming up to climate risks

Climate risk management and decarbonisation objectives are an area of high priority for most insurers driven by regulatory pressures, other external influences (e.g. increasing disclosure requirements under TCFD) and heightened challenge from internal stakeholders such as Boards and policyholders. As long-term investors and risk managers, insurers have and will continue to play an important role in the overall transition to a more sustainable society and economy.

Recent regulatory activities have ensured that climate risk management remains a high-profile activity. For example, in the UK, the Bank of England has recently (March 2023) published a report on climate-related risks and the regulatory capital frameworks. Likewise in wider Europe, EIOPA has recently (December 2022) released a Discussion Paper on the Prudential Treatment of Sustainability Risks.

Many insurers have now been articulating their climate risk and decarbonisation objectives as part of their broader ESG framework – for example in targeting being net zero by 2050. The investments held by an insurer will be a key consideration in this strategy and insurers will need to understand how changes in the investment strategy and implementation approach will best align with these high-level climate objectives. However, integrating climate risks within a Strategic Asset Allocation (SAA) framework provides many challenges.

Extending existing approaches

A traditional SAA exercise for most investors involves some form of measurement of the trade-off between expected return and risk (e.g. volatility or Value at Risk) for different strategies. In addition, for insurers there is often the additional constraint or objective around a balance sheet position including the associated capital requirements for investment and wider financial -related risks.

Incorporating climate-related risks within the SAA framework effectively adds another dimension (and variables) to this process but noting their interconnectivity with expected financial returns and risks (and potentially the capital requirements, although the direction of this remains uncertain).

Challenges of integrating climate risk

Integrating climate risks into a quantitative asset allocation framework is potentially attractive, but there exist various challenges involved in this including:

- **Time Period** – The SCR and many SAA frameworks (particularly for insurers with shorter tailed business) look at time periods of around 1 to 3 years, but climate risks – particularly transition risks – typically unfold over longer time periods.
- **Data** – There is a distinct lack of credible data around the financial impact of climate risks (particularly at a more granular asset class level), a need to disaggregate climate risks from other risks in past data, and questions around extent to which past trends can be extrapolated.
- **Calibration** – Fitting limited past data into a full distribution of returns is complex and subjective, as is assessing correlations with more traditional equity, credit, and other market risks.
- **Transition** – Insurers need to incorporate expectations around how companies will be transitioning and reducing emissions rather than just looking at the current position.
- **Interaction with liabilities** – A particular challenge for non-life insurers and with some business lines – e.g. natural catastrophe risks, flood risk being particularly exposed to climate risks.
- **Resourcing and expertise** – Larger insurers may have in-house capabilities, but for others they may need to outsource some element of this to consultants or asset managers.
- **Complexity & ease of understanding** – There will be a trade-off between implementing a more sophisticated but complex framework versus something easier for stakeholders to understand but less theoretically robust.

Working to frame the problem and solution

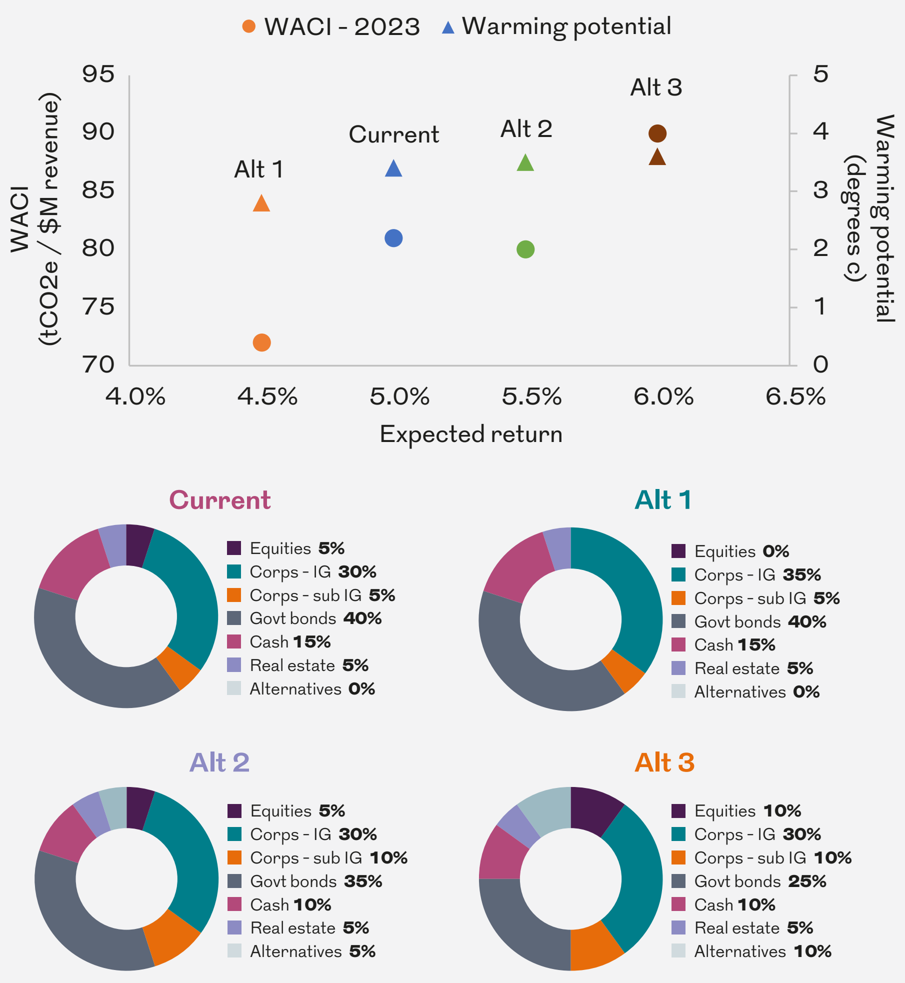
Some insurers may be looking to differentiate between the climate profile of different asset classes – for example traditional (market cap) equities, traditional (market cap) credit, 'green' equities, 'green' credit. The exact classification of 'green' will be key, and there may be different flavours of green depending on the environmental profile and reflecting there can be a spectrum of approaches. This essentially adds another set of building blocks to the SAA universe.

We have noted above the significant challenges of integrating climate risk into traditional market assumptions of risk and return for different assets. Given the complexity, it will be important to have transparency around the assumptions made, the sources of data and the key calibration principles. Stress testing the outcomes of the SAA to different climate risk assumptions will also be very important. The return impact of adopting a 'greener' approach is something that has received significant debate, and we recommend this is considered at a high level as part of an insurer's beliefs.

The types of analysis that could be undertaken to integrate climate-related risks include:

- Expected return vs carbon intensity of investments – ideally a comparison vs the current emissions profile and some forward-looking measure to allow for expected transition – see figure 3 for a simplified example.
- Expected return vs total risk (including both climate-related and non-climate-related financial risks, and possibly underwriting risks)
- Expected return vs capital requirement (to the extent that climate-related risks are allowed for in the capital)
- Impact of climate-related risks on balance sheet position (central outcome and variability around this)

Figure 3. Expected return vs climate risk measures



Source: RLAM

Given the significant challenges (certainly currently) of integrating climate-related risks within a probabilistic framework, scenario analysis is likely to be a key quantification tool. This can facilitate a longer time frame, enhance the transparency of assumptions made, and incorporate holistic scenarios including underwriting and other risks if required. This is particularly relevant for European insurers who are being required to do some form of scenario analysis for their ORSA for existing asset allocations.

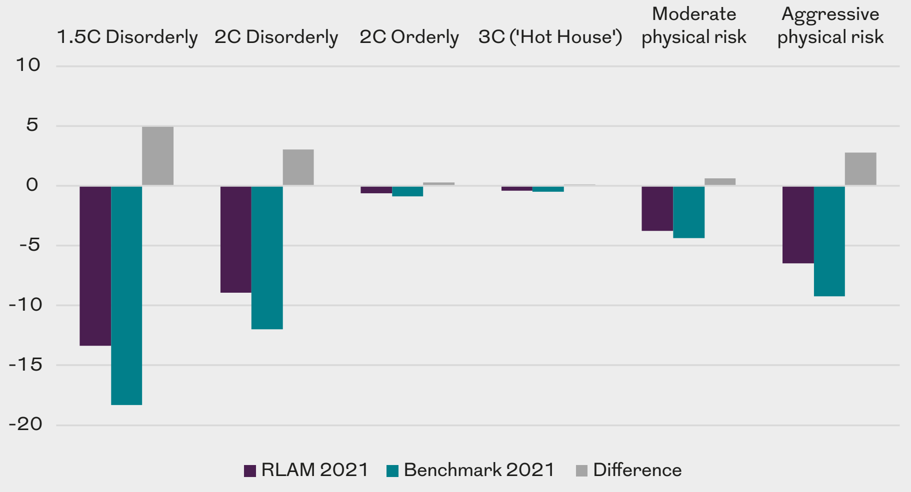
We show in figure 4 an example (taken from our latest Climate Report) of the types of scenarios that could be considered for this purpose.

Integrating climate risks – first steps

It has become increasingly important for insurers to develop a robust climate risk management and disclosure framework given the regulatory pressures and other internal and external influences. A natural extension of this is to allow for climate-related risks within the SAA process, but this has various challenges.

At this stage we believe it is useful for insurers to make initial investigations into such integration – for example adopting scenario analysis and understanding climate and financial exposures to current and alternative investment strategies. Techniques and data in this area are developing rapidly and it is likely that the overall sophistication and robustness of climate risk modelling will evolve significantly over the coming years.

Figure 4. Scenario analysis



Source: RLAM proprietary and MSCI, 31 December 2021

Investment risks

Past performance is not a guide to future performance. The value of investments and the income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit Risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Derivative Risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both strategy losses and gains. The impact to the strategy can be greater where they are used in an extensive or complex manner, where the strategy could lose significantly more than the amount invested in derivatives.

EPM Techniques: The strategy may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the strategy to increased price volatility.

Exchange Rate Risk: Investing in assets denominated in a currency other than the base currency of the strategy means the value of the investment can be affected by changes in exchange rates.

Interest Rate Risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Liquidity Risk: In difficult market conditions the value of certain strategy investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Counterparty Risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the strategy to financial loss.

Appendix

Fixed income	Index used	Returns quoted
Euro Treasuries	Bloomberg Barclays Euro Treasury Index	EUR Hedged
US Treasuries	Bloomberg Barclays US Treasury Index	EUR Hedged
Euro IG Corporates	ICE BofA Euro Corporate & Pfandbrief Index	EUR Unhedged
Global IG Corporates	Bloomberg Barclays Global Aggregate Corporate Index	EUR Hedged
EMD	JPM GBI-EM Global Diversified Index	EUR Hedged
Global High Yield	ICE BofA BB-B Global Non-Financial High Yield Constrained Index	EUR Hedged

Equities	Index used	Returns quoted
Euro Equities	Euro Stoxx 50 Index	EUR unhedged
Global Equities	MSCI World Net Total Return GBP Index	EUR unhedged
EM Equities	MSCI Emerging Markets Net Total Return GBP Index	EUR unhedged

Volatility	Index used
Volatility	Cboe Volatility Index (VIX)

Source: Bloomberg, HIS Markit

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Royal London
Asset Management
80 Fenchurch Street
London EC3M 4BY

www.rlam.com

We can provide this document in Braille, large print and audio.

For any queries or questions coming from UK or non-EEA potential investors, please contact:

Andrew Epsom
Insurance Client Solutions Director
+44 (0)203 272 5594
andrew.epsom@rlam.co.uk

For any queries or questions coming from EEA potential investors, please contact:

Arnaud Gerard
FundRockDistribution S.A.
9A rue Gabriel Lippman
Luxembourg-L-5365, Munsbach
+352 691 992 088
arnaud.gerard@fundrock.com

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