Quarterly insurance update

Q4 2023

Summary

Welcome to the Quarter 4 2023 investment update designed for insurers and produced by Royal London Asset Management. The third quarter was characterised by mixed data around the world, with central banks coming towards the end of their rate hiking path, but with cuts still seemingly a while away. The global economic picture is relatively more positive now than it was at the start of the year, but global growth is concerning again amid a disappointing bounce in China activity, slow-to-no growth in Europe, and against a backdrop of restrictive monetary policy. The US still looks at risk of recession too, even if activity data to date has been fairly robust.

In addition, reviews of the regulatory frameworks within both Europe and the UK have continued to progress.

In the UK, the Prudential Regulation Authority (PRA) published a consultation paper on proposed reforms to the Matching Adjustment under the Solvency UK (SUK) regime. In addition, a speech from the PRA provided wider detail on the SUK reform including around stress testing and alignment with International Capital Standards (ICS).

In wider Europe, the European Insurance and Occupational Pensions Authority (EIOPA) published its latest Insurance Risk Dashboard as well as their consultation response with regards to the European Commission's proposal to improve availability, integrity and transparency of ESG ratings. The European Supervisory Authorities (ESAs) issued their joint Autumn Report on risks and vulnerabilities as well as the second annual report on the extent of voluntary disclosure of Principal Adverse Impact indicators under the Sustainable Finance Disclosure Regulation (SFDR).

Within this quarterly update, we cover developments in 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:

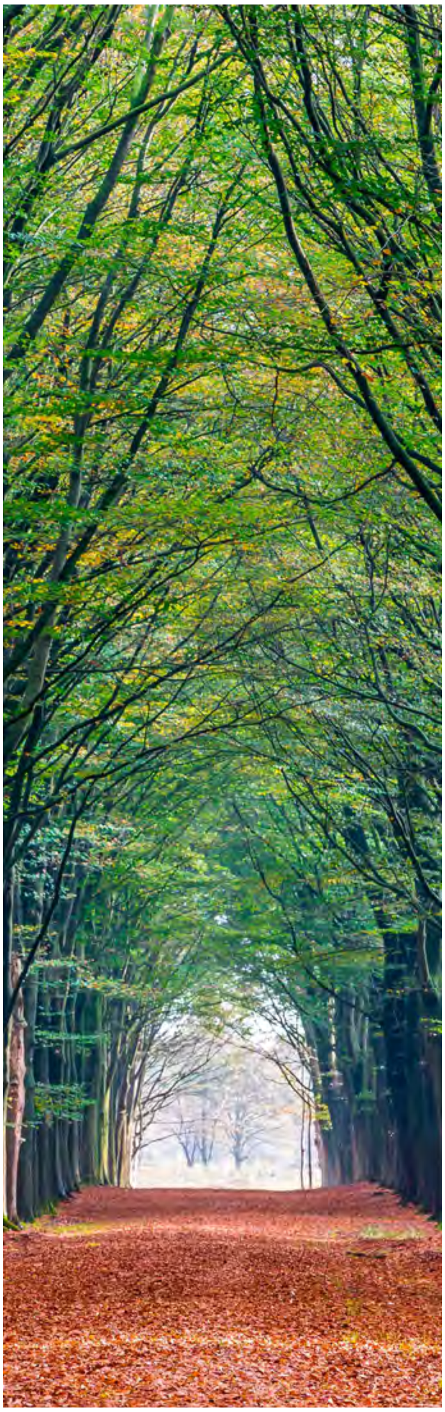
- Government bond markets continued to see yields move higher. Central banks in major economies maintained accommodative monetary policies, contributing to steady demand for government bonds. Investors closely monitored inflation data and economic indicators as concerns about potential interest rates pursued.
- Global corporate bond markets saw similar underlying influences over the third quarter, with differing overall results. All markets faced the headwind of rising government bond yields, but with this mitigated by ongoing additional carry, and tighter credit spreads as corporates continued to perform well despite the higher interest rate environment.
- Equity markets made losses over the period on fears that interest rates will remain higher for longer than expected, which saw equities drop to their lowest levels since early June.

Regulatory update:

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

Europe

- EIOPA published its latest Insurance Risk Dashboard summarising the main risks and vulnerabilities in the EU's insurance sector through a set of risk indicators.
- EIOPA also published a report on how the current higher inflationary environment impacts insurers in Europe.
- Insurance Europe has disclosed their consultation response with regards to the European Commission's proposal to improve the availability, integrity and transparency of ESG ratings.
- In addition, Insurance Europe wrote to the European Commission calling for a reduction to existing reporting requirements as well as ensuring that any new reporting is kept to a minimum.
- The European Supervisory Authorities (ESA) – including EIOPA – issued their Autumn 2023 joint Committee Report on risks and vulnerabilities in the EU financial system.
- The ESAs also published their second annual report on the extent of voluntary disclosure of Principal Adverse Impact indicators under the Sustainable Finance Disclosure Regulation.



UK

- The PRA has invited affected insurers to apply to recalculate their Transitional Measure on Technical Provisions, given the material rise in interest rates.
- The PRA published a consultation paper on proposed reforms to the Matching Adjustment under the Solvency UK regime.
- A senior member of the PRA gave a speech covering completed and anticipated actions towards implementing the new Solvency UK regime. The speech covered the Matching Adjustment, implementation of reforms, stress testing and alignment with international standards.
- Finally, the FCA has published a consultation paper asking insurers to provide feedback on their proposed approach to addressing some existing retained EU law (REUL).

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:

- **Global Sustainable Equity:** Insurers are generally being subjected to increasing expectations around investing more sustainably although what this means in practice can vary materially between insurers. Many insurers are becoming concerned with an apparent trade-off between investing more sustainably whilst preserving financial returns.
  We consider how a Sustainable Equity strategy can target both increased risk-adjusted returns and sustainability criteria.
- **Reporting and Disclosing Sustainable Outcomes:** Insurers are also under increasing pressure from their stakeholders, including policyholders, shareholders, and regulators, to measure, monitor and report on the ESG profile of these assets. We think it is important to report the positive and negative outcomes of investments (particularly those with a more explicit sustainable focus), to provide accurate information and to help improve outcomes for all stakeholders, outlining important environmental and social issues by presenting available data and identifying opportunities for improvement.

Market update

	Yield (%)*		Total 3 month return*
	30 June 2023	30 September 2023	
Euro Treasuries†	3.21	3.55	-2.17% (GBP) -2.52% (EUR)
UK Gilts†	4.46	4.66	-0.63% (GBP)
US Treasuries†	4.37	4.85	-3.21% (GBP) -3.56% (EUR)

	Spread (bps)*		Total 3 month return*
	30 June 2023	30 September 2023	
Global IG Corporates†	138	134	-1.78% (GBP) -2.13% (EUR)
Euro IG Corporates†	156	147	0.27% (EUR)
UK IG Corporates†	153	143	2.26% (GBP)
Emerging Market Debt†	432	430	-3.68% (GBP) -3.99% (EUR)
Global High Yield†	377	376	0.47% (GBP) 0.07% (EUR)

	Price index*		Total 3 month return*
	30 June 2023	30 September 2023	
Global Equities†	431.34	429.09	0.56% (GBP) -0.52% (EUR)
Euro Equities†	4399.09	4174.66	-5.10% (EUR)
UK Equities†	4096.26	4127.24	1.88% (GBP)
Emerging Market Equities†	438.72	438.86	1.12% (GBP) 0.03% (EUR)

	Index*	
	30 June 2023	30 September 2023
Volatility†	13.59	17.52

*Source: Bloomberg, IHS Markit.

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

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

Overview

The third quarter was characterised by mixed data around the world, with central banks coming towards the end of their rate hiking paths, but with cuts still seemingly a while away. The global economic picture is relatively more positive now than it was at the start of the year, but global growth is concerning again amid a disappointing bounce in China activity, slow-to-no growth in Europe and against a backdrop of restrictive monetary policy. The US still looks at risk of recession, even if activity data to date has been fairly robust.

Inflation has fallen significantly and, although higher energy prices threaten a widespread revival in headline inflation, other factors – including a weak economic activity backdrop – should pull inflation lower still. With managing inflation still the priority for central banks, there is still a possibility of further rate hikes from the Federal Reserve (Fed), European Central Bank (ECB) and Bank of England (BoE), but peak rates look to be near, with real rates now well into positive territory.

The euro area economy may already be in mild recession and forecasts continue to pencil one in. Business surveys have deteriorated and look consistent with falling private sector output. Tighter monetary policy will still be feeding through to the real economy. Bank lending conditions have tightened, and loan growth has slowed. High domestically driven inflation continues to point to the balance of risks being in the direction of further hikes.

Over the third quarter, the ECB again raised rates by 50bps. At the September meeting, they signalled that current levels would potentially mark the peak, while leaving the door open for further rate hikes if necessary. Euro area CPI fell to 4.3% year-on-year in September from 5.5% in June. Core CPI fell over the same period too and showed a clearer downward trend than over the previous quarter. The euro area economy grew (only) 0.1% on a quarterly basis in the second quarter – the same outcome as seen in the first three months of the year. However, business surveys signalled a deterioration in activity into more recessionary territory by the end of the quarter.

Government bonds

Global government bond markets continued to see yields move higher – a trend that started in mid-2020. With the end of the rate rising cycle possibly in sight, but issuance expected to remain high, markets have become even more volatile.

In the US, 10-year treasury yields rose to 4.57% from 3.84%, hitting heights not seen in fifteen years, whilst in Germany the 10-year bund yield increased to 2.84% from 2.39%.

Credit

Global corporate bond markets saw similar underlying influences over the third quarter, with differing overall results. All markets faced the headwind of rising government bond yields, but with this mitigated by ongoing additional carry and tighter credit spreads as corporates continued to perform well despite the higher interest rate environment. In the US, the impact of higher government bond yields dominated returns, leading to a negative return over the quarter with the ICE BofAML US Corporate Index returning -2.70%, while in the eurozone and UK, larger spread tightening and smaller government bond yield increases meant positive returns, with the ICE BofAML Euro Corporate & Pfandbrief Index and iBoxx Sterling Non-Gilt indices returning 0.28% and 2.26% respectively.

Equities

Markets made losses over the period on fears that interest rates will remain higher for longer than expected, which saw equities drop to their lowest levels since early June. The quarter also saw a market rotation, with the best performing sector being the fossil fuel-based energy sector, which had underperformed in prior quarters, and the information technology sector giving back some gains, having been the best performing sector year-to-date. For the third quarter, the MSCI World and MSCI All Countries World Index (ACWI) produced negative returns for the quarter in US dollar terms. Looking at national MSCI indices, the strongest market was Japan, while the weakest was Eastern Europe. In terms of style, the MSCI World Growth Index produced weaker returns versus the MSCI World Value Index.

Regulatory updates

1. EIOPA's Insurance Risk Dashboard

On 31 July 2023, EIOPA published its latest Insurance Risk Dashboard, which summarises the main risks and vulnerabilities in the EU's insurance sector through a set of risk indicators. This showed that macro risks are currently the main concern for insurers.

Key observations:

- **Macro-related risks** remained elevated with concerns remaining around the ongoing high inflation environment and economic growth prospects.
- **Credit risks** were assessed as being at a medium level, with credit default swap (CDS) spreads increasing for financial secured bonds in the second quarter of 2023 and receding slightly for other fixed income market segments.
- **Market risks** decreased from high to medium level with volatility in equity markets falling.
- **Liquidity and funding risks** – the analysis showed an increase in cash holdings, but also a decline in the ratio of liquid assets.
- **Profitability and solvency risks** showed a reduction in the investment return for life insurers in 2022 compared to 2021, mainly due to the large increase in unrealised losses following the increase of interest rates. The median SCR (Solvency Capital Requirement) ratio decreased in the first quarter of 2023.
- **ESG related risks** indicate an increasing trend as the median exposure towards climate relevant assets slightly increased to 3.3% of total assets in the first quarter of 2023 and the catastrophe loss ratio further deteriorated. The share of insurers' investments in green bonds over total green bonds outstanding is stable compared to the previous quarter.

What does it mean for insurers?

With the ongoing market volatility, 'higher for longer' interest rate environment, still elevated inflation levels and heightened geopolitical risks, insurers should ensure investment portfolios are resilient and robust to mitigate potential risks that lie ahead. Many insurers would have already conducted a strategic asset allocation review given the fundamental change in market conditions (interest rates and inflation) over recent periods, and this should be reviewed regularly to assess ongoing appropriateness.

2. Insurance Europe feedback on ESG data and ratings

On 4 September, Insurance Europe, the industry body for European insurers, welcomed the European Commission's (EC) proposal to improve the availability, integrity and transparency of Environmental, Social and Governance (ESG) ratings. However, in its consultation response, Insurance Europe set out seven areas of potential improvements to the proposals:

1. **Include raw ESG data products in the scope of the regulation** — as well as ESG ratings, it was stated that ESG data was equally important to support sustainable investment strategies and manage risk with a need for common standards and requirements to improve quality and facilitate reliability and comparability.
2. **Include the entire group of ESG rating providers in the regulation** — to mitigate the potential for avoidance of the regulations through the involvement of third parties.
3. **Disclosure requirements** — should apply in full, regardless of whether these were provided directly from an ESG rating agency, an affiliated company or a third party.
4. **Ensure non-discriminatory access to ESG ratings, including for private investors** — to allow investors to have more insights into ratings and enable smaller institutional investors and retail investors to better include ESG ratings in their investment decisions.
5. **Clear definition of 'financial products'** — it was felt that the EC proposal lacked a clear definition of financial products.
6. **Transitional provisions** — the implementation deadlines and transitional periods should be chosen to allow affected parties to set up the necessary, legal organisational structures.
7. **Risk of market concentration with oligopolistic structures** —to avoid a similar market concentration as seen in credit ratings, the ESG regulations should not impose price restrictions to facilitate a wider number of parties offering associated services.

What does this mean for insurers?

The availability and transparency of credible ESG ratings / data has for some time been one of the main challenges for not only insurers but the wider investor universe. The planned introduction of regulatory standards for ESG rating activities should improve the quality of information and facilitate better informed decisions. However, as for credit ratings, insurers should continue to mitigate reliance on a pure data driven approach for implementing an ESG policy and include wider criteria and data (likely involving other parties such as asset managers).

3. Insurance Europe feedback on reporting requirements for insurers

On 13 September 2023, Insurance Europe wrote to the European Commission calling for both a reduction in existing reporting requirements, as well as ensuring that any new reporting is kept to an absolute minimum, is proportionate, simpler, more consistent across EU regulation, and allows sufficient time for implementation.

Insurance Europe welcomed the March 2023 announcement by the EC to simplify and reduce reporting by 25%. It noted that reporting for EU insurers needed to be simplified and consistent across the different EU regulations that directly or indirectly affected the industry, such as Solvency II, sustainability reporting and the upcoming Retail Investment Strategy.

The more detailed package expected to be unveiled by the EC later in the year.

What does this mean for insurers?

The reforms once unveiled and implemented should provide positive outcomes for the EU insurance industry in reducing and simplifying the existing requirements. This is likely to be particularly beneficial for many smaller to medium sized insurers, where insurance reporting typically represents a proportionally higher cost resource and time burden. Insurers should pay close attention to the more detailed plans due to be released later in 2023 to understand what it would mean for them and plan accordingly.

4. ESAs warn of risks resulting from a fragile economic outlook

On 18 September 2023, the European Supervisory Authorities (ESAs) – including EIOPA – issued their Autumn 2023 Joint Committee Report on risks and vulnerabilities in the EU financial system.

It was acknowledged that recent years have presented a series of challenging events e.g. the pandemic, the Russian aggression against Ukraine, the energy crisis, and the Gilt crisis in the UK. It was noted that most financial institutions (including insurers) have navigated these well, partly supported by sound fundamentals such as robust capital positions. However, a period of heightened uncertainty remains, which presents material financial stability risks.

Against the backdrop of these risks and vulnerabilities, the ESAs advised insurers and other financial institutions to take the following policy actions:

1. Closely monitor the broader impact from any further increases in interest rates and sudden rises in asset risk premia.
2. Remain prepared for a deterioration in asset quality in the financial sector.
3. Closely monitor inflation risks including not just within the assets but also wider exposures (e.g. funding costs and expenses).
4. Maintain and further develop effective risk management and governance arrangements, in particular in relation to liquidity risk and interest rate risk (including being prepared for the potential impact of future interest rate changes).

What does this mean for insurers?

The common regulatory themes around appropriate risk management and liquidity frameworks and reporting monitoring processes are emphasised and insurers should ensure these remain fit for purpose. On investments more specifically, risks around inflation and interest rates were emphasised as well as inherent credit risks in assets. Insurers should ensure that these are being monitored and addressed within investment portfolios (e.g. counterparty diversification, credit limits and a robust Asset-Liability Matching policy).

5. Insurance Europe feedback on international Insurance Capital Standard (ICS)

On 25 September 2023, Insurance Europe responded to a consultation conducted by the International Association of Insurance Supervisors (IAIS) on the Insurance Capital Standard (ICS) as a Prescribed Capital Requirement (PCR). The objective of this is to create a high-quality and robust global insurance standard to promote a robust and consistent global regulatory environment.

In the response, Insurance Europe supports the project's overall objective, but highlighted that the changing nature and scope of the project had impacted on this, particularly with the emphasis now being around an overall reference minimum standard rather than being more detailed.

More detailed feedback from Insurance Europe included:

- Support for the inclusion of internal models in the ICS, but with caution against undermining them through the inclusion of output floors or inappropriate benchmarking.
- Some concerns over the technical specifications of the ICS standard model, notably that the Margin Over Current Estimate (MOCE) parameter – equivalent to the Risk Margin under Solvency II – create an unjustified and excessive prudential buffer as currently described.
- There should be no 'double reporting' requirements given the extensive reporting burdens that insurers are typically already subject to
- The Solvency II, Solvency UK and Swiss Solvency Test (SST) frameworks as appropriate should represent the implementation of the ICS within Europe.

What does this mean for insurers?

The further harmonisation of global regulatory standards should be beneficial for the global insurance sector as a whole and wider stakeholders such as regulators, policyholders, and shareholders.

For European insurers the impact of this is likely to be limited as Solvency II and related frameworks (e.g. SUK) are already generally viewed as the gold standard for regulators globally. However, where insurers have businesses outside of Solvency II type regimes then a more consistent framework is likely to be beneficial but there needs to be care around initial implementation costs, impacts and timelines.

6. ESAs analyse the extent of voluntary disclosure of principal adverse impacts under the SFDR

On 28 September 2023, the European Supervisory Authorities (ESAs) – including EIOPA – published their second annual report on the extent of voluntary disclosure of Principal Adverse Impact (PAI) under the Sustainable Finance Disclosure Regulation (SFDR). These disclosures relate to the impact that investment decisions of financial sector participants (including insurers) have on various sustainability factors.

The main highlights from the report were:

- There was an overall improvement compared to the previous year in the extent of disclosures, although with significant variation in the extent of compliance and the quality of the disclosures both across financial market participants and jurisdictions.
- Disclosures appear easier to find on websites compared to the previous year.
- When financial market participants do not consider principal adverse impacts, they should better explain the reasons for not doing so.
- Financial market participants are generally still not disclosing to what extent their investments align with the Paris Agreement
- Voluntary disclosures of PAI consideration by financial products will be further analysed in future reports.

The 2023 Report also includes a set of recommendations for the European Commission to consider ahead of the next comprehensive assessment of the SFDR.

What does this mean for insurers?

The report highlights that overall progress has been and continues to be made around the voluntary disclosure of PAIs. However, further work is still generally needed around the more detailed disclosure of the degree of alignment with the objective of the Paris agreement, and the rationale for not considering PAIs where relevant. Insurers should allow for this feedback in their future disclosures as well as paying close attention to the evolving requirements in this important area relating to sustainability reporting.

7. EIOPA report on the impact of inflation on the insurance sector

On 5 October 2023, EIOPA published a report on how the current higher inflationary environment impacts insurers in Europe – both to date and looking forwards.

It was noted that the rapid transition from a long period of low inflation and ultra-low rates to a new macroeconomic environment had implications for insurers' capital levels, profitability and liquidity positions, and also for underlying consumers.

- **Capital position** – High inflation together with an increase in interest rates affects insurer's capital positions across both assets and liabilities. The report states that, over the past year, European insurers' assets over liabilities have trended down, but with insurers in general remaining well capitalised.
- **Profitability** – the impact of the higher inflation environment differed materially between insurer type. For non-life insurers, in addition to investment impacts, claims and expense inflation generally required increased reserves and gradual premium adjustments. Life insurers have additionally been facing reduced profits due to higher expenses caused by inflation. The report stated that non-life insurers' underwriting profitability has deteriorated in 2022 relative to 2021, while the return on investments of life and composite insurers was at the lowest level since 2016.
- **Liquidity** – In the current economic landscape, insurers' liquidity positions come under strain for several reasons. With interest rates rising, the value of liquid assets decreases, with any forced sale of these assets incurring losses and reducing future cash flows. Higher claims costs, policy lapses and potential margin calls on derivatives represented additional sources of liquidity risk.

What does this mean for insurers?

The higher inflation environment has and continues to provide material challenges for most insurers impacting on balance sheets, profitability and liquidity. To mitigate this, insurers should consider the following:

- **Understanding inflation exposures and risks** – holistic consideration of inflation risk throughout balance sheet – including assets, liabilities, cashflows, expenses, and liquidity requirements. This can be aided by robust modelling including specific scenarios allowing for interactions with other risks. Any basis risks – particularly for non-life insurers claims exposures – should be understood.
- **Mitigating actions** – consideration of hedging using investments (e.g. inflation-linked bonds or real assets such as real estate and infrastructure) and derivatives (e.g. inflation and / or interest rate derivatives). This should consider the risk vs reward trade-off allowing for any costs or loss of return from hedging, as well as the governance and operational requirements of more sophisticated hedging strategies.
- **Products and profitability** – For life insurers in particular, there may be changes in customer behaviour as consumers consider alternative savings products with higher returns. This could potentially result in reduced new business as well as higher lapse and surrender rates. Insurers should consider their exposure to these longer trends and plan accordingly.

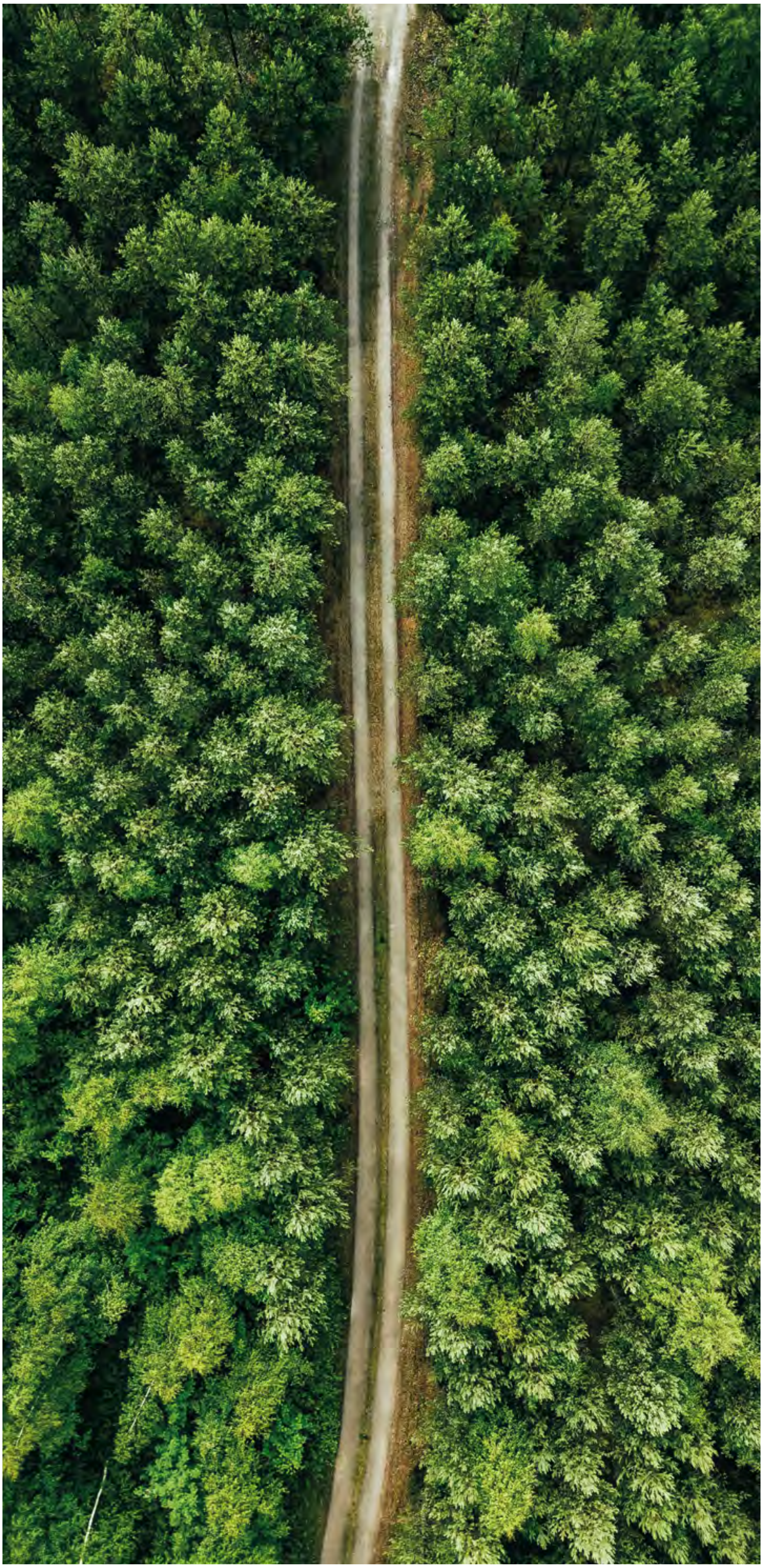
1. PRA invite firms to apply to recalculate TMTP

Given the significant recent rise in interest rates, in a 17 July 2023 statement, the Prudential Regulation Authority (PRA) has invited relevant insurers to apply to recalculate their Transitional Measure on Technical Provisions (TMTP) effective as of 30 June 2023. Since the previous recalculation of the TMTP in December 2021, the PRA has been monitoring market conditions. As a result, the PRA has determined that market conditions have materially changed in a way that has been sustained, with the successive rate hikes that have occurred over the first half of 2023 leading to a change in risk profile for insurers.

As such, the PRA has announced that it is willing to accept applications to recalculate the TMTP of affected firms (as of 30 June 2023).

What does it mean for insurers?

Insurers who have elected to apply the TMTP should undertake analysis to determine whether the recalculation of the TMTP would materially change their balance sheet position as of 30 June 2023. If so, insurers should consider applying to the PRA for a recalculation of the TMTP but also noting that the PRA is expecting firms to demonstrate that a material change in risk profile has occurred and also that existing TMTP calculation methodologies should continue to be applied.



2. Maintaining Momentum for SUK Reform – PRA Speech

On 20 September 2023, a senior PRA representative gave a speech which covered the key points of the consultation paper on Matching Adjustment (MA) reforms, as well as additional considerations for regulatory reform beyond Solvency UK (SUK) implementation in 2024. The speech specifically covered reforms to the MA, the implementation of the reforms, stress testing and alignment with international standards.

Consistent with the PRA's secondary objective to contribute to the growth and competitiveness of the economy, the changes outlined in the speech are intended to create a simplified regime. The SUK is expected to be better adapted to the UK market, support new entrants and facilitate insurers investing in more productive finance.

The PRA has already published several measures (in a Consultation Paper of 29 June 2023) for simplifying various aspects of SII, improving scope for flexibility and fostering a more encouraging environment for new entrants to the UK market. The next milestone was the publication of the consultation paper on reforms to the MA. This covered the following areas for the Matching Adjustment:

1. Improved investment flexibility by widening the scope of eligible assets to include assets with highly predictable cashflows.
2. Simplifying the operational process and streamlining parts of MA approvals, through a new attestation framework. This is targeted to accelerate new investments for inclusion within MA portfolios and make the process more responsive to changes in credit risk.
3. Introduce new supervisory measures to enhance firms' responsibility for risk management. This will be done by improving existing reporting focused on monitoring the evolution of MA portfolios given the significant regulatory reforms and the other relevant market trends such as the growth in life insurers' bulk annuity pension transfers.

The majority of the SUK reforms are expected to be implemented by the end of 2024, whereas the PRA is aiming for mid-2024 for MA reform. It is also considering how it can continue making improvements to the new regulatory regime beyond its implementation in 2024. At present, these considerations include:

1. Stress testing – the development of enhanced stress testing frameworks as well as publishing individual firm's results as opposed to aggregated results for the sector. This is consistent with the evolution of reporting for banks that has already happened.
2. Prudential regulation and the contribution of insurers to the economy – focusing first on life insurers, the PRA will consider the role they play in the supply of risk transfer and finance as well as assessing the potential macroeconomic benefits and costs (through insurer distress or failure).
3. Alignment with international standards – the International Capital Standards (ICS) will provide a minimum set of capital standards that insurers operating within the international space will have to abide by. The SUK regime will be constructed to be consistent with these minimum criteria, facilitating ease of entry to the international markets for domestic insurers.

What does it mean for insurers?

For UK life insurers, the proposed MA reforms are likely to have a direct significant impact on the asset allocation decisions and associated risk management, governance and reporting frameworks. The widening of the available investment universe and the range of products/liabilities that could qualify for the MA will be viewed favourably, albeit the PRA is expecting processes around these to be even more robust.

Life insurers should continue to monitor developments closely given the material impact this is likely to have.

3. PRA consultation paper on Matching Adjustment under SUK

The PRA published a consultation paper dated 28 September 2023 on proposed reforms to the Matching Adjustment (MA) under the Solvency UK (SUK) regime. The reforms fall under the following categories: improved business flexibility; responsiveness to the level of risk; and enhancing a firm's responsibility for risk management.

The goal of the reforms is to enhance flexibility for life insurers to make long term investments in the UK, without eroding policyholder protections. The key proposals are as follows:

- Improving business flexibility
  - Widening the range of assets that can be included within a firm's MA portfolio. The reforms will enhance incentives for insurers to invest in a wider range of assets, which can include those involving a constructing phase.
  - Expanding the types of insurance products / liabilities that can be eligible for the MA.
  - Removing the cap on the MA that can be claimed from sub-investment grade assets, potentially permitting greater allocations to assets close to and below the investment grade boundary.
- Improving responsiveness to the level of risk
  - Streamlined MA application for select assets to improve efficiency and relieve the operational burden.
  - Treatment of breaches of MA conditions to be more proportional.
  - Increased granularity of fundamental spreads (i.e. use of notches within credit ratings) to better reflect the credit quality of the assets held.
- Enhancing firms' responsibility for risk management
  - Introducing an attestation process for the level of MA. This is set to ensure that firms are accountable for MA, with a fundamental spread that is representative of the risks within the firm's pool of assts. The intention is also to reduce systematic risk, where this was previously determined by a single, sector-wide model.
  - Clarifying risk management for sub-investment grade assets with increased risk management whilst facilitating a greater degree of investment freedom across these assets.
  - Better structuring the data submitted to the PRA on the assets and liabilities making up MA portfolios. This includes facilitating more precise determining of MA benefits through a new Matching Adjustment Asset and Liability Information Return (MALIR).
  - Introducing a new MA eligibility condition to demonstrate compliance with the Prudent Person Principle (PPP) including showing that firms have assessed the suitability and risks of assets held within MA portfolios.

The PRA has set 5 January 2024 as the deadline for insurers to submit responses to this consultation paper.

What does it mean for insurers?

The intended changes to the MA under the SUK regime should be positive for affected UK life insurers. The increased scope of assets covered under the MA framework will provide more flexibility to invest into the sub-investment grade assets as well as assets with highly predictable cashflows that were previously ineligible. In addition, the wider scope of insurance liabilities that could qualify for MA treatment is also positive.

Associated with these potential relaxations around asset and liability eligibility is a strong emphasis on risk management, governance and reporting, and insurers should continue to work on these to ensure that they are aligned with the requirements and any changes in asset/liability profile.

We encourage all affected life insurers to respond to the consultation and they should continue to monitor developments very closely given the materiality of the areas covered in the consultation document.

4. FCA consultation paper on the Future Regulatory Framework – The Insurance Distribution Directive

The Financial Conduct Authority (FCA) has published a consultation paper dated 5 September 2023 to all UK firms engaging in insurance activities requesting feedback on their proposed approach to addressing some existing parts of Retained EU Law (REUL). The aim is to integrate the outstanding laws into the FCA handbook and to prioritise operational consistency for insurers. This is part of the wider process of onshoring regulation, which was previously set by the EU, as part of the post-Brexit transition.

The REULs that are affected by this include: establishing a standardised presentation format for the insurance product information document; effecting product oversight and governance requirements for insurers and distributors; effecting information requirements and conduct of business rules applicable to the distribution of insurance—based investment products; effecting various other regulatory technical standards.

The FCA is prioritising operational consistency and as such is not looking to make material changes to the regulations when transferring the REULs over to the FCA handbook. As such, the changes made are to ensure coherency and consistency with the rest of the FCA handbook, and do not represent any material impact or change to requirements of existing operations for insurers.

The deadline for insurers to submit responses to this consultation paper was 9 October 2023.

What does it mean for insurers?

From an operational perspective, it is expected that there will be minimal impact on insurers given the intention is, at least initially, to only translate existing REULs into the FCA handbook.

The FCA is currently considering the feedback received and will then publish the final rules which are expected to be in line with the UK Government's timetable for repealing the relevant legislation. Given the significant operational and information requirements associated with the distribution of insurance products, UK insurers should continue to monitor developments from the FCA and other parties in case more fundamental changes are announced in the future.

Insurance investment themes

1. Sustaining returns within equity. More than just a change in climate…

Insurers are generally being subjected to increasing expectations around investing more sustainably although what this means in practice can vary materially between insurers. The regulatory environment for insurers continues to evolve, with an increasing focus on ESG risks from a broad perspective including risk management, reporting and potentially differentiation in capital requirements.

Some insurers are focusing mainly on mitigating climate risk and supporting the development of a more sustainable society by only investing (at least for part of their assets) in companies with low or zero emissions currently or with a longer-term decarbonisation trajectory. However, whilst this will result in a greening of these insurers' portfolios, arguably at a holistic level this will not achieve the overall objectives of creating a more sustainable society which considers broader criteria, including the concept of a socially acceptable and 'just' climate transition. There therefore needs to be additional steps to achieve the goal of a more sustainable society, for example, by investing in companies that make a positive contribution towards a cleaner, healthier, safer and more inclusive society.

Within our sustainable investment range, climate-related risks are an important factor but by no means the only area we focus on. We assess both sustainable and financials factors equally in buying companies for our portfolio, and the sustainable elements we look at means those companies fall into a number of core themes - as shown for our Global Sustainable Equity strategy in figure 1. This includes broader ESG drivers such as inclusiveness, next generation medicine and digitalisation.

Figure 1: Sustainable themes – RL Global Sustainable Equity strategy

Circular Economy & Environmental Efficiency	14%	Financial inclusion and resilience	18%
Cleaner and safer transport	9%	Hygiene and wellbeing	5%
Digital world	20%	Industry 4.0	7%
Energy transition	6%	Next generation medicine	12%
ESG Leadership	6%	Social & Environmental infrastructure	1%

Source: RLAM internal sustainable themes, for illustrative purposes only. As at 30 September 2023. Excludes cash. Figures may be subject to rounding.

Trade-off between financial returns and sustainability?

Many investors, including some insurers, believe that by investing more sustainably, there could be a loss of financial returns. There is no simple answer to whether there is such a trade-off, and this will partly depend on how targeted the sustainable approach is (e.g. a very specific impact approach that narrows the investment universe materially could impact on returns). In our view however, a more sustainable approach can improve risk-adjusted returns if implemented well. We again use the example of our sustainable investment range to highlight this.

For our sustainable range, our overarching philosophy is that sustainable performance is a good leading indicator of future financial performance and our approach to sustainable investing focuses on exploitable market inefficiencies:

1. **Products & Services** – innovative companies providing solutions to society's challenges achieve higher and more durable growth
2. **ESG Leadership** – companies with leading operational ESG standards are more resilient

Through this, integrating sustainable and financial factors together gives a broader range of inputs into investment decision making. As a result of our investment processes, we can assess and consider sustainable companies who are leaders in their fields with durable competitive advantages and who are financially resilient. In practice, our sustainable approach has delivered superior returns relative to the majority of peers and benchmarks – Figure 2 shows the performance of our Sustainable Leaders strategy (mainly focused on UK equities) and Global Sustainable Equity strategy.

Figure 2: Sustainable Leaders and Global Sustainable Equity strategy performance

Source: RLAM as at 30 September 2023. The inception date of the RL Sustainable Leaders strategy is 29 May 1990, inception figures shown are since 1 January 2004 when we implemented the sustainable investment process.

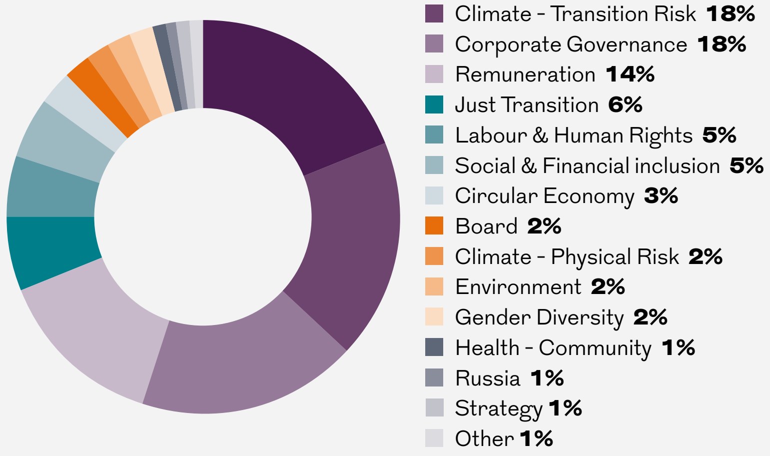
Past performance is not a guide to future performance. The impact of fees or other charges including tax, where applicable, can be material on the performance of your investment.

Engaging for change

Given the long-term focus of sustainable strategies, it is pertinent to also look at the long-term active ownership approach as well. Engagement and voting can be used to support and encourage positive corporate behaviour over a longer investment time horizon and insurers should encourage their managers to be doing this to incorporate their Environment, Social and Governance practices.

Figure 3 shows a list of engagement topics that our Global Sustainable Equity strategy has engaged on, which highlights the importance of engaging and voting across all different topics.

Figure 3: Engagement topics



Source: RLAM. Year to end May 2023. Figures may be subject to rounding.

Delivering the desired outcomes

Where there is the flexibility in an insurers sustainable investment policy to have a longer term and more nuanced approach to supporting the development of a more sustainable society, we believe that this can provide material benefits for both the insurer and wider society.

Within Royal London Asset Management, we have a wide range of investment solutions that focus specifically on helping our clients be an important part of the development of a more sustainable society. This involves investing in companies who are leaders in their fields with durable competitive advantages and who are financially resilient.

The unavoidable fact is that the move to a more sustainable society cannot be done overnight through simple divestment. Insurers as meaningful holders of capital have a crucial role to play in implementing positive change through facilitating improved engagement as well as investing in companies that we believe will deliver more robust growth and lower operational volatility because of strong management of ESG risks. Whilst this approach does require more effort and commitment from both insurers and their underlying asset managers, it is critical that this proactive method occurs to facilitate a more sustainable society and, when implemented correctly, we believe insurers can also benefit through improved risk-adjusted returns.

2. Reporting and disclosing sustainable outcomes

ESG investing - so what have you actually achieved?

Insurers are being subjected to increasing expectations around investing more sustainably. But alongside this, they are also under increasing pressure from their stakeholders, including policyholders, shareholders, and regulators, to measure, monitor and report on the ESG profile of these assets.

Much of the focus has historically (and understandably) been around climate-related metrics (e.g. Weighted Average Carbon Intensity (WACI), warming potential, etc). However, many investors now have a broader focus around monitoring and reporting other criteria such as how the companies invested in are delivering on issues such as diversity, human rights, quality of work, waste, water, and pollution.

We think it is important to report the positive and negative outcomes of investments (particularly those with a more explicit sustainable focus), to provide accurate information and to help improve outcomes for all stakeholders, outlining important environmental and social issues by presenting available data and identifying opportunities for improvement.

The PAI (Principal Adverse Impacts) framework recently developed within the EU has partly taken this forward. The regime is one of the most challenging elements of the EU's Sustainable Finance Disclosure Regulation, requiring relevant firms to provide extensive disclosures on various ESG related matters, including greenhouse gas emissions and other broader areas. However, whilst a positive step forward, this framework does have various drawbacks.

- Only directly applicable for EU insurers
- Some of the disclosures are voluntary
- The metrics that are included are relatively limited in scope, and still more focused around climate-related risks

We believe that a broader framework is beneficial, whether this is as a complement to the PAI disclosures, or in place of this. For our sustainable investment range, we have developed such a disclosure process where we assess alignment of the outcomes to the sustainable objectives, to assess whether the companies we invest in are truly making a positive contribution towards a cleaner, healthier, safer and more inclusive society.

Case Study: Schneider Electric

Schneider Electric is a company in which our Global Sustainable Equity strategy invests, and can be shown as an example of a company we believe contributes to a cleaner society. Schneider Electric leads the digital transformation of energy management and automation in homes, buildings, data centres, infrastructure and industries. To keep pace with the Paris Agreement, which seeks to limit global temperature rise to 1.5°C, Schneider Electric estimates that from now until 2030, society needs to accelerate decarbonisation three to five times more than the current commitments. The company displays strong operational ESG performance and publishes quarterly sustainability reports to track its progress towards its annual and long-term ESG targets. It has committed to several ambitious carbon commitments to achieve net zero both in its operations and supply chain. Figure 4 provides a table which reports on the company's positioning relative to a range of sustainability-related metrics.

Figure 4: How Schneider Electric operates

	2019	2021
Total tCO_2e (Scope 1 + 2 + 3)*	65.9m	66.2m
Carbon Intensity (tCO_2e Scope 1 + 2 + 3/£m)*	2241.7	2149.4
Renewable consumption %**	50%	82%
SBTi approved?***	Scope 1 & 2 targets aligned with 1.5c warming approved as of 2019	
Biodiversity*	Not Available	No significant incidents
Waste**	2.3t / $m EVIC	1.1t / $m EVIC
Recycling**	89.6%	84%
Water**	52.0m³ / $m EVIC	17.2m³ / $m EVIC
Female board**	36%	42%
Female manager**	23%	27%
H&S*	Not Available	10
Employee Reps on Board*	Not Available	3
Equal voting rights?*	Not Available	Yes
Stakeholder constituency provision?*	Not Available	No
CEO: Exec pay ratio less than 3:1*	Not Available	Yes
Vote on exec pay?*	Not Available	Yes
Data security score*	Not Available	10

*Certain information ©2023 MSCI ESG Research LLC. Reproduced by permission. CO_2 emissions based on 2020 and 2018 data due to availability at time of report

** Data from Net Purpose

*** Data from Science Based Targets initiative

Source: RLAM Global Sustainable Equity Outcomes Report 2021.

As well as the absolute level of these reporting metrics, it is also useful to monitor the change over time and the position relative to benchmarks (although the latter is more beneficial at a strategy-level).

Disclosures at strategy-level

Whilst Schneider Electric is just one example, we are able to aggregate these metrics at strategy or fund-level across all relevant companies / investments. For example, using the topic of a cleaner world and society, figure 5 shows overall strategy-level positioning for our Global Sustainable Equity strategy.

Figure 5: Positioning of our Global Sustainable Equity strategy against the benchmark (where appropriate) for the indicators available.

Cleaner	Benchmark (MSCI ACWI)		Global Sustainable Equity Strategy		
Weighted Average Absolute Emissions Scope 1&2 (tCO_2e)	5.1m tonnes	vs	1.5m tonnes	→	71% better
Weighted Average Carbon Intensity Scope 1&2 (tCO_2e / $m revenue)	153 tonnes	vs	45 tonnes	→	71% better
Weighted Average Absolute Emissions Scope 3 (tCO_2e)	37.8m tonnes	vs	10.9m tonnes	→	71% better
Weighted Average Carbon Intensity Scope 3 (tCO_2e / $m revenue)	710 tonnes	vs	409 tonnes	→	42% better
Renewable energy consumption (% of total energy consumption)	54%	vs	59%	→	5% better
Companies with SBTi approved climate targets (% exposure of fund)	32.3%	vs	41.3%	→	9% better
Waste generated (tonnes per $m EVIC)	67 tonnes	vs	0.8 tonnes	→	98% better
Recycling rate (%)	58.0%	vs	63.9%	→	5.9% better
Water use (m^3 per $m EVIC)	6350m^3	vs	52.6m^3	→	99% better
Biodiversity impact (% companies severely impacting biodiversity)	0.12% (4 companies)	vs	0% (0 companies)	→	0.12% better

Source: RLAM Global Sustainable Equity Outcomes Report 2021.

From these indicators, we can then determine where our companies perform well and where they need to make improvements. In the example above, the aggregated position of our companies for the strategy generates 98% less waste than the benchmark, and recycles 6% more than the benchmark.

Similar tables are produced for metrics related to inclusiveness, employee safety, and governance.

Commencing the disclosure journey

The understanding of outcomes and impacts, and data availability, are rapidly and constantly evolving. Currently there are still large gaps in the data, with a low coverage in some of the metrics and a scarcity of readily available data in some of the outcomes.

However, given the pressures that insurers are under to measure, monitor and report on the ESG profile of these assets, we believe it is important to get an initial framework in place that can be developed and enhanced over time. The above illustrates how we are currently approaching this within Royal London Asset Management for our sustainable range.

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.

The price of strategies that invest in a reduced number of holdings, sectors, or geographical areas may be more heavily affected by events that influence the stockmarket and therefore more volatile.

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.

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.

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.

Investing in Emerging Markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

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.

The strategy can only invest in holdings that demonstrate compliance with certain sustainable indicators or ESG characteristics. This reduces the number of securities in which the strategy can invest and there may as a result be occasions where it forgoes more strongly performing investment opportunities, potentially underperforming non sustainable strategies.

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

Ref: PDF RLAM PD 0170

Contact us

For more information about our range of products and services, please contact us. Royal London Asset Management has partnered with FundRock Distribution S.A, who will distribute Royal London Asset Management's products and services in the EEA. This follows the United Kingdom's withdrawal from the European Union and ending of the subsequent transition period, as UK Financial Services firms, including Royal London Asset Management, can no longer passport their business into the EEA.

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