4.5 Geopolitical, Legislative, and Regulatory Risk

Hotspot Description

The risk that actuaries are unable to consider or plan for geopolitical, legislative, and regulatory change, and as such under-react to those changes that involve their actuarial work, resulting in poor outcomes for users.

Current Influences

The COVID-19 pandemic has dominated global life since early 2020 and into 2021. The exceptional risks created by EU Exit have somewhat subsided, but some ongoing risks remain. Regulation of the actuarial profession is undergoing change.

Key developments and JFAR member regulators' actions during 2020/21

Business Interruption insurance

The COVID-19 pandemic triggered widespread policyholder attempts to claim coverage on commercial insurance policies for business interruption (BI), usually via prevention of access / public authority clauses or notifiable disease clauses. In response, various commercial insurers resisted virtually all attempts to claim coverage. The Financial Conduct Authority (FCA) accordingly sought clarification from the UK High Court as a test case,[158] aimed at resolving the contractual uncertainty around the validity of many BI claims. This topic is discussed further in Systemic Risk (Section 4.2, Page 15), sub-section 'Financial Impacts' (Page 17).

The UK High Court handed down a judgment[159] on 15 September 2020, and then subsequently on appeal the UK Supreme Court handed down a judgment[160] on 15 January 2021. Broadly speaking, both judgments found in favour of the FCA / policyholders.[161] [162] In particular, even though it did not rely on the precedent in its judgment, the UK High Court explicitly rejected the 'but for' argument of the insurers; a precedent that originated from a much-earlier case involving a hurricane in New Orleans.[163] A FCA Dear CEO letter[164] swiftly followed.

Insurers' difficulties on this issue were not limited to the UK: for example, in Australia the Insurance Australia Group (IAG) sought to rely on pandemic exclusions in a policy wording which included a reference to an outdated

158 https://www.fca.org.uk/news/statements/insuring-smes-business-interruption
159 https://www.bailii.org/ew/cases/EWHC/Comm/2020/2448.html
160 https://www.bailii.org/uk/cases/UKSC/2021/1.html
161 https://hsfnotes.com/insurance/2020/09/15/judgment-handed-down-in-fcas-covid-19-business-interruption-insurance-test-case/
162 https://hsfnotes.com/insurance/2021/01/15/supreme-court-hands-down-judgment-in-fcas-covid-19-business-interruption-test-case/
163 https://www.bailii.org/ew/cases/EWHC/Comm/2010/1186.html
164 https://www.fca.org.uk/publication/correspondence/dear-ceo-letter-business-interruption-insurance-january-2021.pdf

act of parliament. IAG's position was rejected unanimously by the New South Wales Supreme Court of Appeal.[165]

Business Interruption policy wordings are notoriously complex, but the failure of insurers to defend their interpretation of their own policy wordings and/or the inherent lack of clarity present in the policy wordings could genuinely be regarded as a manifestation of Operational Risk. Searching questions regarding the sizing of Operational Risk in capital models should follow.

Actuaries are generally regarded as 'numbers people' but it may be that broadening the actuarial skillset to encompass analysis of policy wordings is necessary, to satisfy oneself as to the adequacy of pricing, reserving, and capital modelling. This may be achieved by forming an opinion as to the robustness of the governance surrounding policy wordings,[166] rather than a detailed analysis of the policy wordings themselves.

A coalition of UK insurance bodies has done commendable work over the last two decades on Contract Certainty,[167] that is: "*complete and final agreement of all terms between the insured and insurer at the time that they enter into the contract, with contract documentation provided promptly thereafter*." More-recently, on 13 November 2020, the Prudential Regulation Authority (PRA) issued a Dear CRO letter[168] discussing Contract Uncertainty specifically with respect to the COVID-19 pandemic, among other topics.

Contract Certainty and Contract Uncertainty (in these contexts) are separate but related ideas. Contract Certainty is about the 'four corners' of the contract being certain between the two parties at contract inception. Contract Uncertainty is about unexpected circumstances that arise subsequent to contract inception that give rise to a dispute or uncertainty as to the contract's response (sometimes called Unintended Exposures); this has a prudential aspect, with regulators keen to ensure the full range of possible outcomes to the insurer are considered.

An additional area of Contract Uncertainty is how an insurer's reinsurance programme will respond to unexpected circumstances.

EU Exit

The exceptional risks created by EU Exit have somewhat subsided. Following the UK exit from the EU on 31 January 2020 the UK entered a Transition Period,[169] ending on 31 December 2020. A permanent trade agreement (the EU–UK Trade and Cooperation Agreement[170] (TCA)) was announced on 24 December 2020 and was passed by the UK Parliament and subsequently received Royal Assent. The EU, via the European Parliament, only ratified the TCA on 28 April 2021.

The earlier EU-UK Withdrawal Agreement[171] provides (among other things) for free access of goods between Northern Ireland and the Republic of Ireland, if checks are made to goods entering Northern Ireland from the rest of the UK.

Discussions on access to financial markets continue, with progress reported as positive e.g. the Joint UK-EU Financial Regulatory Forum.[172] However, not all discussions have had a positive outcome: on 12 April 2021 the European Commission unexpectedly rejected[173] the UK's attempt to join the 'Lugano convention', an international legal co-operation agreement addressing cross-border civil and commercial disputes.

165 https://www.iag.com.au/iag-responds-business-interruption-test-case-judgment-and-announces-capital-raising-750-million
166 https://www.smh.com.au/business/banking-and-finance/iag-swings-to-460-million-loss-after-preparing-for-covid-related-claims-20210210-p5713g.html
167 https://lmg.london/documents/contract-certainty/
168 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2020/pra-review-reserving-and-exposure-management.pdf
169 https://www.bbc.co.uk/news/uk-politics-50838994
170 https://ec.europa.eu/info/relations-united-kingdom/eu-uk-trade-and-cooperation-agreement_en
171 https://ec.europa.eu/info/relations-united-kingdom/eu-uk-withdrawal-agreement_en
172 https://www.ft.com/content/4222515b-e501-4b7f-82ce-f94810f4a819
173 https://www.ft.com/content/7aad8362-ef75-4578-81eb-38b5d2c51223

The UK is also embarking on a range of non-EU trade initiatives,[174] which may prove positive over time.

UK regulators' relationships with key international regulatory partners and international standard-setters may weaken post-EU Exit, resulting in the UK not being able to shape the global regulatory agenda to the same extent as previously.

Solvency II post-EU Exit

On 24 February 2021 Her Majesty's Treasury issued a Solvency II Review: Call for Evidence.[175] The UK government undertook this review "*to ensure that Solvency II properly reflects the unique structural features of the UK insurance sector*".

One might expect a slight change-of-direction from EU principles, in that the UK government's first-stated objective is "*to spur a vibrant, innovative, and internationally competitive insurance sector*".

Areas of review focus on UK-specific concerns: risk margin, matching adjustment, calculation of the solvency capital requirement, calculation of the consolidated group solvency capital requirement, calculation of the Transitional Measure on Technical Provisions (TMTP), reporting requirements, branch capital requirements for foreign insurance firms, thresholds for regulation by the PRA under Solvency II, and lower regulatory requirements for new insurance firms.

Senior PRA representatives have been active in sharing their thoughts: Anna Sweeney,[176] [177] Sam Woods,[178] and Charlotte Gerken.[179]

Post Implementation Review of Technical Actuarial Standards

On 26 February 2021 the Financial Reporting Council (FRC) published the Post Implementation Review of Technical Actuarial Standards Call for Feedback[180] (PIR TAS CFF), seeking feedback on the current Framework for Technical Actuarial Standards, Technical Actuarial Standard 100 (TAS 100), and a potential actuarial standard in relation to IFRS 17.

The PIR TAS CFF is phase 1: a phase 2 encompassing TAS 200 / 300 / 400 will be released at a later date.

The FRC has not yet developed policy positions on potential changes to the TASs; it is soliciting feedback on a range of issues including professional judgement, modelling, statement and evidence of TAS compliance, and IFRS 17.

Practising Certificates Scheme

On 8 April 2021 the Institute and Faculty of Actuaries (IFoA) launched a consultation on changes to its approach to Practising Certificates[181] (PCs).

The proposals are for more emphasis to be placed on the initial PC application stage than on annual renewals, introduction of a competency-based criteria (rather than the current requirements for technical experience of particular work), and enhanced support for IFoA Members throughout the different stages of the PC process, including the pathway to being a PC Holder.

174 https://www.bbc.co.uk/news/business-54654814
175 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/927345/Solvency_II_Call_for_Evidence.pdf
176 https://www.bankofengland.co.uk/speech/2021/february/anna-sweeney-westminster-business-forum
177 https://www.bankofengland.co.uk/speech/2021/may/anna-sweeney-association-of-british-insurers-prudential-regulation
178 https://www.bankofengland.co.uk/speech/2021/march/sam-woods-association-of-british-insurers-executives-neds-and-chairs-network-webinar
179 https://www.bankofengland.co.uk/speech/2021/april/charlotte-gerken-pre-recorded-18th-bulk-annuities-conference
180 https://www.frc.org.uk/getattachment/3177e677-8d1b-4d95-aaf5-5520167f14ec/-;.aspx
181 https://www.actuaries.org.uk/upholding-standards/regulatory-communications-and-consultations/current-consultations/consultation-practising-certificates-pc-scheme-proposals

Continuing Professional Development

On 1 September 2020 the Institute and Faculty of Actuaries (IFoA) launched a new Continuing Professional Development[182] (CPD) scheme.

The most-significant change was the new requirement to "*arrange and conduct a reflective practice discussion*[183] *with an Appropriate Person*". "*A reflective practice discussion*[184] *is a conversation in which you reflect on what your learning needs and objectives were for the year and the outcomes of your CPD activities*." The IFoA will begin IFoA-led reflective practice discussions with selected IFoA Members from September 2021.

Regulation of the actuarial profession

On 18 March 2021 the UK government published Restoring trust in audit and corporate governance,[185] a consultation document on the UK government's proposals for audit and corporate governance, but additionally on the UK government's proposals for the future of regulation of the UK actuarial profession.

Although tucked away on pages 198-205 of a document of 230 pages, the UK government's proposals for the future of regulation of the UK actuarial profession are potentially significant. Central to the proposals is placing the Financial Reporting Council's (FRC's) oversight of the Institute and Faculty of Actuaries (IFoA) on a strengthened and statutory footing via a new regulator, the Audit, Reporting and Governance Authority (ARGA), rather than the current Memorandum of Understanding (MoU) arrangement. In addition, the setting of technical standards (by ARGA) would be placed on a statutory footing and powers would be extended to allow monitoring of the application of those technical standards.

Climate Change, and other Environmental, Social, and Governance (ESG) risks

Climate change / ESG is discussed more-extensively in Climate-Related Risk (including Biodiversity) (Section 4.1, Page 8), but this topic merits a brief discussion from a geopolitical, legislative, and regulatory risk point-of-view.

After a long period of global discussion, but only modest progress, the last few years have seen considerable change and progress with respect to climate change / ESG actions, and this brings to actuaries the need to understand the elevated geopolitical, legislative, and regulatory risk in actuarial work from climate change / ESG risks. The three hallmarks of climate change risk are:

- risks are long-acting;
- risks are (largely) non-priced; and
- risks have fundamental uncertainty.

Climate change risk affects all actuaries in all disciplines. It is imperative that all actuaries have some level of climate change risk knowledge to inform needed judgement. Regulators, governments, trans-national non-profit bodies, and even some large private actors (e.g. BlackRock, Inc.[186]) are all moving rapidly to impose new standards. Many standards lack legislative backing but carry a heavy burden from a reputational point-of-view for non-compliance (or lack of adoption).

The IFoA has assembled an extensive curated library[187] of resources related to climate change: an exceptional store of information for both the novice and the expert.

182 https://www.actuaries.org.uk/system/files/field/document/2020_09_01%20CPD%20Scheme%20v1.pdf
183 https://www.actuaries.org.uk/system/files/field/document/2020_10_05%20Reflective%20Practice%20Discussion%20Information%20-%20FOR%20PUBLICATION%20v2.pdf
184 https://www.actuaries.org.uk/learn-and-develop/continuing-professional-development-cpd/reflective-practice-discussions
185 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/970673/restoring-trust-in-audit-and-corporate-governance-command-paper.pdf
186 https://www.blackrock.com/ch/individual/en/themes/sustainable-investing/esg-integration
187 https://www.actuaries.org.uk/learn-and-develop/lifelong-learning/sustainability-and-lifelong-learning/climate-change-curated-library

Geopolitical Risk

There are various indices[188] that measure geopolitical risk.[189] Generally, they do this by monitoring the occurrence of key words and topics in selected sources. In this way they measure the relative level of concern as a proxy for the underlying risks.

In addition to post-EU Exit UK-EU friction (including in Northern Ireland) the changing dynamics of international relations of the US administration of Joe Biden, particularly with respect to China and Russia and in addition to rogue states like North Korea, present particular geopolitical risk.

Actuaries may also need to consider the possible impact on equity prices and volatility when matching assets to liabilities or selecting asset portfolios for investors, as the impact on the asset side of the balance sheet could be significant.

Models need to be understood carefully to ensure that they include allowance for a suitable level of the risk of geopolitical impacts. In this regard it may be useful to consider giving greater prominence to scenario-testing techniques.

Supply Chains

Global supply chains may be subject to disruption and this may impact business costs, highlighting the need for resilience planning. Recent examples include EU Exit, COVID-19, vaccine nationalism, and the Ever Given[190] container ship that disrupted global trade via the Suez Canal. Resilience planning will likely result in the need to build 'reserves', a carrying cost that may be resisted. Ongoing risks remain with respect to the highly uncertain outcomes of climate change, and other environmental, social, and governance (ESG) issues such as societal justice / fairness and 'inclusive wealth' will become more significant.

In addition, global supply chains remain extremely susceptible to terrorism and cyber-sabotage.

Claims costs on personal lines motor insurance could increase as supply chains are heavily dependent on efficient movement of goods; claims costs on property insurance could increase as labour could become more difficult to source (particularly post-EU Exit). Short-to-medium-term modelling (pricing, reserving, and capital modelling) could become more difficult due to the increased uncertainty. Care is needed to anticipate changes in supply chain disruption, costs of production and movement, and the risks of unanticipated loss (e.g. due to terror attacks, nationalisation, or infrastructure failure).

IFRS 17 Insurance Contracts

The adoption and implementation of IFRS 17 will have an impact on the work of actuaries. The IASB's objectives for IFRS 17 are to improve the consistency, transparency, and comparability of financial reporting for insurance contracts globally. The implementation is an opportunity for actuaries to work with other functions to support a smooth transition to the new financial reporting basis. Challenges for actuaries may arise from implementation, interpretation, and communication of the changes in actuarial work supporting financial reporting.

Part VII Insurance Transfers

Part VII insurance transfers are subject to UK High Court approval. In 2019 Prudential reached an agreement with Rothesay Life to transfer a closed book of business; both the FCA and the PRA did not object to the transfer. An independent expert opined that the transferring policyholders would be at least as well protected as previously, based on the solvency capital of Rothesay Life. Some

188 https://www.blackrock.com/corporate/insights/blackrock-investment-institute/interactive-charts/geopolitical-risk-dashboard
189 https://www.matteoiacoviello.com/gpr.htm
190 https://en.wikipedia.org/wiki/Ever_Given

policyholders did object, however, and on 16 August 2019 the judge refused to approve the transfer[191] citing the reputational advantage of Prudential over Rothesay Life and the likelihood of parental support for the former in the event of financial distress.

On 2 December 2020 the Court of Appeal allowed the appeal.[192] The Court of Appeal emphasised the importance of the Solvency II Solvency Capital Requirement (SCR) in Part VII insurance transfer approvals, and the role of effectively communicating technical matters to potentially affected policyholders.

The Court of Appeal gave guidance on the word 'material' as it pertained to potentially affected policyholders: "*real or significant, as opposed to fanciful or insignificant*", and most-certainly excluding non-contractual support potentially available to parties to a transaction, and further excluding any subjective factor.

Equity Release Mortgages

On 17 June 2020 the Financial Conduct Authority (FCA) published a report on the equity release sales and advice process.[193] While less directly connected to actuarial work, actuaries operating in this field should be alert to the potential for poor advice to consumers, and the subsequent prudential risk to legal entities offering equity release mortgages.

The PRA released a Dear Chief Actuary letter[194] in February 2021 reminding chief actuaries of the PRA's earlier Supervisory Statement on Solvency II: illiquid unrated assets[195] (SS3/17) and more-particularly the assessment of the appropriateness of the matching adjustment (MA) benefit life insurers derive from restructured equity release mortgages.

This topic is discussed further in Unfair Outcomes for Individuals (Section 4.4, Page 27), sub-section 'Equity Release Mortgages' (Page 30).

Funeral Plans

In January 2021 the UK government legislated to bring pre-paid funeral plans ('funeral plans') under FCA regulation from 29 July 2022, and from that same date consumer disputes may be referred to the Financial Ombudsman Service (FOS). The Financial Conduct Authority (FCA) launched Funeral Plans: Proposed approach to regulation, Consultation Paper CP21/4[196] on 2 March 2021, and on 5 July 2021 published final rules, guidance and standards (PS21/8)[197] for when the pre-paid funeral plans sector enters FCA regulation.

Replacing a period of self-regulation, the FCA's rules are quite broad, covering conduct standards, prudential soundness, and consumer dispute resolution. For example, the FCA has included a rule that "*a funeral plan provider must arrange for a solvency assessment report to be produced at least once every 12 months by an actuary who is a fellow of the Institute and Faculty of Actuaries*".

The IFoA issued a Risk Alert on 15 January 2021: Transitional risks for UK Trust-based Pre-paid Funeral Plans.[198]

In July 2020 the Financial Reporting Council (FRC) published an updated Technical Actuarial Standard 400[199] (TAS 400).

191 https://www.bailii.org/cgi-bin/format.cgi?doc=/ew/cases/EWHC/Ch/2019/2245.html
192 https://www.bailii.org/cgi-bin/format.cgi?doc=/ew/cases/EWCA/Civ/2020/1626.html
193 https://www.fca.org.uk/publications/multi-firm-reviews/equity-release-sales-and-advice-process-key-findings
194 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2021/february/feedback-on-the-application-of-the-evt.pdf
195 https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss
196 https://www.fca.org.uk/publication/consultation/cp21-4.pdf
197 https://www.fca.org.uk/publications/policy-statements/ps21-8-regulation-of-funeral-plans-feedback-to-cp21-4-and-final-rules
198 https://www.actuaries.org.uk/system/files/field/document/January%202021%20Risk%20Alert%20-%20Funeral%20Plan%20Trusts.pdf
199 https://www.frc.org.uk/getattachment/7c531301-230c-4c9b-9fe1-1ddd10aeca56/TAS-400-Jul-20-Full.pdf

Pension Schemes Act 2021

The Pension Schemes Act 2021[200] received Royal Assent on 11 February 2021. The Act requires trustees of Defined Benefit pension schemes to set a long-term objective and determine a consistent "*funding and investment strategy*". The Act also expanded the powers of The Pensions Regulator (TPR), and made provisions for the Pensions Dashboards Programme (PDP), for regulation of trustees of occupational pension schemes with respect to climate change governance, and for regulation imposing limits on the right to transfer.

The Act also established a framework for Collective Defined Contribution (CDC) schemes ('collective money purchase schemes'). This will be a new area of work for actuaries, who will have responsibilities in helping design the CDC schemes and acting in the capacity of CDC scheme actuary.

A new code for funding defined benefit pension schemes

TPR is working to revise its code of practice on DB pension schemes' funding to provide better security for pension schemes' members through greater clarity on the standards of funding expected, and to embed good practice in the management of long-term risks. Among other things it will provide greater clarity to ensure the flexibilities in the regime are used appropriately and set out a framework within which pension schemes can determine prudent technical provisions, appropriate recovery plans, and investment strategies which can be supported by the sponsoring employer's covenant. A consultation[201] seeking views on aspects of the new framework was undertaken in 2020, and a second consultation to include a draft code of practice for pension schemes' funding is expected to be published in December 2021.

Annual guidance on actuarial valuations of DB pension schemes

Each year TPR issues their Annual Funding Statement[202] to provide pension schemes' trustees undertaking actuarial valuations with guidance on navigating topical issues to set funding and investment strategies which balance fairly the interests of pension schemes' members and sponsoring employers. The focus has been on an integrated approach to risk management, with a key role for actuaries in advising pension schemes' trustees and sponsoring employers on the complex issues. Recent statements have dealt extensively with new risks for maturing pension schemes including the impact of COVID-19 and EU Exit on the actuarial assumptions, as well as on the sponsoring employer's ability to finance contributions and to support investment risk.

200 https://www.legislation.gov.uk/ukpga/2021/1/contents/enacted
201 https://www.thepensionsregulator.gov.uk/en/document-library/consultations/defined-benefit-funding-code-of-practice-consultation
202 https://www.thepensionsregulator.gov.uk/en/document-library/statements/annual-funding-statement-2021