HYMANS ROBERTSON

Newsflash

Solvency II: Prudent Person Principle

On 18 September, the PRA published a Consultation Paper (CP22/19) laying out its proposed expectations in relation to the Prudent Person Principle. The requirements cover firms' investment strategies, investment risk management and governance systems, with the Consultation Paper ('CP') laying out areas of focus to ensure compliance with the PPP.

In this newsflash, we take a look at the proposed regulation in relation to:

- The development and maintenance of investment strategies;
- The management of investment risks, including internal governance; and
- Investment in illiquid or 'non-traded assets' and intra-group loans and participations.

The Prudent Person Principle

On 1 January 2016, Solvency II introduced the Prudent Person Principle ('PPP') to insurance investment, replacing a set of asset admissibility rules and quantitative limits that had applied under Solvency I. This brought greater investment freedom for insurers, provided they could demonstrate that their actions met the benchmark standard of the prudent person.

The PPP has three general principles defining **what** assets can be invested in, **how** the portfolio should be managed and prioritising **the interests of policyholders**[1]:

1. the firm must only invest in assets and instruments the risks of which it can properly identify, measure, monitor, manage, control and report and appropriately take into account in the assessment of its overall solvency needs;
2. all the assets of the firm must be:

   (a) invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio of assets of the firm as a whole; and

   (b) localised such as to ensure their availability; and
3. in the case of a conflict of interest, the firm must, or must procure that any third party which manages its assets will ensure that the investment of assets is made in the best interest of policyholders.

Over the nearly four years since the launch of Solvency II, the PRA has provided UK insurers with plenty of guidance around their investments – from internal ratings of illiquid assets to the management of climate risk, and from liquidity risk management to requirements for securitisations. Now, for the first time, the regulator has addressed the PPP directly, setting out its proposed expectations in CP22/19 "Solvency II: Prudent Person Principle".

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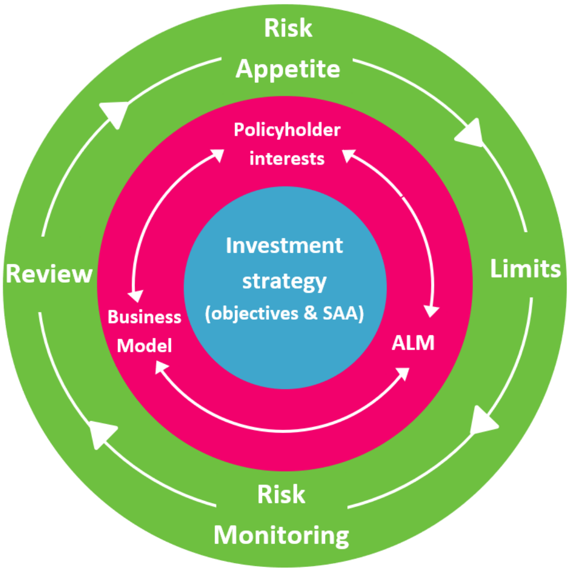
[1] As defined in the Investments section of the PRA Rulebook.

Investment strategy

The PRA sets out its minimum expectations for how a firm should develop and maintain its investment strategy. It envisages – and lays out requirements for – the embedding of firms' investment strategies into the wider strategy of the firm.

A firm's investment strategy should allow for operational and structural constraints. These will be dictated not only by the firm's business model – including the profile of its liabilities – but also by the need to consider the best interests of policyholders in the investment decision-making process.

More broadly, a firm's investment strategy should be aligned with its Board's risk appetite and a clearly defined set of risk tolerance limits. The appropriateness of the investment strategy should be "challenged, approved and controlled" on an ongoing basis, informed by a continual process of investment risk monitoring and review. More detail on the requirements relating to risk limits and monitoring are laid out below.



Investment risk management

The PPP requirements relating to investment risk management can be summarised under 4 key areas: *risk measurement, risk monitoring, setting of risk limits* and *diversification of risk*.

Risk Measurement

Risk measurement is a natural first step and, as a part of this, firms should seek to quantify the impact of potential investment risks crystallising. This can be supported by scenario analysis, both in the absence of and allowing for assumed management actions.

Of particular interest is the impact of risk events on a firm's **solvency position** and its **ability to pay policyholders**, both of which should be quantified.

Risk Monitoring

Once investment risk has been measured, firms need to monitor factors which could materially change the level of risk in their portfolios. These factors include:

- Asset values and volatility
- Asset characteristics (e.g. credit rating)
- The external environment affecting asset security
- The firm's risk profile leading to asset-liability mismatches

Firms should also monitor for breaches of internal risk limits and concentrations of single risk exposures (see below).

Additionally, the PRA draws attention to the need to monitor the effectiveness of any hedging arrangements, and it notes that the control of both spread and default risk are areas where firms should pay particular attention.

Setting risk limits

As part of an effective risk management policy, the PRA expects firms to set quantitative investment limits for their asset portfolios.

These limits should be consistent with the Board risk appetite and defined (at least) in terms of **asset class, geography, single-name exposure, sector and off-balance sheet exposures.**

These limits should reflect factors including:

- The nature and duration of the firm's liabilities
- Access to appropriately sophisticated investment risk management capabilities
- The perceived 'riskiness' of each category of asset
- The need for "proper diversification" of the asset portfolio.

Diversification of risk

In addition to setting quantitative risk limits, firms must ensure that assets issued by the **same issuer or group** do not lead to an excessive accumulation of risk. Firms should demonstrate this through stress testing under a range of scenarios.

Exposure to a single source of risk should not demonstrably threaten the solvency of a firm even in a severe stress scenario. If firms have "excessive" levels of concentration risk in their portfolios, the PRA notes that they can expect to be subject to greater regulatory scrutiny.

Firms should also lay out in their investment risk management policy how they have identified and are managing any potential excessive concentrations of risk.

Non-traded assets

Investment in non-traded assets is becoming ever more popular, not just amongst annuity providers – where we are seeing record levels of buy-ins and buy-outs – but also for some with-profits funds and general insurers.

The PRA notes the non-standardised nature of these assets – as opposed to exchange-traded assets – and highlights an additional level of consideration that will need to be given to the risks arising from such investments[2].

Firms should ensure they have an appropriate valuation methodology – noting the additional valuation uncertainty that can arise due to the lack of an independently verifiable market price – and (where applicable) a robust internal rating methodology. Firms will be expected to increase their level of expertise in line with the volume and complexity of non-traded assets on their balance sheets.

Overall, firms will be expected to set **quantitative limits** specifically for non-traded assets and to keep overall volumes at **"prudent levels"**.

Intra-group loans

On the topic of intra-group loans, the PRA highlights that assets used to back Technical Provisions must be invested in the **"best interests of all policyholders"**, and that intra-group loans may not meet this objective.

It notes that conflicts of interest may arise between shareholders and policyholders, and loan issuers may find themselves in a position where they are unwilling, or indeed unable, to enforce repayment.

The Board must be satisfied that any potential conflicts of interest have been resolved before proceeding with an intra-group investment.

It is also to be noted that intra-group assets should be subject to the same levels of scrutiny and governance as any other investment opportunity.

[2] A topic that the PRA has addressed elsewhere, most recently in CP23/19.

What next?

The proposed regulations included in CP22/19 are open for consultation until mid-December 2019.

Whilst the PPP sets standards which touch on many aspects of an insurer's investment activities, the requirements are not prescriptive and still facilitate a broad range of possible investment strategies.

Nonetheless, the PRA has reminded firms that it will exercise "independent judgement" in relation to these standards and will expect firms' **senior managers responsible for investment** to take action if it feels that these standards are not being met. In particular, it highlights the role of the CRO in keeping the Board informed of all risk management processes across the business, including investment risk management.

Notably, the CP includes two examples of case law where the courts have determined whether an objective, prudent, standard has been met – a message, perhaps, to take this topic seriously.

Over the coming months, firms may wish to review their investment risk management approaches and governance structures in advance of the proposed regulation coming into force.

Hymans Robertson has a wealth of experience across all matters relating to Investment and ALM. We would be delighted to support you in understanding the implications of the proposed Prudent Person Principle requirements for both your investment and risk functions.

If you would like to discuss with one of our specialists, please get in touch.

Ross Evans
Head of Insurance Investment & ALM
ross.evans@hymans.co.uk

Daniel Becker
Insurance Investment Lead
daniel.becker@hymans.co.uk

Liam Mohan
Life Consultant
liam.mohan@hymans.co.uk