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UK: PRA publishes Consultation Paper 22/19 "Solvency II: Prudent Person Principle"

On 18 September 2019, the Prudential Regulation Authority (the "**PRA**") published Consultation Paper ("**CP**") 22/19, which details its proposed expectations of firms investing in accordance with the Prudent Person Principle ("**PPP**").

Background

The PPP can be found in Chapters 2 to 5 of the Investments Part of the PRA Rulebook, which transposes Article 132 of the Solvency II Directive (2009/138/EC). The PPP sets objective standards for prudent investment which, when applied to a particular firm's circumstances, are likely to allow for a range of reasonable investment strategies.

In addition, the PPP embeds investment activity within the wider qualitative risk management requirements placed on firms under Solvency II. The PPP requires firms to have adequate governance and risk management in place and requires investment decisions to be made in the context of a firm's broader framework for enterprise risk management.

Proposals

CP 22/19 draws on the PRA's recent discussions with industry, in the light of which the PRA has identified certain inconsistencies in the way the PPP is applied by firms. CP 22/19 sets out the PRA's proposed expectations for the management of investment risk in accordance with the PPP in a draft Supervisory Statement ("**SS**"). The PRA has noted that it will exercise independent judgement regarding whether a firm is meeting the requisite PPP standards.

The proposed SS sets out the PRA's expectations in relation to the following areas.

Investment governance and risk management under the PPP

The PRA proposals include expectations relating to firms' investment strategies. In particular, some investment risks may only be properly addressed via governance requirements, such as board oversight of changes to the investment strategy and clear documentation of firms' compliance with the Investments Part of the PRA Rulebook.

The proposed SS also sets out detailed requirements regarding the content of firms' risk management policies and investment risk monitoring frameworks. When firms invest in asset structures where the risk exposure depends on the performance of underlying assets, firms' risk management frameworks must include the risks of those underlying assets. As part of their investment risk management policies, firms must develop internal quantitative investment limits for assets and exposures, which must take into account counterparty risk.

Diversification and asset concentration risk

The proposals include expectations about the factors that firms should consider for the purposes of avoiding "excessive accumulation of risk" in their portfolio as a whole, including when setting their own investment limits. The PRA expects firms to stress test their portfolio to demonstrate proper diversification and the SS sets out expectations relating to stress testing exposures to risk concentrations.

The PRA proposes that firms' internal investment limits should take into account the characteristics of the assets held, levels of risk correlation between individual assets and common exposure to single risks.

The PRA would expect firms to be able to demonstrate that the limits they set can be justified in accordance with the requirements of the PPP, within the overall context of their investment strategy, their overall risk appetite, and their approach to risk management, and that they would be able to provide evidence of not exceeding these limits.

Outsourcing

The PRA proposals include expectations relating to the outsourcing of investment activities, including the expectation that firm's will undertake appropriate due diligence and be confident that external parties have sufficient risk management expertise to comply with the proposed SS.

Exposures to non-traded assets

One of the key concerns that the PRA intends to address in the draft SS is the increase in life insurers with annuity books having exposure to assets not admitted to trading on a regulated market, such as equity release mortgage loans and commercial real estate loans. These non-traded assets require firms to have specific expertise and sophisticated systems, may give rise to new concentrations of risk and introduce additional valuation uncertainty and liquidity risk which the firms needs to manage properly. All of these factors need to be considered in light of the PPP.

The PRA considers that firms should fully assess the risks posed by investment in non-traded assets. In addition to requiring firms to avoid excessive accumulation of risk in their investment portfolio as a whole, the PPP specifically requires firms to keep investment in non-traded assets to prudent levels. Firms must also ensure that key persons have sufficient experience and expertise in relation to non-traded assets and that suitably severe stress scenarios are used when assessing the suitability of investments in such assets. The proposed SS sets out expectations of firms for the purposes of complying with these requirements. The PRA also proposes that firms take particular care when determining internal quantitative limits for non-traded assets, due to the additional risks they introduce.

Valuation uncertainty

Where firms invest in non-traded assets, they introduce additional valuation uncertainty risk into their portfolios. The proposed SS includes the expectation that firms should take into account valuation uncertainty risk for non-traded assets for the purposes of complying with the PPP. When assessing whether firms are meeting this requirement, the PRA proposes to consider (among other things) the extent to which the firm complies with its requirements under the Commission Delegated Regulations (EU) 2015/35 in relation to the valuation of assets both at the point of purchase and on an ongoing basis.

The proposed SS includes the PRA's expectation that the more material a firm's exposure the greater the skills and expertise that will be required of the persons involved in the valuation of these assets.

Intra-group loans and participations

The PPP requires that assets backing technical provisions are invested "in a manner appropriate to the nature and duration of the firm's insurance and reinsurance liabilities and in the best interest of all policyholders, taking into account any disclosed policy objectives" (PRA Rulebook, Investments, 3.1)). This has particular implications for intra-group transactions, as investments in or loans to other group companies may be in the best interest of shareholders but not necessarily in the interests of policyholders.

The PRA expects that it would be difficult for firms to demonstrate that intra-group loans and participations are in the best interest of policyholders and, as such, difficult to demonstrate that they are appropriate for covering technical provisions.

The PPP requires that in the case of a conflict of interest "the investment of assets is made in the best interest of all policyholders" (PRA Rulebook, Investments, 2.1(3)). The PRA considers that investment in intra-group assets is very likely to lead to a conflicts of interest, and it proposes setting the expectation that the Board should be satisfied that any conflicts of interest have been resolved in the best interest of policyholders before investing in an intra-group asset. The PRA would also except that any conflicts of interest that arise following investment in an intra-group asset should also be resolved in the best interest of policyholders. This may mean ceasing to invest in that asset.

Although remaining interested in intra-group reinsurance arrangements, the PRA generally expects that such arrangements with no element of investment are less likely to create conflicts of interest than intra-group loans.

The PRA also expects intra-group assets to be subject to the same "arm's length" scrutiny and risk management as other investments subject to the PPP.

Interaction with Brexit

The current proposals have been designed in the context of the current UK and EU regulatory framework, and therefore the proposals contained in CP 22/19 will be affected in the event that the UK leaves the EU with no implementation period. In that instance, the proposed supervisory statement should be read in conjunction with SS 1/19 "Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU".

Next Steps

The PRA proposes that the expectations in the proposed SS will apply from the date of its final publication.

The consultation documentation can be found on the PRA's site, here. Firms have until 18 December 2019 to respond via email to CP22_19@bankofengland.co.uk.