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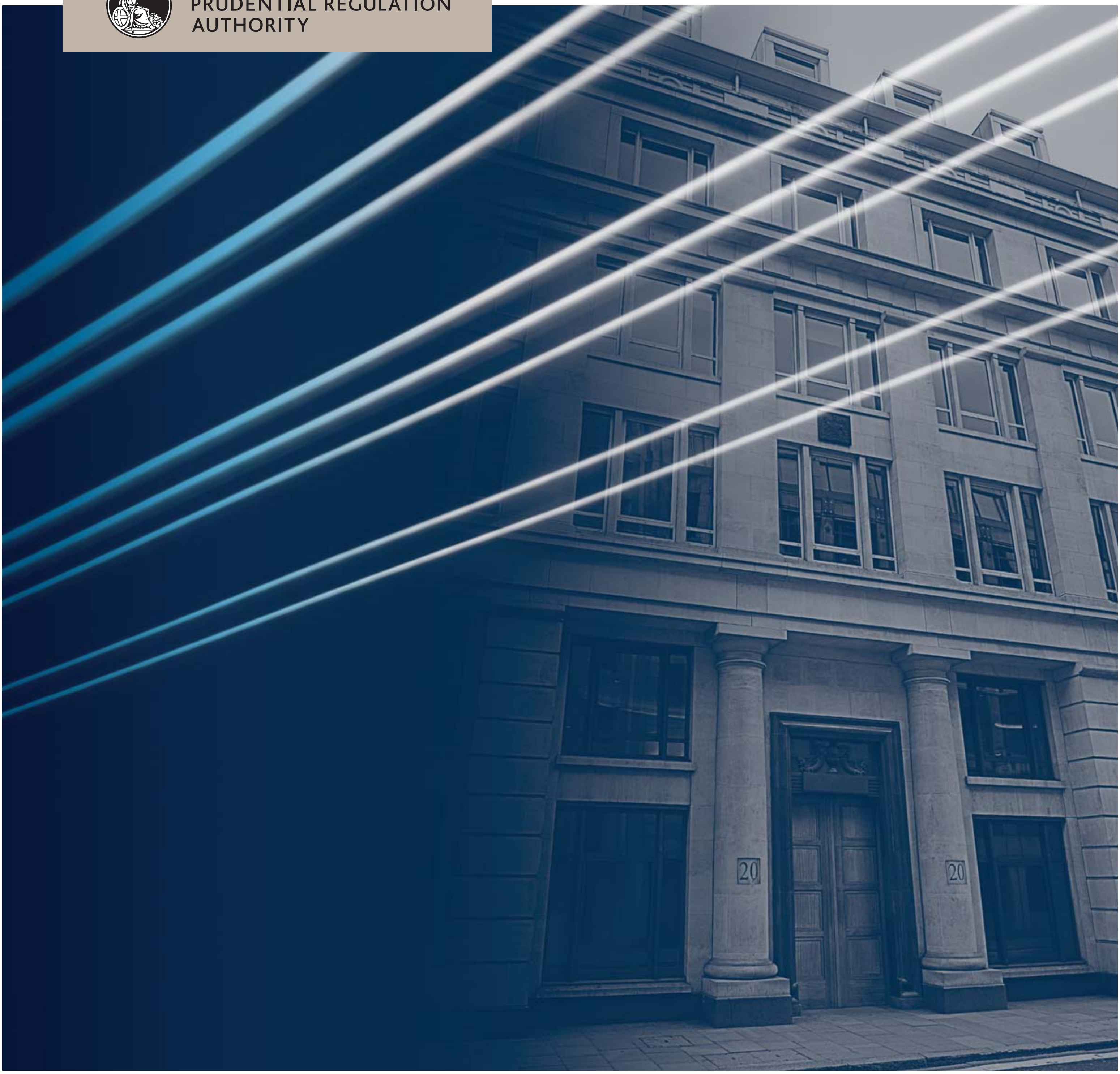
Supervisory Statement | SS9/14

Valuation risk for insurers

August 2014

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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1 Introduction

1.1 This supervisory statement sets out the Prudential Regulation Authority's (PRA's) expectations of firms in relation to existing rules on the valuation of financial assets. It applies to all PRA authorised insurers (firms) and may also be relevant to insurance holding companies and other entities in the same group, together with their advisors. The statement is equally relevant to life and general insurers, whether they are mutuals or proprietary companies.

1.2 The statement seeks to reduce the risk to the PRA's objectives caused by intended or unintended misstatement of values and hence misstatement of capital resources, by clarifying the PRA's existing expectations. The statement is therefore designed to help the PRA meet its statutory objectives of promoting safety and soundness of the firms it regulates and, specifically for insurers, to contribute to securing an appropriate degree of protection for policyholders, along with its secondary objective; to promote effective competition.

1.3 The PRA's public consultation(1) on this statement ended on 11 July 2014. At consultation, the PRA considered the way in which the policy advances the PRA's objectives, the impact on mutuals; consistency with the Regulatory Principles;(2) the impact on equality and diversity and the costs and benefits of the proposed policy. The PRA's findings on these issues are unchanged following consultation and the PRA's consideration of the feedback received.

1.4 This statement does not represent a change of policy. Future clarifications or expectations on the topic of valuation risk may be added to the statement.

Response to consultation feedback

1.5 The feedback received during the consultation period identified some elements of the text that the PRA considers require further clarification. The following points clarify important issues raised in the feedback, that are not reflected in the statement (as they are not directly related to the content of the statement):

- Accounting fair value and regulatory prudent value are not the same. Accounting guidelines, in general, target neutrality, whereas GENPRU 1.3 explicitly requires prudence. Areas where differences may arise include (but are not limited to), the treatment of model risk, credit valuation adjustments and concentrated positions. Differences may arise due to the level of judgement inherent in estimating fair value, or because the basis of measurement adopted or prescribed under accounting rules differs from a prudential basis.
- IFRS 13.88 refers to the need for fair value to reflect risk adjustments that a market participant would make in pricing to compensate itself for market, non-performance, liquidity and volatility risks. These adjustments are required in order to calculate the expected value that would be obtained on exit of a position. This is not the valuation uncertainty referred to in this statement, which instead relates to the range of plausible values for this exit price.

2 PRA expectations regarding valuation uncertainty and prudent valuation

2.1 The PRA reminds governing bodies of firms to review their compliance with GENPRU 1.3(3) on valuation uncertainty and prudent valuation(4) and expects firms to have governance and processes in place to meet these requirements.

2.2 In order to comply with GENPRU 1.3, firms must monitor and manage valuation risk. This risk is often most material for portfolios of structured products or illiquid securities. In such cases, the insurers' assessment and quantification of valuation uncertainty needs to be sufficiently robust and complete. Valuation uncertainty is the term used to refer to the existence, at the reporting date and time, of a range of plausible values for a financial instrument or portfolio of positions. Determining a prudent valuation requires an assessment of valuation uncertainty, which is a measure of valuation risk.

2.3 The assessment and quantification of valuation uncertainty needs to be underpinned by adequate standards of financial asset valuation governance and control. This includes sufficient independence in valuing assets, adequate documentation of policies and procedures, appropriate control over valuation models (including an understanding of model assumptions and limitations), suitable management information and consistent governance between internally and externally managed funds. Where governance and control failings over asset valuations exist, the increased valuation uncertainty should be reflected in reporting on the affected portfolio.

2.4 Where firms consider valuation uncertainty to be immaterial, the PRA expects that there would be some analysis to evidence this. While valuation uncertainty can be significant for complex financial products (eg derivatives), it can also be significant for vanilla products (eg where a firm holds illiquid equities or corporate bonds, for which there is no transparent market price).

(1) *PRA Consultation Paper CP10/14*, 'Valuation risk for insurers', May 2014; www.bankofengland.co.uk/pra/Documents/publications/cp/2014/cp1014.pdf.
(2) Section 3B of the Financial Services and Markets Act (FSMA) 2000.
(3) Of the General Prudential sourcebook of the PRA Handbook.
(4) For the purpose of this statement, references to prudent valuation mean prudent valuation in accordance with GENPRU 1.3.

3 PRA expectations regarding client-supplied prices

3.1 One example of the governance and control failings referred to in paragraph 2.3, is the lack of appropriate controls around what are commonly referred to as 'client-supplied' prices.

3.2 For the purposes of this statement, the term 'client-supplied' prices, refers to prices or pricing inputs that are sourced by external valuation providers directly from their clients (insurers/investment managers/other relevant entities). Such prices, when received from external valuation providers, may have the appearance of being independent when they are not. We have seen utilisation of 'client-supplied' prices where the valuation function has been outsourced by an insurer, investment manager or other relevant entity.

3.3 The lack of independence inherent in 'client-supplied' prices may allow investment managers to manipulate their performance. In the absence of effective controls to highlight 'client-supplied' prices, insurers, investment managers or other relevant entities may be unable to identify and address the lack of independence and potential manipulation.

3.4 The PRA expects firms to monitor and limit, their use of 'client-supplied' prices and to have clear visibility of all price sources used, in particular where 'client-supplied' prices are used in their valuations. The PRA expects that insurers and their investment managers will not supply their own prices or pricing inputs to external valuation providers without additional governance (eg appropriate sign-off) and documented justification.

3.5 In situations where practical alternatives to 'client-supplied' pricing are not available, the PRA expects to see robust controls including (but not limited to) independent price verification and reporting of the materiality of 'client-supplied' prices to senior management.