



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP10/14

Valuation risk for insurers

May 2014

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Please address any comments or enquiries to

CP10_14@bankofengland.co.uk by Friday 11 July 2014.

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1 Introduction

1.1 This consultation seeks views on a draft supervisory statement which sets out the PRA's expectations of firms in relation to existing rules on the valuation of financial assets.

1.2 The draft supervisory statement is intended to apply 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 intended to be equally relevant for life and general insurers — whether they are mutuals or proprietary companies.

Purpose of the statement

1.3 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 to promote the safety and soundness of the firms it regulates and contribute to securing an appropriate degree of protection for policyholders, along with its secondary competition objective.

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

Statutory obligations

1.5 The PRA has considered matters to which it is required to have regard, and it considers that this draft statement is compatible with the Regulatory Principles in section 3B of the Financial Services Act 2012⁽¹⁾ and relevant provisions of the Legislative and Regulatory Reform Act 2006. The PRA has considered equality and diversity issues and has not identified any impacts arising from the statement.

1.6 Please address any comments or enquiries to CP10_14@bankofengland.co.uk by Friday 11 July 2014.

(1) In particular, section 3B(1)(b) which provides the principle that a burden or restriction which is imposed on a person, or on the carrying on of an activity, should be proportionate to the benefits, considered in general terms, which are expected to result from the imposition of that burden or restriction.

2 Draft supervisory statement — Valuation risk for insurers

1 Introduction

1.1 This supervisory statement sets out the PRA's expectations of firms in relation to existing rules on the valuation of financial assets in the General Prudential sourcebook (GENPRU).

1.2 The supervisory statement 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 for life and general insurers — whether they are mutuals or proprietary companies.

2 PRA expectations on valuation uncertainty and prudent valuation

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

2.2 The PRA requires firms to monitor and manage valuation risk. This risk is often most material with portfolios of structured products or illiquid securities. In such cases, the insurer's 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 PRA's observation of practice in relevant firms has highlighted the importance of the assessment and quantification of valuation uncertainty being underpinned by adequate standards of financial asset valuation governance and control. This includes:

- sufficient independence in valuing assets;
- adequate documentation of policies and procedures;
- adequate control over valuation models (including understanding the model assumptions and limitations);

- adequate management information; and
- consistent governance between internally and externally managed funds.

Where governance and control failings over asset valuation are not rectified, 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 them to provide analysis as evidence. While valuation uncertainty can be significant for complex financial products (eg derivatives), it can also be significant on a large portfolio of more vanilla products (eg where a firm holds concentrated positions which they may be unable to unwind at reported fair value).

3 PRA expectations on client-supplied prices

3.1 Insufficient controls around prices received from external valuation providers, which are not independent because they have been calculated using prices or pricing inputs sourced directly from the insurers or their investment managers, is an example of a governance and control failing over asset valuation. Such prices are commonly referred to as 'client-supplied' by external valuation providers.

3.2 This lack of independence may allow investment managers to manipulate their performance. In the absence of effective controls to highlight such prices, a firm may be unable to identify and address the lack of independence and potential manipulation.

3.3 The PRA expects firms to monitor and limit their use of client-supplied pricing and to have clear visibility of the price sources used, in particular to identify where client-supplied prices are used in their valuations. The PRA expects that insurers or 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.

3.4 There may be situations where practical alternatives to client-supplied pricing are not available. In such situations, the PRA expects to see robust controls including independent price verification and reporting of the materiality of client-supplied prices to senior management.