BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Consultation Paper | CP22/19

Solvency II: Prudent Person Principle

September 2019

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Responses are requested by 18 December 2019.

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Contents

1	Overview	1
2	Proposals	3
3	The PRA’s statutory obligations	6
Appendix		9

1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) sets out its proposed expectations for investment by firms in accordance with the Prudent Person Principle (PPP) as set out in Chapters 2 to 5 of the Investments Part of the PRA Rulebook (which transpose Article 132 of the Solvency II Directive (2009/138/EC) ('Solvency II')[1]).

1.2 The proposals are relevant to all UK Solvency II firms (including in the context of provisions relating to Solvency II groups), mutuals, third-country branches, the Society of Lloyd's (the Society) and its managing agents (collectively, 'firms').

Background

1.3 In accordance with Solvency II,[2] the PRA rules require that 'as regards investment risk, a firm must demonstrate that it complies with the Investments Part of the PRA Rulebook'.[3] In the scope of the Solvency II supervisory review process,[4] the PRA's supervision of firms includes reviewing and evaluating firms' compliance with (among other matters) the PRA rules transposing the Solvency II prudent person investment requirements. The draft Supervisory Statement (SS) (see appendix) sets out the PRA's proposed expectations of firms relating to the PPP as set out in Investments Chapters 2 to 5 of the PRA Rulebook.

1.4 The PRA's proposed expectations relate to a firm's investment strategy, investment risk management and governance system. The draft SS sets out specific areas (eg asset class concentration and intra-group investment) where the PRA would expect firms to pay particular attention in order to comply with the PPP. The draft SS also identifies circumstances under which firms may be subject to greater supervisory scrutiny

1.5 The PPP under Solvency II replaced the prescriptive asset admissibility requirements and quantitative investment limits that applied to insurance undertakings under the Solvency I regime.[5] Solvency II allows firms to invest appropriately given the nature of their liabilities, their risk profile, and their risk appetites without prescribing specific types of assets and without prescribing specific exposure limits. However, the freedom of investment that applies under Solvency II is not absolute – it is constrained by the PPP and firms must ensure compliance with those requirements.

1.6 The PPP sets objective standards for prudent investment.[6] These include standards in relation to portfolio diversification,[7] the use of financial derivatives,[8] exposure to non-regulated markets[9] and risk concentration,[10] asset-liability matching[11] and the security, quality and profitability of the whole investment portfolio.[12] When applied to a particular firm's circumstances, these standards

1 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance, OJ L 335.
2 Article 44(3) of the Directive.
3 Conditions Governing Business 3.4 of the PRA Rulebook.
4 A36(2) of the Directive.
5 Directive 2005/68/EC of the European Parliament and of the Council of 16 November 2005 on reinsurance and amending Council Directives 73/239/EEC, 92/49/EEC as well as Directives 98/78/EC and 2002/83/EC, OJ L 323.
6 For an example of a decision on the requirement to invest assets prudently see: http://www.bailii.org/ew/cases/EWHC/Ch/2016/1538.html
7 Rule 5.2(3) of the Investments Part of the PRA Rulebook.
8 Rule 5.2(1) of the Investments Part of the PRA Rulebook.
9 Rule 5.2(2) of the Investments Part of the PRA Rulebook.
10 Rule 5.2(4) of the Investments Part of the PRA Rulebook.
11 Rule 3.1 of the Investments Part of the PRA Rulebook.
12 Rule 2.1(2) of the Investments Part of the PRA Rulebook.

are likely to allow for a range of reasonable investment strategies. However, it is not necessarily enough that a particular board considers that it has prudently invested its portfolio if in fact that is not the case. In line with the PRA's supervisory approach to insurance regulation, the PRA will exercise its independent judgement, and where it concludes that a firm is not meeting those standards it will expect the firm's senior managers responsible for investment to take action.

1.7 In addition to setting these standards, the PPP embeds investment activity within the wider qualitative risk management requirements placed on firms under Solvency II. In order to comply with the PPP, a firm must have adequate governance and risk management systems so as to ensure and be able to demonstrate that it is only invested "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 in accordance with Rule 3.8(2)(a) of the Conditions Governing Business (Part of the PRA Rulebook)'.[13] Rule 3.8(2)(a) requires firms to take into account, as part of their risk management strategy, 'the specific risk profile, approved risk tolerance limits and the business strategy of the firm'. Under the PPP therefore, investment decisions must be made in the context of a firm's broader framework for enterprise risk management

1.8 Since the introduction of Solvency II, the PRA has observed through its supervision inconsistencies in the way the PPP is understood and applied by different firms. The draft SS is intended to highlight particular inconsistencies that the PRA has identified. Part of the PRA's motivation for issuing the draft SS is also to address PRA concerns that have emerged in the context of recent changes in the insurance sector, e.g. life insurers with annuity books have increased their exposures to assets not admitted to trading on a regulated market (hereafter 'non-traded assets').[14] This raises potential PPP issues as these assets require firms to have specific expertise and sophisticated systems in order to properly identify, measure and manage investment risk. Such assets may also give rise to new concentrations of risk which need to be considered in light of the PPP, including the requirement that 'investments and assets which are not admitted to trading on a regulated market must be kept to prudent levels'.[15]

1.9 Furthermore, while non-traded assets may provide a good match to life firms' long-dated guarantees, they are typically difficult to value and, if it becomes necessary to do so, liquidate. Firms' moves towards such assets have therefore introduced additional valuation uncertainty and liquidity risk, both of which they are specifically required to manage properly under Rule 3.1 Conditions Governing Business and the PPP.[16] The PRA recently consulted on its expectations for insurers' management of liquidity risk in more detail in CP4/19 'Liquidity risk management for insurers'.[17]

1.10 The appended draft SS draws on recent engagements with stakeholders in the insurance sector and the PRA's supervisory experience, including through reviews of Own Risk and Solvency Assessment (ORSA) reports, identifying some key issues for firms to consider when managing investment risk, and to which the PRA pays close attention in the conduct of its supervision. It is not an exhaustive guide to investment risk management. Investment risks are unique to each individual firm and group.

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13 Rule 2.1(1) of the Investments Part of the PRA Rulebook.
14 Non-traded assets comprise any investments that are not admitted to trading on a regulated market. Some examples of non-traded asset types in which UK insurers have made significant investments in order to back annuity obligations include equity release mortgage loans and commercial real estate loans.
15 See Rule 5.2(2) of the Investments Part of the PRA Rulebook.
16 See Rule 3.1 of the Conditions Governing Business Part and Rule 2.1(2) of the Investments Part of the PRA Rulebook.
17 March 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/liquidity-risk-management-for-insurers.

Implementation

1.11 The PRA proposes that the expectations in the draft SS would apply from the date of final publication.

Responses and next steps

1.12 This consultation closes on Wednesday 18 December 2019. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP22_19@bankofengland.co.uk.

1.13 The proposals set out in this CP have been designed in the context of the current UK and EU regulatory framework. The PRA has assessed that the proposals will be affected in the event that the UK leaves the EU with no implementation period in place. The draft SS attached to this CP should be read in conjunction with SS1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU'.[18]

2 Proposals

2.1 The draft SS sets out the PRA's proposed expectations for how they manage investment risk in accordance with Rule 3.1 Conditions Governing Business and the PPP. These include expectations relating to:

- certain key elements of an insurer's investment governance and risk management framework;
- management of asset concentration risk;
- management of holdings of non-traded assets, including management of valuation risk;
- assets backing technical provisions; and
- intra-group loans and participations.

Investment governance

2.2 Solvency II recognises that some risks may only be properly addressed through governance requirements rather than through the quantitative requirements reflected in the solvency capital requirement (SCR).[19] Firms are therefore required to have effective risk management systems and governance. In line with this, under the PPP, "a 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 in accordance with Conditions Governing Business 3.8(2)(a)". Chapters 2 and 3 of the draft SS set out the PRA's proposed expectations for investment governance and risk management under the PPP. These include proposed expectations relating to firms' investment strategies and risk management policies: for example, the proposed expectation that firms should identify and set investment limits

[18] April 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras approach-after-the-uks-withdrawal-from-the-eu-ss.

[19] Solvency II Directive, recital 29.

for asset classes according to Article 260 (1) (c) of the Commission Delegated Regulations (Delegated Regulations).[20]

Diversification and asset concentration risk

2.3 The PPP requires firms to ensure that assets are 'properly diversified' to avoid 'excessive risk concentration'.[21] In order to ensure firms comply with this requirement, Chapter 3 of the draft SS sets out the PRA's proposed 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 that firms will stress test their portfolios and the draft SS sets out proposed expectations relating to stress testing exposures to risk concentrations.

2.4 Chapter 3 proposes that 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. By setting such limits, firms may place an upper bound on the amount of their capital base that can be lost as the result of a single risk crystallising. 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.

Holdings of assets not admitted to trading on a market

2.5 Investments in non-traded assets can be an appropriate match for insurance liabilities, but may also give rise to additional risks, e.g. they can be difficult to value in the absence of regular market pricing and to sell in a timely manner, particularly under stressed market conditions.

2.6 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,[22] the PPP specifically requires firms to keep to prudent levels investment in non-traded assets.[23]

2.7 The draft SS sets out proposed expectations of firms for the purposes of complying with these requirements in Chapter 5. 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

2.8 Where firms invest in non-traded assets, they introduce additional valuation uncertainty risk into their portfolios. Non-traded assets have no independently verifiable market price. Therefore, there is a heightened risk that firms will not be able to realise the value they have assigned to an asset should they have to sell it.[24] In Chapters 5 and 6 of the draft SS, the PRA proposes that firms should take into account valuation uncertainty risk for non-traded assets for the purposes of complying with the PPP. This includes a proposed expectation that firms' treatment of valuation

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20 Commission Delegated Regulations (EU) 2015/35, supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking up and pursuit of Insurance and Reinsurance, OJ L 12, 17/1/2015.
21 See Rule 5.2(4) of the Investments Part of the PRA Rulebook.
22 Article 132(4) Solvency II Directive.
23 See Investments 5.2(2).
24 This could conflict with Rule 2.1(1) of the Investments part of the PRA Rulebook.

uncertainty risk for non-traded assets meets the risk management requirements set out under Conditions Governing Business 3.4 Part of the PRA rulebook.

2.9 The draft SS also explains how, when assessing whether firms are appropriately taking into account valuation uncertainty risk, the PRA would consider (among other things) the extent to which the firm complies with its requirements under the Delegated Regulations in relation to the valuation of assets both at the point of purchase and on an ongoing basis.[25]

2.10 Chapter 6 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. As one example of this, the PRA would expect that where firms are exposed to valuation uncertainty risk they would be able to quantify this and place bounds on the level of uncertainty to which they are exposed.

Intra-group loans and participations

2.11 In respect of assets backing technical provisions (TPs), the PPP requires that these must be invested 'in a manner appropriate to the nature and duration of the firm's insurance and reinsurance liabilities and in the best interests of all policyholders, taking into account any disclosed policy objectives'.[26]

2.12 The requirement for assets backing TPs to be invested in policyholders' best interests have particular implications for intra-group transactions. Investments in or loans to other group companies may be in the interests of shareholders but they may not necessarily be in the interests of policyholders. For example, the issuers of loans may be less willing or able to enforce repayment, particularly where loans are upstream, and any intra-group transaction will introduce wrong-way risk. The proposals in Chapter 7 of the draft SS set the expectation that it would be a high hurdle for firms to demonstrate that intra-group loans and participations are in the best interests of policyholders and, as such, a high hurdle to demonstrate that they are appropriate for covering TPs.

2.13 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.'[27] This provision applies to all asset classes but is highlighted here as the PRA considers that investment in intra-group assets is very likely to lead to a conflict of interest (for example: between shareholders and policyholders; between subsidiaries and parent companies; and between policyholders in different subsidiaries). The PRA 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. Further to this, the PRA would expect that any conflicts of interest that arise following investment in an intra-group asset should also be resolved in the best interest of policyholders, which may mean ceasing to invest in that asset.

2.14 Chapter 7 of the draft SS notes that the above expectations described in paragraph 2.13 of this CP would not generally apply to pure reinsurance arrangements with no element of investment, but gives some examples of where the PPP is relevant in relation to reinsurance more generally.

2.15 As with any investment, intra-group assets are subject to all the other requirements placed on firms under the PPP.

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25 Articles 9, 16, 263 and 267 of the Delegated Regulations.
26 See Rule 3.1 of the Investments Part of the PRA Rulebook.
27 See Investments 2.1(3).

3 The PRA's consultation process

3.1 The PRA has a statutory duty to consult when introducing new rules and, when not making rules, as is the case here, has a public law duty to consult widely where it would be fair to do so.

3.2 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[28]

3.3 The PRA is also required by the Equality Act 2010 to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.

Cost benefit analysis

3.4 The draft SS sets out the PRA's proposed expectations of firms to comply with its existing rules, and would not introduce additional requirements. The proposals could lead to additional costs for some firms relative to their current practice, both one-off and ongoing. These may vary depending on firm size, complexity, and current investment approaches and risk management practices. The PRA does not view these costs as arising as a result of the proposals, but rather they are costs associated with compliance with the existing PRA Rules and the Delegated Acts.

3.5 Based on feedback from the PRA's engagement with insurance sector stakeholders and the experiences of our supervisors, it does not expect these costs, when compared with firms' current practices, to be significant for most firms. For instance, many firms already use asset class thresholds or similar measures in their investment management. Another area where costs might be incurred could be the expectations relating to intra-group assets. An initial analysis of firms suggests very few are currently using intra-group assets to cover technical provisions and those that do are reducing the levels of these assets.

3.6 The proposals in the draft SS are expected to help promote the safety and soundness of firms by increasing consistency with and transparency in the application of the Solvency II requirements. Moreover, the SS would help make clear the PRA's expectations of firms when complying with the requirements to prudently manage the risks associated with untraded assets, concentration risk and valuation uncertainty. Improved risk management practices and more prudent investment allocation will contribute to improved protection of policyholders and to the safety and soundness of firms.

Compatibility with the PRA's objectives

3.7 The proposals would set out the PRA's expectations around the application of the PPP and therefore promote the proper management of investment risk by firms. This contributes to the safety and soundness of firms, in line with the PRA's general statutory objective.

3.8 The proposals would also advance the PRA's objective to securing an appropriate degree of policyholder protection by setting expectations regarding investment risk management and investing 'in the best interests of policyholders'.

3.9 When discharging its general functions in a way that advances its objectives, the PRA has, as a secondary objective, a duty, as far as reasonably possible, to act in a way that facilitates effective competition in markets for services provided by PRA-regulated firms carrying on regulated activities. Setting out expectations regarding application of the PPP should help firms manage their investment

28 Section 30B of the Bank of England Act 1998.

risk properly, increasing efficiency and ensuring consistency of application, which in turn helps facilitate effective competition.

Regulatory principles

3.10 In developing the proposals in this CP, the PRA has had regard to the regulatory principles as set out in FSMA. The following principles are particularly relevant:

- The principle that a burden should be proportionate to the benefits, which are expected to result from the imposition of that burden: analysis of current practice and engagement with stakeholders have indicated further guidance on the application of the PPP would be useful. The proposals would allow sufficient flexibility for firms to implement their own approaches to investment risk management in line with their business model and risk tolerance.

- The principle that the PRA should use its resources in the most efficient and economical way: clarifying the PRA's supervisory expectations in respect of the PPP would result in better and more efficient engagement between the PRA and firms.

- The principle of the desirability of the PRA exercising its functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different firms: the PRA makes clear in its proposal that firms should develop their own investment risk management approaches, taking into account their own business model, risk profile, and risk appetite, so long as they can adequately explain their approach and justify its compatibility with the PRA's rules and expectations.

- The principle that the PRA should exercise its functions as transparently as possible: the PRA considers that the draft SS enhances the transparency of its expectations of firms with respect to the PPP.

Impact on mutuals

3.11 The PRA considers that the impact of the proposed rule changes on mutuals is expected to be no different from the impact on other firms.

HM Treasury recommendation letter

3.12 HM Treasury has made recommendations to the PRC about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.[29]

3.13 The aspects of the Government's economic policy most relevant to the proposals in this CP are: (i) competition, (ii) growth, (iii) competitiveness, (iv) innovation, (vi) better outcomes for consumers.

3.14 Aspects (i) and (vi) have been considered in the 'compatibility with the PRA's objectives' and 'regulatory principles' sections above.

3.15 Where consideration has been given to the aspects that extend beyond the PRA's objectives and the regulatory principles, these are set out below.

29 The latest letter setting out recommendations from HM Treasury is available on the Bank's website at https://www.bankofengland.co.uk/-/media/boe/files/about/prc/chancellorletter080317.pdf

Innovation

3.16 The PRA considers that the proposals will not hamper innovation in the financial services sector, as firms will be able to develop their own business models within a clearly articulated framework to manage their ongoing financial soundness, taking account of their own risk appetite and risk profile, so long as they can adequately explain their approach and justify its compatibility with the PRA's rules and expectations.

Competitiveness

3.17 The PRA considers that the proposals will help to sustain the reputation of London as a leading international financial centre by ensuring the robustness of firms and the protection of policyholders.

Equality and diversity

3.18 The PRA considers that the proposals do not give rise to equality and diversity implications.

Appendix: Draft Supervisory Statement 'Solvency II: Prudent Person Principle'

1 Introduction

1.1 This supervisory statement (SS) sets out the PRA's expectations of firms in accordance with the requirements under the Prudent Person Principle (PPP) under the Solvency II Directive regarding:

(a) their development and maintenance of an investment strategy;

(b) their management of risks arising from investments and their internal governance within the investment function; and

(c) their investment in assets not admitted to trading on a regulated market (hereafter 'non-traded assets')[1] and intra-group loans and participations.

1.2 The PRA notes that the PPP sets objective standards for prudent investment.[2] These include standards in relation to portfolio diversification,[3] the use of financial derivatives,[4] exposure to non-regulated markets[5] and risk concentration,[6] asset-liability matching[7] and the security, quality and profitability of the whole investment portfolio.[8] When applied to a particular firm's circumstances, these standards are likely to allow for a range of reasonable investment strategies. However, it is not necessarily enough that a particular board considers that it has prudently invested its portfolio if in fact that is not the case. In line with the PRA's supervisory approach to insurance regulation, the PRA will exercise its independent judgement, and where it concludes that a firm is not meeting those standards it will expect the firm's senior managers responsible for investment to take action.

1.3 This SS is addressed to all UK Solvency II firms, including in the context of provisions relating to Solvency II groups, mutuals, third-country branches, the Society of Lloyd's (the Society) and its managing agents (collectively called 'firms' in this SS). This SS should be read in conjunction with the following, in particular:

- The Investments, Conditions Governing Business and Valuation Parts of the PRA Rulebook;
- Chapters I (General Provisions), II (Valuation of assets and liabilities), VI (Solvency capital requirement - full and partial internal models), IX (System of Governance), XII (Public disclosure) and XIII (Regular supervisory reporting) and Article 376 (significant risk concentrations) of the Commission Delegated Regulation (EU) 2015/35;
- 'The PRA's approach to insurance supervision';[9]

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1 Non-traded assets comprise any investments that are not admitted to trading on a regulated market. Some examples of non-traded asset types in which UK insurers have made significant investments in order to back annuity obligations include equity release mortgage loans, commercial real estate loans and infrastructure loans.
2 For an example of a decision on the requirement to invest assets prudently see: http://www.bailii.org/ew/cases/EWHC/Ch/2016/1538.html
3 Rule 5.2(3) of the Investments Part of the PRA Rulebook.
4 Rule 5.2(1) of the Investments Part of the PRA Rulebook.
5 Rule 5.2(2) of the Investments Part of the PRA Rulebook.
6 Rule 5.2(4) of the Investments Part of the PRA Rulebook.
7 Rule 3.1 of the Investments Part of the PRA Rulebook.
8 Rule 2.1(2) of the Investments Part of the PRA Rulebook.
9 October 2018: www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-approach-documents-2018.

- SS41/15 'Solvency II: applying EIOPA Set 2, System of Governance and ORSA Guidelines';[10]
- SS4/18 'Financial management and planning by insurers';[11]
- SS19/16 'Solvency II: ORSA';[12]
- SS3/17 'Solvency II: Matching adjustment – illiquid unrated assets and equity release mortgages';[13]
- SS7/18 'Solvency II: Matching adjustment';[14]
- SS5/16 'Corporate governance: Board responsibilities';[15]
- SS3/19 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change';[16]
- SS10/18 'Securitisation: General requirements and capital framework';[17]
- SS35/15 'Strengthening individual accountability in insurance';[18]
- Policy Statement 15/18 'Strengthening individual accountability in insurance: extending the SM&CR to insurers';[19]
- SS1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU';[20]
- SS20/16: 'Solvency II: reinsurance – counterparty credit risk';[21] and
- EIOPA Guidelines on the systems of governance.[22]

1.4 In accordance with Solvency II,[23] the PRA rules require that 'as regards investment risk, a firm must demonstrate that it complies with the Investments part of the PRA Rulebook'.[24] Accordingly,

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10 October 2015: www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-applying-eiopa-set2-system-of-governance-and-orsa-guidelines-ss.
11 May 2018: www.bankofengland.co.uk/prudential-regulation/publication/2018/financial-management-and-planning-by-insurers-ss.
12 November 2016: www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-orsa.
13 December 2018: www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss.
14 July 2018: www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-matching-adjustment-ss.
15 July 2018: www.bankofengland.co.uk/prudential-regulation/publication/2016/corporate-governance-board-responsibilities-ss.
16 April 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss.
17 November 2018: www.bankofengland.co.uk/prudential-regulation/publication/2018/securitisation-general-requirements-and-capital-framework-ss.
18 July 2018: www.bankofengland.co.uk/prudential-regulation/publication/2015/strengthening-individual-accountability-in-insurance-ss.
19 July 2018: www.bankofengland.co.uk/prudential-regulation/publication/2018/strengthening-individual-accountability-in-insurance-extension-of-the-smcr-to-insurers.
20 April 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras-approach-after-the-uks-withdrawal-from-the-eu-ss.
21 November 2016: www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-reinsurance-counterparty-credit-risk-ss.
22 eiopa.europa.eu/publications/eiopa-guidelines/guidelines-on-system-of-governance.
23 Article 44(3) of the Directive.
24 Conditions Governing Business 3.4 of the PRA Rulebook.

this SS addresses firms' investment risk management practices and sets out some specific areas where the PRA would expect firms to pay particular attention in order to comply with the PPP.

1.5 The PRA also reminds firms that in accordance with Solvency II, the PRA must review and evaluate firms' compliance with matters including the PRA's Investment Rules, which implement the Solvency II PPP.[25]

1.6 The PRA reminds firms of the responsibilities resting with Senior Management Functions under the Senior Managers and Certification Regime. Specifically the Chief Risk Officer is responsible for managing and reporting to the board on the risk management strategies and processes in place, including those relating to investments.

1.7 If firms appear to the PRA to be in breach of the PRA Investment Rules, the PRA would consider exercising its relevant supervisory powers under section 55M of the Financial Services and Markets Act 2000.

1.8 The PRA reminds firms that breach of the PPP may be associated with a failure to meet the requirements set out in the Conditions Governing Business Part of the PRA Rulebook. The PRA may consider imposing capital add-ons when certain of these requirements are breached.

2 Investment strategy

2.1 The PRA expects firms to develop and document an investment strategy which describes at least:

- investment objectives and strategic asset allocation;
- consideration of investment constraints when setting investment objectives and strategic asset allocation;
- alignment of the investment strategy with the business model and, where appropriate, how the strategy takes into account the nature and duration of a firm's liabilities and obligations, and the best interests of policyholders;
- alignment of investment strategy with board risk appetite, risk tolerance limits and investment risk and return objectives. Firms should review their investment strategy on an annual basis and additionally, where appropriate, following a major external event or material change in the firm's risk profile; and
- a complete list of assets and how those assets have been invested in accordance with the PPP(in line with the requirements set out in Article 309(2)(e) of the Delegated Regulations).

2.2 The continuing appropriateness of, or significant changes to, the investment strategy should be challenged, approved and controlled by the board or relevant sub-committee of the board. These changes might include, but are not limited to, situations where the firm is planning to invest in a new asset class, make a material, non-routine investment or materially alter the composition of its investment portfolio. Firms wishing to invest in asset classes not already approved by their board should conduct a comprehensive risk assessment to ensure all the necessary expertise, systems and

25 A36(2) of the Directive

processes are in place to value the asset, and to identify, measure, manage, monitor, control and report associated risks.

2.3 A firm must demonstrate that it complies with the Investments Part of the PRA Rulebook.[26] The PRA expects that firms document compliance in a way that enables the board to easily engage with, understand and challenge the material. Firms should be able to provide evidence of this compliance to the PRA on request.

3 Investment risk management

3.1 The PRA expects investments to be aligned with the firm's risk appetite, risk management policies, risk tolerance limits and investment strategy alongside the firm’s overall business model (including the profile of their products and policyholders).

3.2 Firms may only invest in assets whose risks they can understand sufficiently to be able to identify, measure, monitor, manage, control, report and take into account in their assessment of own solvency needs in the Own Risk and Solvency Assessment (ORSA).[27] Firms’ risk management frameworks should deliver this. Chapter 4 sets out PRA expectations for investment risk management where firms have outsourced their investment activities.

3.3 Paragraphs 3.4 to 3.23 of this chapter do not apply to firms investing in assets covering technical provisions for linked long-term contracts of insurance, except where the assets are held to cover the additional technical provisions in respect of policyholder liabilities including those for any guarantee of investment performance or other guaranteed benefit provided under those contracts.

3.4 The PRA expects that when firms invest in asset structures or other investments where the risk exposure is dependent on the performance of underlying assets, they should also include the risks of these underlying assets within the scope of their investment risk management framework.

3.5 As part of measuring their risks, the PRA expects firms to quantify, under a range of scenarios, the potential impact of investment risks crystallising on their solvency position and their ability to pay policyholders, before and after management actions. Firms are expected to identify scenarios that would cause these risks to crystallise, and to identify and analyse potential risk management actions, in response to stress scenarios.

3.6 Firms’ investment risk monitoring should cover, but not be limited to:

- the changes in the value and volatility of their investment portfolios and individual assets and the firm’s ongoing ability to monitor these;
- changes in the characteristics of the assets held (eg changes in the credit quality);
- changes in the value or characteristics of underlying exposures on which the performance of the asset(s) invested in depend;
- changes in the external environment which may affect the security of assets;
- breaches of internal quantitative limits for assets and exposures (see paragraph 3.10 of this SS);

[26] PRA Conditions Governing Business Rule 3.4.
[27] Investments 2.1 (1).

- concentrations of single risks in the investment portfolio (e.g. counterparty, asset class, geographical industry or sector); and
- changes to the firm's risk profile which may lead to asset-liability mismatch.

3.7 The board and any relevant sub-committees of the board should receive appropriate, accurate and timely management information on the firm's investment risks. This management information should be provided, at a minimum, whenever the board or relevant committee meets to review the investment strategy, internal investment limits or investment risks. Firms are reminded of their requirements to at least ensure that their investment risk management feeds in to their ORSA process and report,[28] and the PRA expects firms to pay particular attention to this where investment risk is assessed to be a key risk currently facing the firm or likely to face the firm in the future

3.8 The PRA reminds firms of the requirements of Investments Rule 5.2(1) in the PRA Rulebook. Where firms have hedged risks with derivatives and similar commitments, the PRA expects firms to be able to monitor the effectiveness of any hedge in mitigating the relevant risk exposure, and take remedial action in the event that it becomes less effective. The PRA notes that the requirements of Investments Rule 5.2(1) apply to derivatives and quasi derivatives, and as such, firms may only invest in such instruments where it contributes to a reduction of risks or facilitates efficient portfolio management.[29]

3.9 The PRA expects firms to pay particular attention to the measurement and control of credit spread and default risk. In particular, the PRA expects firms to make their own internal assessment of the credit risk on their investments and reminds them of their obligations under Article 259(4) of the Delegated Regulations. Where firms internally assign credit ratings for unrated assets, firms are reminded of the PRA's expectations as set out in SS3/17 'Solvency II: Matching adjustment – illiquid unrated assets and equity release mortgages'.[30]

Investment Risk Management Policy

3.10 The risk management system in accordance with Solvency II must cover areas, including those listed below and firms must produce policies including for:[31]

- underwriting and reserving;
- asset-liability management;
- investment risk management;
- liquidity risk management;
- concentration risk management;

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[28] Investments Rule 2.1(1).
[29] An example of a quasi-derivative is a long dated interest rate swap repackaged as a bond.
[30] December 2018: www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss.
[31] Specific requirements are set out in Article 260 Commission Delegated Regulation.

- operational risk management; and
- reinsurance and other insurance risk mitigation techniques.

3.11 Firms must develop an investment risk management policy that, where appropriate, in order to ensure effective risk management, includes internal quantitative investment limits for assets and exposures. [32] The PRA cannot envisage circumstances where it would not be appropriate to set such internal limits and, as such, expects firms to define and operate within these limits. The PRA expects that such limits would encompass at least asset class, geographic, single-name, sector and off-balance sheet exposures that the firm would expect to hold in reasonably foreseeable market conditions.

3.12 The PRA expects quantitative investment limits to be consistent with the board's risk appetite. As such, the PRA expects firms to document how their limits are determined and how they are consistent with the overall risk appetite and risk management of their firms. The PRA may review the appropriateness of the limits when assessing compliance with the requirements on the system of governance and investments as part of the supervisory review process.

3.13 The PRA expects that firms will review their internal quantitative investment limits in line with reviews of the firm's investment strategy and investment risk management policy.

3.14 When setting internal quantitative investment limits for assets and exposures, the PRA expects firms should take into account at least the:

- nature and duration of the firm's liabilities;
- nature and quantification of the risks associated with each category of asset and with individual assets;
- access to investment risk management capabilities proportionate to the complexity of the asset class involved (especially for any planned new categories of investment);
- need for proper diversification of assets, as set out in PRA Investments Rule 5.2(3);
- impact of any uncertainty on the valuation of assets, or on the ability of the firm to realise an asset's value in the event of sale, including under stress;
- uncertainty around the timing and the channels through which investment risks may materialise and the actions available to mitigate them; and
- material reinsurance cessions and whether these create correlations of counterparty credit risk, particularly if collateral arrangements are used, whether, for example, as a results of the counterparty itself, or, as the results of collateral arrangements, where utilised.

Counterparty Risk

3.15 Internal quantitative investment limits should be set in order to ensure a properly diversified and resilient portfolio of assets (with an acceptable level of volatility) that avoids a material reliance on counterparties (or other common risk factors between the assets).

32 A44(2) Solvency II and A260(1)(c)(v) Commission Delegated Regulation.

3.16 When setting quantitative investment limits, firms should consider an assessment of the impact of the failure of the firm's largest counterparties.

Risk concentration, risk accumulation and lack of diversification

3.17 Rule 5.2(4) of the Investments part of the PRA Rulebook requires firms to ensure that assets issued by the same issuer, or by issuers belonging to the same group, shall not expose the insurance firm to excessive risk concentration. This is an objective standard and is not referable to firms' subjective judgement about what constitutes excessive concentration.[33]

3.18 Firms are also reminded of their obligations relating to risk concentration reporting under Article 295 of the Delegated Regulations. The PRA expects that firms will stress test their portfolios to demonstrate that they are not exposed to excessive risk concentration. The PRA expects, at the least, that the solvency of a firm would not be threatened by any plausible crystallisation of a risk related to assets issued by the same issuer or by issuers belonging to the same group.

3.19 Rule 5.2(3) of the Investments Part of the PRA Rulebook requires assets to be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings, or geographical area and excessive accumulation of risk in the portfolio as a whole. The concept of proper diversification is an objective standard and not referable to firms' subjective judgement. One way the PRA expects that firms will seek to demonstrate proper diversification is that they stress test their portfolios. More specifically, the PRA expects that with regard to risks arising from a particular asset, issuer or group of undertakings, or geographical area (eg default, change in government policies, deterioration in market or macroeconomic conditions), or other single source of risk:

- the solvency risk appetite of the firm is not threatened in a moderate stress scenario; and
- the solvency of the firm is not threatened in a severe stress scenario.

3.20 The PRA expects firms to demonstrate how their quantitative investment limits and forward-looking investment strategy would prevent solvency from being threatened under a range of stress scenarios. The PRA expects that firms that appear to it to have excessive levels of concentration risk within their investment portfolio will be subject to greater supervisory scrutiny. This could include increasing the severity of stress scenarios. The PRA would expect firms to use a combination of simultaneous stresses and be able to identify the set of circumstances that would threaten their solvency risk appetite.

3.21 The PRA also expects that the investment risk management policy will articulate how the firm has identified and is managing any potential correlation or contagion risks between assets which would lead to excessive concentration of risk and any risks which are common to a material proportion of the firm's investment portfolio.

3.22 In determining their quantitative investment limits, firms should have due regard for concentration risk and set out the level of concentration exposure that they will not exceed.

[33] In the past the courts have determined whether objective standards have been met, for example Cowan v Scargill [1984].

3.23 The PRA expects firms to ensure that their investments do not expose them to unmanageable longer-term risks. For example, firms should consider whether there is an excessive accumulation of financial risks from climate change in their investment portfolio, consider appropriate mitigants to that risk where it arises and note the expectations set out in SS3/19 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change'.[34] As another example, firms should consider their exposure to political risk, particularly when investing in assets that are ultimately backed by government.

4 Outsourcing of investment activities

4.1 When outsourcing investment-related activities, firms are subject to Part 7 of Conditions Governing Business in the PRA Rulebook, which sets out requirements for outsourcing in general. Rule 7.1 states that 'if a firm outsources a function or any insurance or reinsurance activity, it remains fully responsible for discharging all of its obligations under the rules and other laws, regulations and administrative provisions adopted in accordance with the Solvency II Directive'.

4.2 As such, firms that outsource their investment function themselves remain subject to the requirements of the PPP. In drawing up a written agreement to define respective roles, firms must ensure that the external investment manager has a mandate in its investment strategy only to invest in accordance with the PPP. Boards must be fully aware of any outsourced investment activities and must monitor and regularly review how these align with the firm's strategy, strategic asset allocation and risk appetite.

4.3 The PRA expects that firms will undertake appropriate due diligence in relation to outsourced investment activities. A firm's risk function should have the ability to understand and manage the specific risks associated with outsourcing its investment function. Additionally firms should be confident that any external party has sufficient risk management expertise to comply with this SS.

4.4 Article 274 of the Solvency II EU Delegated Regulation applies for outsourced investment functions/activities. For the purposes of this article, the PRA would normally expect 'investment' to be regarded as a 'critical or important operational' function or activity. Consistent with the European Insurance and Occupational Pensions Authority (EIOPA) guidelines 60 and 63 (Systems of governance), firms should identify a process to determine which functions and activities are critical or important.[35] The PRA would expect to challenge firms to explain their reasoning if as a result of this process they determine that investment functions are not 'critical or important'.

5 Exposures to non-traded assets

5.1 This chapter does not apply to firms' investments in assets covering technical provisions (TPs) for linked long-term contracts of insurance, except where the assets are held to cover the additional TPs in respect of policyholder liabilities. This includes those for any guarantee of investment performance or other guaranteed benefit provided under those contracts.

5.2 Investments in non-traded assets can be an appropriate match for insurance liabilities, particularly annuities, but they can also give rise to additional risks. For example, they can be difficult to value in the absence of regular market pricing and to sell in a timely manner, particularly under stressed market conditions.

[34] April 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss.

[35] eiopa.europa.eu/publications/eiopa-guidelines/guidelines-on-system-of-governance.

5.3 In addition to the factors set out in paragraph 3.14 of this SS, the PRA also expects that, prior to investing in a non-traded asset, when determining any internal investment limit, and as part of ongoing practice, firms will also consider and assess matters including the following:

- appropriateness and robustness under a suitable range of operating conditions of the valuation methodology
- in the case of internally-rated assets: the robustness, capability and maturity of the internal rating framework;
- if using an internal model, any inconsistency between the economic view of the investment risk and its capital treatment that is material to the overall capital position of the firm; and
- the materiality of any embedded optionality, how this may change over time and under stress, and how any change will affect the risk profile of the asset

5.4 Non-traded assets will often be more heterogenous than those traded on a regulated exchange. As such, the PRA expects that where firms seek to identify risks arising from these investments (in line with Rule 2.1(1) of the Investments Part of the PRA Rulebook) they will take particular care to consider both the systemic and idiosyncratic risks arising from the features of each investment.

5.5 Non-traded assets by definition do not have a deep or liquid secondary market. Therefore, there is relatively little credible historic data that can be used to measure the risks they introduce as required under Rule 2.1(1) of the Investments Part of the PRA Rulebook. It is therefore important for firms to undertake a fundamental analysis of the underlying risks on their non-traded assets.

5.6 The PRA expects that the level of expertise of key persons (including investment managers) and the robustness of risk management systems and controls would increase commensurate with any increases in the scale, complexity or concentration of investments in non-traded assets.

5.7 The PRA reminds firms of its expectations relating to liquidity risk arising from investment in non-traded assets, as set out in CP4/19 'Liquidity risk management for insurers'.[36]

5.8 The PRA expects firms' investing in non-traded assets to be able to demonstrate matters including:

- that key persons have sufficient experience and expertise to be able to understand and manage the risks involved in the assets held and challenge decisions; and
- when assessing the suitability of an investment to match long-dated liabilities, suitably severe stress scenarios have been projected over suitably long horizons and did not lead to a material deterioration in the firm's solvency or liquidity position.

5.9 As part of the internal investment limits guidance set out in Chapter 3 of this SS, the PRA expects that firms will set quantitative limits for overall investments in non-traded assets. However, the PRA Rulebook requires 'assets not admitted to trading on a regulated financial market' to be kept to 'prudent levels'.[37] The question of what constitutes prudence is not referable to firms' subjective judgement – it is an objective standard.

[36] March 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/liquidity-risk-management-for-insurers.
[37] Investments Rule 5.2(2).

6 Valuation uncertainty

6.1 Valuation uncertainty is one of the additional risks posed by investment in non-traded assets. Non-traded assets have no independently verifiable market price. There is therefore a heightened risk that firms will not be able to realise the value they have assigned to an asset should they have to sell it.[38] The PRA expects that firms take into account valuation uncertainty risk for non-traded assets for the purposes of complying with the PPP. This includes an expectation that firms' treatment of valuation uncertainty risk for non-traded assets meets the risk management requirements set out under Conditions Governing Business 3.4 of the PRA Rulebook.

6.2 When assessing whether firms are appropriately taking into account valuation uncertainty risk, the PRA will consider (among other things) the extent to which the firm complies with its requirements under the Delegated Regulations in relation to the valuation of assets. In particular, in relation to the alternative valuation methods referred to in Article 10(3) of the Delegated Regulations, which are used to value the non-traded assets, the PRA will consider whether the firm has credibly justified the alternative valuation approach used. The PRA will also consider whether the firm has adequately assessed the valuation uncertainty of those assets in accordance with Article 263 of the Delegated Regulations.

6.3 When assessing firms' management of valuation uncertainty risk for the purposes of complying with the PPP, the PRA will also consider the extent to which the firm satisfies the requirements under Article 267 of the Delegated Regulations relating to the internal control of valuation of assets. The PRA expects that the more material the firm's exposure, the greater the skills and expertise that will be required of the persons involved in the valuation of these assets.

6.4 In accordance with Article 49 of the Solvency II Directive, firms 'remain fully responsible for discharging all of their obligations under this Directive when they outsource functions or any insurance or reinsurance activities'. Accordingly, firms must take the steps necessary to adequately assess and manage valuation uncertainty risk, regardless of whether the valuation function is outsourced. In assessing a firm's compliance with the requirements of the PPP in the context of its investment in non-traded assets where the firm does outsource the valuation function, the PRA will consider (among other things) the extent to which the firm complies with the requirements for outsourcing set out in Article 274 of the Delegated Act.

6.5 The PRA expects that firms will be able to quantify bounds on any valuation uncertainty at a granular level and by using available market data. The PRA expects that the level of valuation uncertainty and associated risks is consistent with the defined risk appetite and investment strategy of the firm, including in stress scenarios.

6.6 When setting internal investment limits in line with Paragraph 3.10 of this SS, the PRA expects that firms will set an internal quantitative limit for valuation uncertainty.

6.7 When undertaking a risk assessment to determine the appropriateness of investment in assets not yet approved by the Board (in line with Paragraph 2.2 of this SS) the PRA also expects that firms will quantify bounds on valuation uncertainty.

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38 This could conflict with Rule 2.1(1) of the Investments part of the PRA Rulebook.

7 Intra-group loans and participations

7.1 The PRA considers intra-group loans and participations or arrangements to that effect (termed 'intra-group assets' for the purpose of this SS) as investments and therefore expects firms to manage them in accordance with the PPP. For the reasons set out in paragraph 7.5 of this SS, this section does not generally apply to pure intra-group reinsurance arrangements with no element of investment.

7.2 In respect of assets backing TPs, the PPP requires that these must be invested 'in a manner appropriate to the nature and duration of the firm's insurance and reinsurance liabilities and in the best interests of all policyholders, taking into account any disclosed policy objectives'.[39]

7.3 The requirement for assets backing TPs to be invested in policyholders' best interests has particular implications for intra-group transactions. Investments in or loans to other group companies may be in the interests of shareholders but they may not necessarily be in the interests of policyholders. For example, the issuers of loans may be less willing or able to enforce repayment, particularly where loans are upstream. The PRA expects that it would be a high hurdle for firms to demonstrate that intra-group loans and participations are in the best interests of policyholders and, as such, a high hurdle to demonstrate that they are appropriate for covering TPs.

7.4 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'.[40] This provision applies to all asset classes but is highlighted here as the PRA considers that investment in intra-group assets is very likely to lead to a conflict of interest (for example: between shareholders and policyholders; between subsidiaries and parent companies; and between policyholders in different subsidiaries). The PRA therefore expects 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. Further to this, the PRA expects that any conflicts of interest that arise following investment in an intragroup asset should also be resolved in the best interest of policyholders, which may mean ceasing to invest in that asset.

7.5 Intra-group reinsurance is used to back TPs but the PRA generally expects that intra-group reinsurance arrangements with no element of investment are less likely to present conflicts of interest in the way it observes, for example, that intra-group loans can. Intra-group reinsurance transfers can be, and usually are, different in substance economically from intra-group investments. They usually transfer risk away from the ceding firm in a way designed to ensure that the insurance obligations are closely matched by the reinsurance. As such, in many situations, we would expect the interests of policyholders and the ceding firm to be better aligned.

7.6 Nevertheless, the PRA remains very interested in intra-group reinsurance arrangements recognising that they carry risks of their own that firms need to be able to measure, monitor, manage, control and mitigate. The PRA will look to the economic substance of arrangements and where an intra-group reinsurance arrangement is structured to effectively function as a loan it would treat it as such for the purposes of this section

7.7 As with any investment, intra-group assets are subject to all the other requirements placed on firms under the PPP. As an example of this, the PRA expects that intra-group assets are subject to at least the same level of 'arm's length' scrutiny and risk management as other assets, as well as proper governance and documentation with regard to:

39 See Rule 3.1 of the Investments Part of the PRA Rulebook.
40 See Investments 2.1(3).

- conflicts of interest;
- concentration risk;
- credit risk;
- liquidity risk;
- legal and operational risk;
- wrong-way risk where counterparty default risk is positively correlated with other risks borne by the firm (when the crystallisation of a risk could affect the financial condition both of the firm and of other group entities) ; and
- increased complexity of the group structure leading to dependencies that increase the fragility of the group or entity in stress scenarios.