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PRA CP22/19 Solvency II: Prudent Person Principle

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the PRA's consultation. Members of the Finance and Investment Board and the Life and General Insurance Boards/consultation committees have contributed to this response.

Key points

The IFoA would be grateful for clarification that references to objective standards in the draft Supervisory Statement (SS) refer to the legal definition of this phrase, and that the PRA is not suggesting that the use of judgement should be curtailed.

We would welcome a focus in the CP on any specific requirements for assets backing unit-linked business.

Our understanding is that compliance with the PPP is the responsibility of the insurer. We are therefore concerned about the requirement for the investment mandate of an outsourced provider to be in accordance with the PPP (4.2 in the draft SS). This suggests that the asset manager is taking on the legal risk of stating it complies with the PPP, whereas we believe the manager's obligations should be determined against directly measurable standards which the insurer has assessed comply with the PPP.

While the draft SS requires firms to carry out an internal assessment of each asset in relation to credit spread and default risk, we note that the insurer will not always carry out such an assessment itself as this may be outsourced to an external manager.

It would be helpful for the SS to highlight the extent to which firms should consider the risk of the UK government choosing to default on legal contracts, together with other political risks.

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General comments

“Objective Standards”

1. The draft SS makes extensive use of the phrase “objective standard” (1.2, 3.17, 3.19). Our understanding is that ‘objective standard’ refers to the legal definition of this phrase, and means that the test for an investment approach being prudent is whether a hypothetical “prudent person”, without considering any specific circumstances, would deem it to be prudent.

2. This seems consistent with the description in paragraph 1.6 of the consultation paper (CP) overview, and also with the speech entitled ‘Insurance risk management in a changing world’ given by PRA Director Charlotte Gerken on 24 September 2019, in which she referred to “allowing for a range of reasonable investment strategies and practices, and avoiding crude, top down constraints”.

3. We are broadly comfortable with this interpretation, but we note that in some areas the PRA seeks to define what they think is necessary to meet that “objective standard”. We suggest that in some cases these tests are sufficient but should not be treated as necessary. For example, the requirements for stress testing in the draft SS (3.19) to demonstrate that a firm has “sufficient diversification” could reasonably be considered excessive for an insurer if, for example, it invests solely in cash and money-market funds.

4. More generally, we would be grateful for clarification that, in referring to objective standards, the PRA did not intend to suggest that the use of judgement should be curtailed, or that assessing whether or not something is prudent can be done without qualitative considerations, i.e. an element of subjectivity. We would suggest that the wording of these references be reviewed to ensure that the intention is clear, and to state explicitly if legal language is being used.

Interaction with Proportionality

5. The CP makes no specific reference to proportionality. As this is a significant principle in Solvency II it may have relevance to the PRA’s proposals regarding the Prudent Person Principle.

Unit-linked business

6. The CP does not include any specific requirements in respect of assets backing unit-linked business. We would welcome some discussion of this important area.

7. In addition, while the investment risks are borne by the policyholders, unit-linked business is also a source of risk for firms. Failure to meet policyholders’ expectations, in terms of returns and accumulated funds (even if there are no conduct issues around how the business is sold or communicated to policyholders), would create a reputation risk for the whole industry as well as the individual firms. There would also be a secondary impact on the profits flowing into the business.

Comments by section of the draft Supervisory Statement

1 - Introduction

8. 1.3 lists documents that should be read alongside the draft Supervisory Statement. We would note that SS5/19 (Liquidity risk management for insurers) may be relevant here given that the topics are related. It would also be helpful to include a specific reference to the definitions of assets of primary and secondary liquidity.

2 – Investment strategy

9. 2.1 refers to the investment strategy describing a complete list of assets and how those assets have been invested in accordance with the PPP. We assume that the PRA does not intend firms to produce a

line-by-line assessment of why each asset complies with the PPP. We suggest this would be difficult if not impossible to achieve in practice, since an individual asset may or may not comply depending on how it fits into a firm's overall portfolio and strategy.

10. However, assuming the PRA is expecting firms to demonstrate why all their assets are compliant, this could be done at asset class level. To make this clearer, the last bullet point in section 2.1 could be split into requiring (a) a complete list of assets, and (b) how the asset classes have been invested in accordance with the PPP.

11. In 2.3, clarification would be helpful that the PRA expects firms to be able to demonstrate their compliance with the Investment parts of the Rulebook, but does not intend them to produce a PPP Compliance Report (2.3).

3 - Investment risk management

12. Paragraph 3.9 refers to firms' obligations in relation to credit spread and default risk under the Delegated Regulations (Article 259(4)). We suggest that the draft SS goes slightly beyond the requirements of the Regulations by requiring firms to carry out an internal assessment of each asset, which is more onerous than the wording in the Regulations of "not solely or automatically" relying on external ratings.

13. We would also note that the insurer will not always carry out such an assessment itself. For example, consider an investment mandate that has credit risk limits based on external ratings. There will be an expectation (validated through due diligence) that the external manager carries out a credit assessment on the assets that are bought, but this does not require the insurer to carry out credit assessments.

14. Paragraph 3.23 briefly mentions political risk. It might be helpful here to highlight the extent to which firms should consider the risk of the UK government choosing to default on legal contracts. There is an interaction with the test proposed in 3.19, as we suspect that the solvency position of many UK insurers would deteriorate significantly if the UK government defaulted on its government bonds. We are unclear whether the PRA would expect firms to consider this risk.

15. There are further political risks that could be considered – for example, Network Rail (supported by the Department of Transport), PFI, Local Authorities, NHS trusts, tenancy agreements of government departments, non-UK sovereigns and supra-national entities. It might be helpful for the PRA to give a steer on the scope of these considerations (or acknowledge that there is a range of reasonable positions for firms to take in this area).

4 - Outsourcing of investment activities

16. This section of the draft SS focuses on the outsourcing of the full investment function. It could also consider the outsourcing of components of the investment portfolio (or clarify that there are no specific considerations in that regard).

17. Our understanding is that compliance with the PPP is the responsibility of the insurer. We are therefore concerned about the requirement that an outsourced provider should have "a mandate in its investment strategy only to invest in accordance with the PPP" (4.2, and similarly in 4.3).

18. An asset manager must comply with all the legal obligations in its IMA (and, for an Outsourced CIO provider, any other services it provides such as Strategic Asset Allocation advisory). Those obligations should be directly measurable standards without subjectivity/judgement. The totality of those legal obligations should allow the insurer (in conjunction with any due diligence and oversight) to demonstrate that it complies with PPP. And an insurance-focused asset manager (particularly one offering Outsourced CIO capability) should make that as straightforward as possible.

19. This structure is very different to the asset manager taking on the legal risk of stating it complies with the PPP. In the IFoA's view, it is very unlikely that the mandate can state "compliance with PPP", given that this is a matter for the Board. Instead, we would argue that the obligations should be determined against directly measurable standards (which the insurer has assessed comply with the PPP).

5 – Exposures to non-traded assets

20. We note the absence in CP22/19 of any discussion regarding the assets backing Periodic Payment Order (PPO) liabilities on the balance sheets of general insurers and reinsurers. It might be worth noting in section 5 of the draft SS that, as well as life insurers with annuity books, non-life insurers with PPO liabilities might also invest in non-traded assets.

6 - Valuation Uncertainty

21. The first sentence in 6.1 implies that valuation uncertainty only applies to “non-traded” assets. However, we note that where an insurer holds a material percentage of the issuance of a specific traded asset, they may need to consider valuation uncertainty because market pricing is based on marginal trade price. We therefore suggest that 6.1 should be widened to include traded assets.

22. Furthermore, valuation uncertainty also applies to long-term contracts linked to either non-traded or traded assets, and we would welcome the inclusion of a reference in this section of CP22/19 that the requirements for assets backing unit-linked business are applicable to such long-term contracts.

23. In 6.5, we would suggest replacing the word “bounds”, which suggests that the price cannot fall outside those bounds, with “range” or “confidence interval”.

24. We agree with the requirement in 6.6 for a quantitative limit on valuation uncertainty in relation to firms’ allocation to non-traded assets. Our understanding is that the PRA would expect a firm’s limit on valuation uncertainty would be one factor in assessing its maximum allocation to non-traded assets. (This is also referenced in paragraph 1.9 in the CP Overview.)

7 - Intra-group loans and participations

25. We assume that the “high hurdle” in 7.3 can be cleared – that is, this is not an outright ban on intra-group loans backing technical provisions. To avoid potential confusion, we suggest that the SS should make it clear that this would be considered on a case-by-case basis.

If you would like to discuss any of the points raised please contact Matthew Levine, Policy Manager (Matthew.Levine@actuaries.org.uk / 0207 632 1489) in the first instance.

Yours Sincerely,

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