NEAM VANTAGE POINT

Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

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Complying with the Prudent Person Principle – What is Required of London Market Insurers?

The PRA uses Supervisory Statement 1/20 to promote consistent compliance with the Prudent Person Principle. What actions should be taken by London Market insurers?

INTRODUCTION

In May 2020, the Prudential Regulation Authority ("PRA") released its supervisory statement ***SS 1/20 Solvency II: Prudent Person Principle*** ("SS 1/20"), which applies to all UK Solvency II firms, including Lloyd's and its managing agents. The Prudent Person Principle ("PPP") is fundamental to firms' investment governance and operations, thus demanding the close attention of both the board and senior management.

In this piece, NEAM summarises the key points from the supervisory statement to assist managing agents and insurers in identifying potential areas requiring improvement.[1] There are now a number of additional requirements relative to those already captured in "Lloyd's Minimum Standards MS5 – Risk Management" and "Lloyd's Minimum Standards MS15 – Investment Management." We think it's highly likely that these requirements will be incorporated into the Lloyd's Minimum Standards framework in due course.

KEY POINTS FROM SS 1/20

Given the PPP requirements are principles-based to date, the PRA has decided to specify its expectations in this area to achieve more consistent compliance across firms. Whilst they emphasise the need to assess PPP compliance on a case-by-case basis, the PRA specifies certain objective standards for prudent investments.

SS 1/20 outlines the requirements in the following three areas;

- **i.** Development and maintenance of an investment strategy
- **ii.** Investment risk management and internal governance
- **iii.** "Non-traded assets" and intragroup loans and participations

Note: For ease of reference, we have summarised these requirements by six key internal function or focus areas.

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1) Responsibilities of the Board

SS 1/20 reaffirms the importance of the role of the board in risk management and the PPP, which includes the following tasks:

- Setting investment objectives and risk appetite
- ***Continuingly challenging, approving and controlling the investment strategy*** (or delegate to a relevant sub-committee of the board)
- Challenging and approving significant changes[2] to the investment strategy
- Being aware of any ***outsourced investment activities*** and monitoring alignment with the firm's strategy, strategic asset allocation and risk appetite
- Before ***investing in an intragroup asset***, reviewing any conflicts of interest and signing off that these have been resolved in the best interest of policyholders

2) Strategic Asset Allocation

Firms are now expected to ***review their investment strategy on an annual basis*** and, where appropriate, following a major external event or material change in the firm's risk profile. In addition, the investment strategy should allow for at least:

- Investment objectives and risk appetite set by the board
- Investment risk and return objectives, plus any investment constraints or risk tolerance limits
- Alignment with the business model, allowing for nature and duration of insurance liabilities and obligations, as well as the best interest of policyholders
- Onward review of internal quantitative investment limits for assets and exposures

3) Investment Risk Management

In line with the original PPP requirements, SS 1/20 reiterates the need for firms to demonstrate their ability to ***identify, measure, monitor, manage, control and report*** risks of all financial investments. In addition, investments should align with the firm's risk management policies and feed into the Own Risk and Solvency Assessment ("ORSA") process and report.

Whilst most firms are already engaged in the following exercises, they are now specified in detailed terms to promote further conformity:

- ***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***
- ***Identify scenarios that would cause these risks to crystallise, and identify and analyse potential risk management actions, in response to stress scenarios***

Additional details on items to monitor and the development of quantitative investment limits could be found in SS 1/20. One aspect to highlight is the ***specific requirements on stress and scenario testing***:

- Demonstrate how quantitative investment limits and ***forward-looking investment strategy*** would prevent solvency from being threatened under a range of stress scenarios[3]
- Use a combination of simultaneous stresses and be able to identify the set of circumstances that *would* threaten their solvency risk appetite (this is also known as "***reverse stress testing***")
- Test and articulate ***potential correlation or contagion risks*** between assets which would lead to excessive concentration of risk

4) Outsourcing of Investment Activities

For a typical insurance firm, the PRA would expect investments to be regarded as a "critical or important operational" function or activity under Solvency II which has governance and risk implications, including the requirement to notify the PRA of any material changes (e.g. outsourcing more/less of the investment function, switching managers).

In addition to the board's explicit responsibilities in reviewing and monitoring outsourced investment activities, the PRA expects that firms will undertake appropriate due diligence. The risk function should have the ability to understand and manage the specific risks associated with outsourcing all or parts of the firm's investment function.

Moreover, firms are required to take steps (perhaps as part of the due diligence) to ascertain that the external asset manager(s) has sufficient risk management expertise to comply with SS 1/20.

5) Other Requirements Relevant to Managing Agents and Insurers

Other relevant requirements for managing agents and insurers include;

- Non-traded assets (on a regulated exchange): a set of comprehensive requirements regarding these assets are prescribed and the PRA notes that many firms utilise such assets to back Periodic Payment Order liabilities ("PPOs")
- Valuation uncertainty risk regarding non-traded/thinly-traded assets: the PRA expects that the skills and expertise involved in the valuation of these assets is proportional to the firm's exposure. Firms are expected to quantify or grade their exposure to this risk, "regardless of whether the valuation function is outsourced"
- Intragroup loans and participations: the PRA considers that investment in intragroup assets is likely to lead to a conflict of interest. Therefore, the PRA requires the board's involvement in this matter. In addition, they require these assets to be 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. The PRA is more comfortable with intragroup reinsurance arrangements (with no element of investment) but insists on evaluating these based on economic substance (i.e. whether an intragroup reinsurance arrangement is structured to effectively function as a loan)
- Outwards reinsurance: the PRA expects to assess any reinsurance assets' compliance to PPP, allowing for risk mitigation factors (e.g. collateral arrangements)
- Derivatives/quasi-derivatives: firms are expected to monitor the effectiveness of any hedge in mitigating the relevant risk exposure and to take remedial action when it becomes less effective

6) Documentation Requirements

Although the PRA "*is not seeking to impose additional reporting requirements*," SS 1/20 does explicitly or implicitly refer to certain additional documentation requirements. These include:

- Regularly testing the alignment of investment strategy with the board's risk appetite, risk tolerance limits and investment risk and return objectives
- Documenting a ***complete list of assets and noting how those assets have been invested in accordance with the PPP*** (including any assets resulting from reinsurance arrangements)
- Maintaining evidence of compliance with the Investments part of the PRA Rulebook
- Maintaining a log to demonstrate that the board and its relevant sub-committees have received appropriate, accurate and timely management information on the firm's investment risks
- Documenting relevant discussions at board and committee meetings regarding key items such as strategic asset allocation, intragroup reinsurance, etc.

KEY TAKEAWAYS

- Supervisory Statement 1/20 aims to promote further conformity and to facilitate a more consistent approach in complying with the Prudent Persons Principle
- Boards and senior management teams are required to document compliance effort in some detail
- There continues to be a strong focus on robust risk management policies and practices with an emphasis on impact quantification, as well as stress and scenario testing
- In order to comply with the PRA's requirements, an investment strategy review is required to be performed at least annually

ENDNOTES

[1] *Please refer to the original document for full detail of the regulatory requirements.*

[2] *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.*

[3] *The PRA expects to apply greater supervisory scrutiny to firms with excessive levels of concentration risk within their investment portfolio.*

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