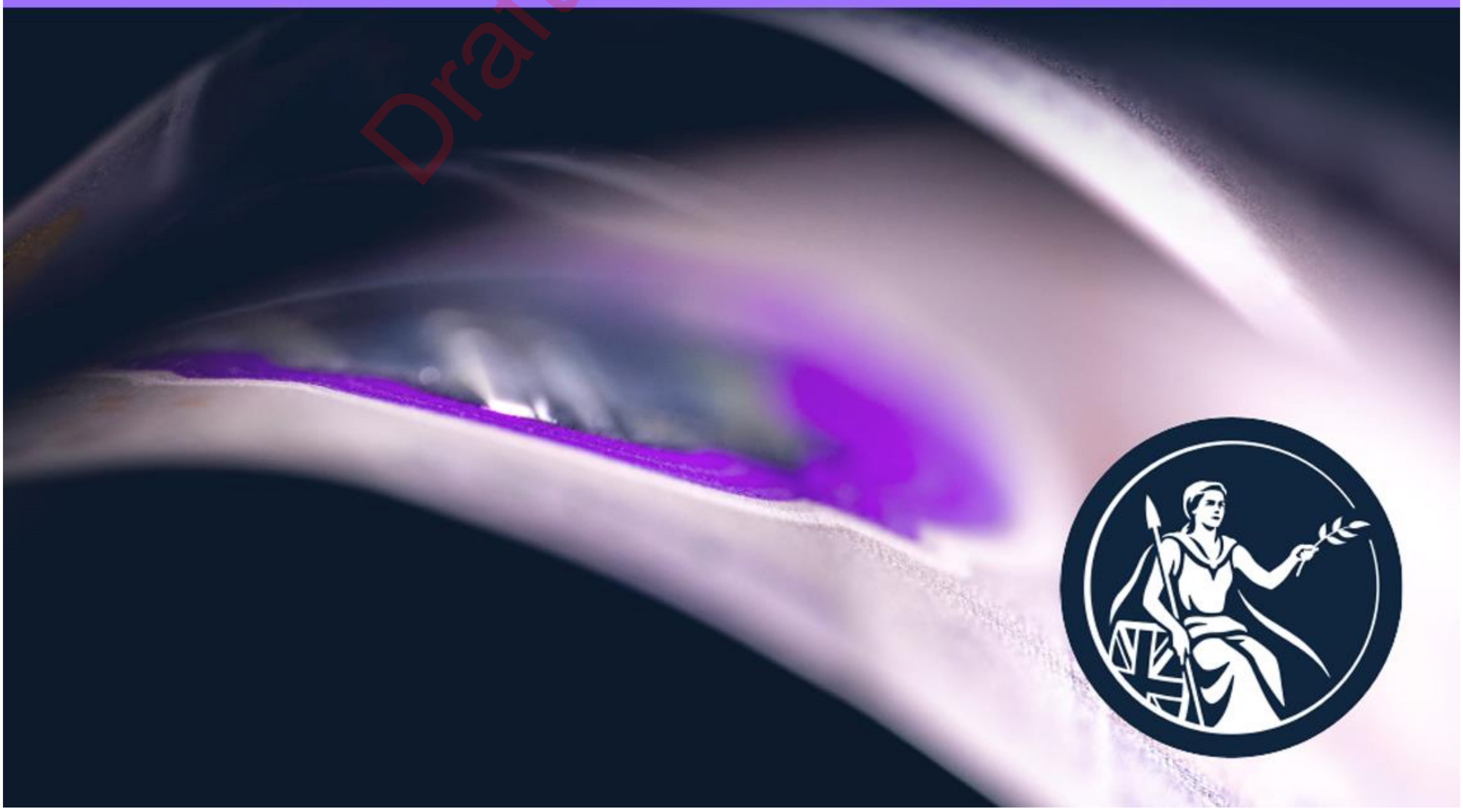
Bank of England PRA

Appendix 6: Draft amendments to SS1/20 Solvency II: Prudent Person Principle

Consultation paper | CP19/23

September 2023



Draft amendments to SS1/20 Solvency II: Prudent Person Principle

In this appendix, new text is underlined and deleted text is struck through. The text below reflects the version of SS1/20 effective from 27 May 2020.

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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~~ Investments Part of the PRA Rulebook 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 intragroup loans and participations.

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1.5 The SS should be read in conjunction with the following:

- The Investments, Conditions Governing Business, ~~and~~ Valuation and Matching Adjustment 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';[2]
- SS5/19 'Liquidity risk management for insurers';[3]
- SS41/15 'Solvency II: applying EIOPA Set 2, System of Governance and ORSA Guidelines';[4]

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 ~~October 2018: www.bankofengland.co.uk/prudential-regulation/publication/2018/pra-approach-documents-2018~~ July 2023: www.bankofengland.co.uk/prudential-regulation/supervision.

3 September 2019: ~~https://~~www.bankofengland.co.uk/prudential-regulation/publication/2019/liquidity-risk-management-for-insurers-ss.

4 ~~October 2015~~ December 2021: www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-applying-eiopa-set2-system-of-governance-and-orsa-guidelines-ss.

- SS4/18 'Financial management and planning by insurers';[5]
- SS19/16 'Solvency II: ORSA';[6]
- SS3/17 'Solvency II: illiquid unrated assets';[7]
- SS7/18 'Solvency II: Matching adjustment';[8]
- SS5/16 'Corporate governance: Board responsibilities';[9]
- SS3/19 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change';[10]
- SS10/18 'Securitisation: General requirements and capital framework';[11]
- SS35/15 'Strengthening individual accountability in insurance';[12]
- Policy Statement 15/18 'Strengthening individual accountability in insurance: Extension of the SM&CR to insurers';[13]
- SS1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU';[14]
- SS20/16 'Solvency II: reinsurance – counterparty credit risk';[15] ~~and~~
- SS8/18 'Solvency II: Internal models - modelling for the matching adjustment';[16]
- statement of policy on MA permissions;[17] and
- EIOPA Guidelines on the systems of governance.[18]

1.6 ~~In accordance with Solvency II,[19] the~~ The PRA rules require that 'as regards investment risk, a firm must demonstrate that it complies with the Investments Part of the PRA Rulebook'.[20] Accordingly, this SS addresses

5 May 2018: www.bankofengland.co.uk/prudential-regulation/publication/2018/financial-management-and-planning-by-insurers-ss.
6 November 2016: www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-orsa.
7 ~~December 2018: www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss.~~ [See the proposed update to SS3/17 currently undergoing simultaneous consultation; this footnote will be updated to provide a link following the consultation.]
8 ~~July 2018: www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-matching-adjustment-ss.~~ [See the proposed update to SS7/18 currently undergoing simultaneous consultation; this footnote will be updated to provide a link following the consultation.]
9 July 2018: www.bankofengland.co.uk/prudential-regulation/publication/2016/corporate-governance-board-responsibilities-ss.
10 April 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss.
11 ~~November 2018~~ October 2021: www.bankofengland.co.uk/prudential-regulation/publication/2018/securitisation-general-requirements-and-capital-framework-ss.
12 ~~July 2018~~ June 2021: www.bankofengland.co.uk/prudential-regulation/publication/2015/strengthening-individual-accountability-in-insurance-ss.
13 July 2018: www.bankofengland.co.uk/prudential-regulation/publication/2018/strengthening-individual-accountability-in-insurance-extension-of-the-smcr-to-insurers.
14 ~~April 2019~~ December 2020: www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras-approach-after-the-uks-withdrawal-from-the-eu-ss.
15 November 2016: www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-reinsurance-counterparty-credit-risk-ss.
16 [See 8/18 and the proposed update to it that is currently undergoing simultaneous consultation; this footnote will be updated to provide a link to the updated SS following the consultation.]
17 [See the proposed statement of policy – Solvency II: Matching Adjustment Permissions, currently undergoing simultaneous consultation; this footnote will be updated to provide a link following the consultation.]
18 ~~https://www.eiopa.europa.eu/content/guidelines-system-governance_en~~ A link to these guidelines can be found in Appendix 1 of statement of policy - Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU (August 2022, updating January 2021) www.bankofengland.co.uk/paper/2019/interpretation-of-eu-guidelines-and-recommendations-boe-and-pra-approach-sop.
~~19~~ ~~Article 44(3) of the Directive.~~
20 Conditions Governing Business 3.4.

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.

1.7 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;[21]~~
- 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;
- that if firms appear to the PRA to be in breach of the ~~PRA Investment Rules~~ Investments Part of the PRA Rulebook, the PRA would consider exercising its relevant supervisory powers under section 55M of the Financial Services and Markets Act 2000; and
- that a breach of the PPP may be associated with a failure to meet the requirements set out in the Conditions Governing Business ~~Part~~ or Matching Adjustment Parts of the PRA Rulebook. In particular, a breach of the PPP within matching adjustment (MA) portfolios may also translate to a breach of MA eligibility conditions[22]. The PRA may consider imposing capital add-ons when certain of these requirements of the Conditions Governing Business Part are breached. In the case of a breach of MA eligibility conditions that is not rectified for more than two months, the PRA may consider necessary changes to the MA permission (which may be in addition to the reduction to the MA required by Matching Adjustment 13.5).

1.8 The expectations set out in this SS do not amend the scope of the requirements that apply under ~~Solvency II~~ the rules in the PRA Rulebook ~~and under directly applicable EU regulations~~. In some cases, the rules or regulations apply at a portfolio level while in others the requirements are more granular.[23] Accordingly, the level of granularity at which the expectations in this SS should be applied will depend in each case on (among other things) the scope of all relevant requirements to which the expectation refers or relates and the specific circumstances of each firm case-by-case, taking into account the principle of proportionality.

1.9 In this SS, any reference to any provision of direct EU legislation is a reference to it as it forms part of retained EU law.

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3 Investment risk management

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3.6A The PRA expects that, in their monitoring of investment risks, firms should also consider the impact of concentrations on the solvency position, including concentrations on the amount of MA benefit claimed. Monitoring of concentrations should include the impact of the crystallisation of single risks (as set out in paragraph 3.6 of this SS) on the MA benefit.

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21 ~~A36(2) of the Directive.~~

22 Matching Adjustment 2.2(6).

23 For example, Investments 5.2(1) requires consideration of each of a firm's derivatives and quasi-derivatives and it would not be sufficient for the purposes of satisfying this rule to consider derivatives only at a portfolio level, while Investments 2.1(2) expressly requires consideration of the security, quality, liquidity and profitability of a firm's assets at a whole portfolio level.

Investment ~~Risk Management Policy~~ risk management policy

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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.[24] 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.

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Risk concentration, risk accumulation and lack of diversification

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3.19 Investments 5.2(3) 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. This is an objective standard that must be assessed on an objective basis. One way the PRA expects that firms could demonstrate proper diversification is by stress testing 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~~,~~ or downgrade resulting from a change in government policies~~,~~ or 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 and the firm is able to recover from a severe shock and restore compliance with all its regulatory requirements.[25]

In this context, the PRA considers that what constitutes 'moderate' and 'severe' stress scenarios depends on the individual circumstances of a firm.

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~~ supervisory expectations for relatively more severe stress scenarios. The PRA would expect ~~firms~~ a firm to use a combination of simultaneous stresses and be able to identify the set of circumstances that would threaten ~~their~~ its solvency risk appetite.

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3.23 Firms must ensure that their investments do not expose them to risks that cannot be managed effectively in accordance with the requirements of the rules in the Conditions Governing Business and ~~the~~ Investments Parts of the PRA Rulebook. The more complex the risk and the less understood it is (eg climate risk), the more difficult it is for firms to manage their exposure to such risks effectively. Therefore, the PRA expects ~~firms to be able~~ a firm to pay particular attention to such risks in ~~their~~ its investment risk management policy and to avoid overexposure to such risks. For example, ~~firms~~ a firm should consider whether there is an excessive

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24 ~~A44(2) Solvency II~~ Conditions Governing Business 2.5(1) and ~~A260~~ Article 260(1)(c)(v) of the Commission Delegated Regulation (EU) 2015/35.

25 This is in line with ~~SS4/18 Financial Management and Planning by Insurers~~ paragraph 2.3 of SS4/18 – Financial management and planning by insurers (May 2018), in which the PRA expects that firms set their risk appetites by considering, amongst other factors, 'recovery options that may be available to the insurer, including consideration of when each option may not be available': www.bankofengland.co.uk/prudential-regulation/publication/2018/financial-management-and-planning-by-insurers-ss.

accumulation of financial risks from climate change in ~~their~~ its investment portfolio, consider appropriate mitigants to those risks and note the expectations set out in SS3/19. As another example, ~~firms~~ a firm should consider ~~their~~ its exposure to political risk, particularly when investing in assets that are ultimately backed by government.

3.24 In considering the nature and quantification of the risks associated with each category of asset and with individual assets (see paragraph 3.14 of this SS), the PRA expects a firm to limit its investment appropriately where there is insufficient data to quantify the risks.

4 Outsourcing of investment activities

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4.4 Article 274 of the ~~Solvency II EU~~ Commission Delegated Regulation (EU) 2015/35 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 (System of governance), firms~~ Firms should identify a process to determine which functions and activities are critical or important.[26] 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'.

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5 Exposures to non-traded assets

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5.7 The PRA reminds firms of its expectations relating to liquidity risk arising from investment in non-traded assets, as set out in ~~SS18/19~~ SS5/19.[27]

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6 Valuation uncertainty

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6.1 The PRA recognises that there is inherent uncertainty in the valuation of any asset. This will be most material for any asset where there are no quoted market prices in active markets in the same assets, as it is not possible to know for certain what a buyer would pay to a seller for such an asset at a point in time. The less deep, liquid and transparent the market for a particular asset, the greater reliance a firm will have to place on modelled values, and hence the greater the valuation uncertainty.[28] The MA benefit resulting from including a particular asset in the MA portfolio will depend on the modelled values, hence its uncertainty will also be affected by the nature of the market for a particular asset.

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6.5 In accordance with Conditions Governing Business 7.1, ~~firms remain~~ a firm 'remains fully responsible for discharging all of ~~their~~ its obligations under the rules and other laws, regulations and administrative provisions

26 ~~https://www.eiopa.europa.eu/content/guidelines-system-governance_en~~ EIOPA Guidelines on the systems of governance.
27 ~~March 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/liquidity-risk-management-for-insurers~~ September 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/liquidity-risk-management-for-insurers-ss.
28 This could conflict with Investments 2.1(1).

adopted in accordance with the Solvency II Directive' when ~~they outsource~~ it outsources 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 Commission Delegated ~~Act~~ Regulation (EU) 2015/35.

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