

The Prudent Person Principle

An objective, risk-based approach to Investment

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The Solvency II (“SII”) Prudent Person Principle (“PPP”), Article 132 of the Directive, sets out rules and principles to be followed by (re-)insurers when carrying out asset investment activities. Chapters 2 to 5 of the Investments Part of the Prudential Regulation Authority (“PRA”) Rulebook transpose this Article into UK regulation.

The latest and updated text of PRA’s expectations on the PPP, [Supervisory Statement 1/20](#) (“the SS”), has been issued on the PRA’s website. This was supplemented by the issuance of the [Policy Statement 14/20](#) (“the PS”) which provided PRA’s feedback to responses received to the [Consultation Paper 22/19](#) (“the CP”), and the rationale behind the limited amendments and updated to the proposed expectations.

After consideration of all responses received, the PRA maintained the bulk of its original proposals, but offered clarification in certain areas, notably:

- what the PRA means by objective standards (discussed in section 2 below);
- expectations around outsourcing (9); and
- the distinction when discussing valuation uncertainty between the valuation at a point in time and the value realisable under stress (10).

The PRA also confirmed that the PPP would apply to reinsurance arrangements, as some firms appeared to have assumed this may not have been the case (see 11).

Implementation date

The effective date of the implementation of the SS is immediate, i.e. the date of the publication, 27 May 2020. Nevertheless, PRA did highlight their risk-based approach to regulation and the previously announced [measures aimed at alleviating operating burdens for PRA regulated insurers](#) during the COVID-19 crisis; see [here](#) for Milliman’s take on this.

The concept of the PPP is not new, but we expect that actions to be taken by individual firms, in order to be fully compliant with the PRA’s stated expectations, may vary significantly.

Background to the Prudent Person Principle

The original consultation was issued in September 2019 with a speech by Charlotte Gerken, Director, cross-cutting and Insurance Policy at the PRA, entitled [Insurance Risk Management in a Changing World](#) which brought together three areas of revised standards:

- the CP on the Prudent Person Principle;
- Consultation Paper 23/19 on “Income producing real estate loans and internal credit assessments for illiquid, unrated assets.” The final Policy Statement 9/20 for this was issued in April 2020, as discussed in [our briefing note](#); and
- the final Supervisory Statement 5/19 on Liquidity Risk Management for Insurers. We have developed our own [framework for liquidity risk management](#).

The key element driving all three of these requirements is the increased trend towards insurers investing in illiquid and more complex assets. And the speech put the Prudent Person Principle at the heart of this: “*Much of the response to complex or unmodellable risks is not quantitative but qualitative – the domain of the prudent person principle.*”

The speech also notes that within the, otherwise extensive, Solvency II rules, the Prudent Person Principle for investment covers just two pages, and is based on high level principles, which generally the PRA regards as a desirable approach. But, justifying the issue of the more detailed requirements for the PPP in the CP, the speech concluded:

“High-level principles are desirable. However, we have found that in practice, firms have not implemented them to a consistent standard, taking into account their varying business models, scale and complexity.”

Key PRA expectations

Below we set out our views on the key points from the PRA’s expectations for compliance with PPP.

1. “Firms may only invest in assets the risks of which they are 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)”

This is stated in the Investment 2.1(1) of the PRA Rulebook and referenced in the SS, and can be seen as an overarching requirement for PPP compliance.

The well-known Peter Principle¹ in business states that: “in a hierarchy every employee tends to rise to his level of incompetence.” One of the PRA’s key aims is to avoid the investment corollary of this, and ensure that insurers invest only up to, and not beyond, their level of competence.

This means firms must not invest in assets, the risk of which they cannot effectively identify, measure, monitor, manage, control, report or take into account in their ORSA. This applies even though such assets might be a good match to liabilities, provide diversification benefits, have attractive risk-return profiles or be invested in by peers.

Investment in illiquid assets is a particular focus. These assets can typically include more complex features, as well as creating valuation uncertainty risk, as discussed in section 10.

Furthermore, such assets are often not publicly rated by recognized External Credit Assessment Institutions, and, for inclusion in internal models or Matching Adjustment portfolios, an internal rating framework needs to be developed. The results of this process may impact the insurer’s understanding of the quality and risks of its investment portfolio. This was covered in more detail in Policy Statement 9/20.

This overriding requirement for competence should also feed into the process used by insurers in the suitability assessment of any proposed new asset classes or investment opportunities before requesting Board level approval.

For risks of assets that are less understood like climate change or political risk, insurers should keep their exposure at a prudent level. Where risks cannot be reliably modelled or quantified in insurer’s Solvency Capital requirement (“SCR”) calculations, the PRA still expects that an insurer’s risk management framework should be designed to capture all risks. Beside using scenario and stress testing techniques, we consider that insurers should also leverage the ORSA process to identify, discuss, challenge and document those risks that are more complex to model and/or less quantifiable.

2. “The PRA notes that PPP sets objective standards for prudent investment ... Compliance with these standards must be assessed on an objective basis...”

In the updated text in SS 1/20, the PRA reaffirmed that the PP was an ‘objective’ compliance test, rather than ‘subjective’.

In the September 2019 speech by Charlotte Gerken that launched the consultation, the PRA observed that the Prudent Person Principle is a well-established concept in case law both in the UK and internationally, outside of its specific reference in the Solvency II legislation.

It originates in Trust Law, and more broadly in the concept of fiduciary responsibility. The PRA found references in case law back to the 1740s, but choose to quote a 1883 case to emphasize that prudence does not mean taking no risk:

“No doubt it is the duty of the trustee, in administering the trusts of a will, to deal with the property entrusted into his care exactly as any prudent man would deal with his own property. But the words in which the rule is expressed must not be strained beyond their meaning. Prudent businessmen in their dealings incur risk. This may and must happen in almost all human affairs.”²

A more modern definition of the PPP can be found in a 2002 paper from the Organisation for Economic Co-operation and Development, aimed at international third-pillar pension arrangements, “[Prudent person Rule](#)” [Standard for the Investment of Pension Fund Assets](#):

“A fiduciary must discharge his or her duties with the care, skill, prudence and diligence that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and aims.”

The PRA was keen to clarify in the SS that objectivity:

- doesn’t mean that a firm’s own views are irrelevant, indeed firms are required to make their own judgement; or
- doesn’t imply a one-size-fits-all policy, or limits that would apply irrespective of a firm’s particular circumstances, e.g. its business strategy or risk profile.

But, nevertheless, it does introduce a key element of objectivity which the PRA compared with ‘reasonable person’ test existing more widely in civil and criminal law contexts, sometimes referred to as ‘the man on the Clapham Omnibus test’.

Insurers will therefore be required, in addition to documenting their own views, to be able to justify that it is reasonable to conclude that someone else with the same risk and business profile might have reached a similar conclusion.

3. “Compliance with the PPP must be considered on a case-by-case basis, as what is prudent for one firm... may not be prudent for a different firm”

The PS confirms that no quantitative benchmarks will be used by the PRA in assessing an insurer’s compliance with the PPP. Instead, the compliance will be assessed objectively on a case-by-case basis by considering all relevant factors in each insurer’s circumstances.

This suggests that the compliance with the PPP needs to be assessed in the context of an insurer’s particular circumstances rather than just being a matter of an asset’s features. Certain factors may differentiate individual companies which may include, but are not limited to:

- The in-house expertise for a particular asset class;
- Any previous trading experience of a particular type of assets;
- What data sources does a firm have access to so that it could properly identify, assess and manage the risks from the assets;

¹ The Peter Principle by Dr Peter and Raymond Hull (William Morrow and Company, 1969)

² Bacon VC in Re Godfrey 1883

- The intended size of holding in both absolute and relative terms to the firm's balance sheet; and
- The nature of a firm's liabilities – see section 5.

Further, while the PRA will not themselves set quantitative investment limits, they made it clear that firms should define on their own such limits and operate within them.

4. "...taking into account the principle of proportionality"

There is nothing in the PPP expectation that, in PRA's view, conflicts with the SII proportionality principle and firms, when applying PPP requirements, can take proportionality into account.

However, we recommend insurers to be mindful when exercising this principle in demonstrating that they are PPP compliant, by fully justifying the reasoning behind their judgement of its application. The principle of proportionality should not be used to remove the need to comply with PPP requirements for a particular asset all together.

Instead the proportionality principle may be used to determine how extensive the assessment of the PPP may be for a particular asset or asset class, taking account of both the level of materiality of the holdings versus the insurer's overall portfolio, but also the risks, non-standard features and complexity of the asset concerned.

5. "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'."

This requirement should be embedded in an insurer's process for developing and reviewing an investment management strategy for assets that are intended to back the technical provisions ("TP") on the SII balance sheet. It does not mean assets other than those backing the TPs can be invested freely. Indeed, PRA reminds insurers that the freedom of investment (Article 133 of SII Directive) is not 'absolute', but is subject to meeting all SII requirements including PPP.

The requirement of investing in a manner appropriate to the nature and duration of an insurer's liabilities can be considered as a specific requirement to the insurer's Asset Liability Management ("ALM") function, suggesting the asset cash flows should reasonably match the cash flows of liabilities in the best estimate scenario. In addition, the ALM position under suitably severe stress scenarios should not give rise to a material solvency or liquidity issue to an insurer, i.e. the sensitivity of assets and liabilities should reasonably match. The SS makes it clear that the PRA would not consider a situation where assets backing the TPs give rise to a material solvency or liquidity issue as meeting PPP expectations.

Intragroup transactions were highlighted in the SS as a particular area of focus. The SS has been updated to clarify that there was no intention to prohibit investments of this nature. However, given that a conflict of interest between policyholders and other stakeholders could arise in this type of transactions, the appropriateness of using any such investments to back the TPs should be explicitly assessed on a case-by-case basis.

6. "In some cases, the rules or regulations apply at a portfolio level while in others the requirements are more granular."

The PRA considered that a simple application of PPP expectations at a portfolio level would not be sufficient, and therefore some expectations need to be considered at an asset class level, or even at a more granular, individual asset, level. The PRA did not prescribe an approach to be followed by all firms, instead the judgement of the level of granularity of the application is a matter of the firm, subject to its own circumstances.

As an example, Chapter 5.2 of the Investment Part of the PRA Rulebook states that a derivative or quasi-derivative can only be held if it reduces risks or facilitates efficient portfolio management. In the PRA's view, it is not sufficient to apply this test only at a portfolio level.

In our view, generally speaking, where assets are more conventional and standard to insurers' investment portfolios, as well as where they are more homogeneous in nature, it makes more sense to apply PPP requirements by grouping these assets, and hence justifying their compliance more at an asset class level.

7. "While the PRA is not seeking to impose additional reporting requirements..."

At the consultation stage, some respondents requested further clarification on how the PPP could be documented and evidenced for compliance.

The PRA confirmed in the PS that there was no intention for asking for specific additional reporting in respect of the PPP.

However, the PRA did suggest that the Board should not receive information on the PPP compliance in a piecemeal fashion, but rather in a way that enables them to effectively engage with, understand and challenge the documentation of compliance with the PPP.

The PRA also re-confirmed that they regard investment strategy as something over which the Board itself should have oversight, rather than say a senior level committee of the firm.

8. "The Chief Risk Officer is responsible for managing and reporting to the Board on risk management strategies and processes in place, including those relating to investments"

The Chief Risk Officer ("CRO") has the responsibility of designing and developing a robust risk management framework to properly capture and manage all risks to which an insurer is exposed, including these risks arising from the insurer's investment activities.

For investment risks, the CRO's responsibility may include designing and developing an investment risk management policy under SII rules; opining the setting of quantitative investment limits that encompass a range of asset features; and providing effective challenge to the operation and decisions made by the firm's investment function.

The SS also sets out the PRA's views on some key elements that should apply to an investment policy framework to comply with the PPP.

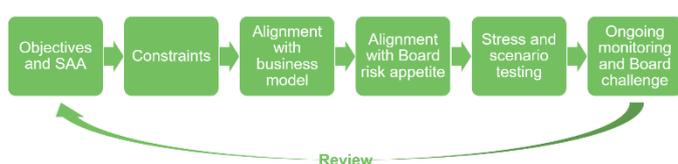
The strategy, risk management policy and internal limits should align with the insurer's business model and objectives, and with its defined (and Board approved) risk appetite and with the Solvency II PPP requirements.

The PRA also expects a clear policy to be developed (potentially with specified management actions) for the scenario in which the defined investment risk limits were breached.

The strategy, risk management policies and risk limits should be submitted to the Board, or relevant sub-committee, for challenge and approval of both the continued appropriateness and any significant changes, such as investment in a new asset class, or a material non-routine investment or change to the portfolio.

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. The current COVID-19 epidemic would seem, to us, an example of an event that should trigger a review of the investment strategy. Such a review could, for example, have a particular focus on the effectiveness of derivatives used for hedging market risks, on implications for liquidity risk management and changes to strategic asset allocation ("SAA") arising from the changed economic outlook.

FIGURE 1: A SCHEMATIC OF A SUITABLE INVESTMENT POLICY AND REVIEW CYCLE:



9. “Rule 7.1 states that ‘if a firm outsources a function... it remains fully responsible...’

The PRA normally considers an insurer's investment function to be designated as a 'critical or important operational' activity. For firms wholly or partially outsourcing their investment-related activities, including the investment oversight function, the PRA confirmed that the firm remains responsible for meeting the PPP requirements.

The Board of the insurer must be aware of any outsourced investment activities, and must monitor these activities performed by external service providers and, as a minimum, be

satisfied that these activities are in line with the contract, the investment strategy and policy, and their risk appetite.

The PRA did amend its original expectations from the CP by removing the specific requirement that an external manager's mandate had a formal requirement to invest only in accordance with the PPP. However, there is still an onus on insurers to ensure that any external manager only invests their assets in accordance with the PPP, although the PS allows firms to determine how this can be achieved.

The PS also states that “the PRA considers that it is likely to be difficult for a firm to outsource investment management oversight in a way that does not breach” the requirements of the Conditions Governing Business, suggesting investment oversight cannot be fully outsourced.

10. “The PRA expects that firms will have effective systems and controls in place to limit and manage their exposure to valuation uncertainty.”

The PRA clarified in the PS that their focus was on uncertainty on the valuation of an asset at a point in time, rather than the value that might be realised under stress scenarios. However, a firm should recognise that the greater uncertainty about the base valuation, the greater uncertainty about the realisable value under stress scenarios.

The valuation uncertainty risk exists, to various degrees, in all assets where the valuation of which is not readily available, and hence needs to be determined by using an alternative mark-to-model approach. It can also exist where the available value is less reliable due to the asset either being less frequently traded, or when the holding by an insurer being large enough to be able to materially influence such valuation.

The PRA considered this valuation uncertainty risk as a key risk to illiquid assets, amongst of all other possible risks presented by this type of assets compared to those in a highly liquid form. For those insurers intending to invest (or already investing) in illiquid assets, they should demonstrate that they meet requirements stated in the Investment 2.1(1) of the PRA Rulebook taking into account the valuation uncertainty risk.

The PRA considered that it is important for companies to develop a framework to be able to quantify or grade the valuation uncertainty risk in the underlying assets, and feed this through into the setting of internal investment limits for assets subject to such uncertainty.

The September 2019 speech highlighted an example of best practice for firms considering multiple valuation techniques when assessing the value of a portfolio of complex illiquid assets. Firms might also consider the impact of alternative data sources in the setting of assumptions, as well as consider the impact of this risk under stress scenarios.

The PRA requires the valuation uncertainty risk to be explicitly quantified for any new asset (class) investment as part of submitting investment proposals for the Board approval.

11. “The PPP applies to all assets, including reinsurance arrangements.”

This statement is newly added to the proposed text in the SS for clarification.

Under Solvency II, reinsurance recoverables are part of the asset side of the balance sheet, instead of being netted against the technical provisions. Indeed, we have also recently seen the PRA emphasise to firms the need for this gross treatment of reinsurance in the context of Matching Adjustment calculations.

This means that reinsurance assets are subject to all relevant PPP requirements. Counterparty credit risk is one key aspect of this and the PRA previously set out their expectations here in [Supervisory Statement 20/16](#). The PRA stated that, as for any asset, a case-by-case approach to PPP compliance would be taken, and this would also reflect risk mitigates, such as collateral.

In our experience one key area for reinsurance relates to counterparty concentration limits.

As a minimum standard, the PRA expects the solvency of a firm not to be threatened by a plausible crystallisation of a risk relating to assets from one issuer (or counterparty) or those in the same group.

More generally, the PPP requires that an insurer’s investment portfolio is sufficiently diversified, not excessively exposed to risks of a single asset, single issuer (or inter-connected group), geography or any accumulation of risk (including risk factors such as a change in government policy), and that this assessment is made by the firm on an objective basis. The PRA expects that:

- 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.

Such stress tests and limits would also be expected to apply to reinsurance arrangements.

We consider that this is an area where we may see further development, with the PRA noting that they “expect to have further dialogue with firms about the application of the PPP to reinsurance.”

Conclusion

The final PS does not impose any significant additional requirements over and above the original CP, although some of the clarifications from the PRA may alter firms’ understanding of the PRA’s requirements.

Given the immediate implementation date, insurers who haven’t already done so will need to perform a near-term exercise to identify any gaps between their current processes and the PRA’s expectations, and to develop a rectification plan.

Milliman consultants are experienced with reviewing insurers’ investment frameworks, and would be pleased to assist with this process, in particular with:

- Gap analysis of firm’s existing investment risk framework and governance against the PPP expectations;
- Review of counterparty risk management frameworks;
- Support in designing and assessing internal credit assessment frameworks for (illiquid) unrated assets; and
- Development of [risk metrics for climate change](#) including transition risks.



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Appendix

- SS 1/20 'Solvency II: Prudent Person Principle'
<https://www.bankofengland.co.uk/prudential-regulation/publication/2020/solvency-ii-prudent-person-principle-ss>
- PS 14/20 'Solvency II: Prudent Person Principle'
<https://www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-prudent-person-principle>
- Milliman Paper 'Regulatory Reporting Updates in light of COVID-19'
<https://milliman-cdn.azureedge.net/-/media/milliman/pdfs/articles/regulatory-reporting-updates-covid-19.ashx>
- Speech by Charlotte Gerken, Bank of England, 'Insurance risk management in a changing world'
<https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/insurance-risk-management-in-a-changing-world-speech-by-charlotte-gerken.pdf>
- Milliman Paper 'PS 9/20 and updated SS 3/17: Illiquid and unrated assets'
<https://www.milliman.com/en/insight/ps-920-and-updated-ss-317-illiquid-and-unrated-assets>
- Milliman Paper 'Liquidity risk management: An area of increased focus for insurers'
<https://www.milliman.com/en/insight/liquidity-risk-management-an-area-of-increased-focus-for-insurers>
- OECD Paper "Prudent Person Rule" Standard for the Investment of Pension Fund Assets'
<https://www.oecd.org/finance/private-pensions/2763540.pdf>
- SS 20/16 'Solvency II: reinsurance – counterparty credit risk'
<https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2016/ss2016>
- Milliman Paper 'Risk metrics for climate change – Climate change risk monitoring: Which metrics and why?'
<https://milliman-cdn.azureedge.net/-/media/milliman/pdfs/articles/climate-change-metrics.ashx>