SLAUGHTER AND MAY

Slaughter and May Podcast
Investment rules podcast

Robert Chaplin	Hello and welcome. I'm Robert Chaplin, one of Slaughter and May's corporate insurance partners. With me is Beth Dobson, our insurance practice support lawyer. This is our overview of investment rules under Solvency II. For more information, please see chapter 10 of our Solvency II App. If you don't already have the App, please email solvency.two@slaughterandmay.com to request access. When the Solvency II regime was introduced it represented a relaxation of the previous rules regarding the way in which insurance companies could invest. The old list of "admissible assets" was replaced with a more flexible "prudent person principle", which applies to all the assets held by an insurer. In broad terms, the prudent person principle requires that an insurer must only invest in assets which it is able properly to identify, monitor and manage, which reflect the firms' overall solvency needs, which contribute to the security, quality, liquidity and profitability of the portfolio as a whole, which are localised to ensure their availability and which are properly diversified. In the event of a conflict of interest, assets must be held in the best interests of policyholders and beneficiaries. Investments in a particular issuer or group must not expose the firm to excessive risk concentration. Some specific rules apply to derivatives and unlisted securities. Investment in derivatives is only allowed to the extent it contributes to a reduction of risks or efficient portfolio management and investment in unlisted securities must be kept to prudent levels. There is no definition of what constitutes a "prudent" level of investment, but this is an area which the PRA has scrutinised closely, as we will come on to. For assets held to cover technical provisions, the assets must also be invested in a manner appropriate to the nature and duration of the relevant insurance liabilities and in the best interests of all policyholders and beneficiaries, taking into account any disclosed policy objective. The rules are slightly different for "linked business", where the policyholder takes the investment risk. For these types of policy the restrictions on investments in derivatives and unlisted securities and the rules regarding diversification and risk concentration do not apply.
Beth Dobson	The PRA has taken a close interest in investments by insurers under Solvency II. This has in particular reflected concerns around changes in investment behaviour driven by economic conditions. In 2017 David Rule, then director of insurance supervision at the PRA, gave a speech to the ABI in which he commented that "Yields on government bonds are low and

	spreads on corporate bonds narrow. Insurers are therefore searching for yield in less liquid, direct investments." This is an ongoing trend and the PRA's concerns remain the same as in 2017 – that these type of investments generally lack observable market prices and external credit ratings, making it more difficult to assess their risks and true value, and that they are more difficult to sell. Interestingly, in the same speech, David Rule said that the PRA aimed to publish a supervisory statement on the prudent person principle later that year, but in the end this was only published in May 2020. We will come back later to what the supervisory statement says.
Robert Chaplin	As well as the need to comply with the prudent person principle, insurers' investment choices are restricted where they want to apply matching adjustment treatment to a particular portfolio of liabilities. We talked about the matching adjustment in an earlier podcast and it is discussed in detail in Chapter 6 of the Solvency II App. Insurers can only use assets with fixed cash flows to cover their matching adjustment liabilities. In practice, however, insurers use a range of different assets to back these types of liabilities, but where necessary have carried out restructurings of the assets to achieve matching adjustment compliance. Assets used to back annuity and other matching adjustment eligible liabilities include real estate assets and equity release mortgages, which are unlisted, unrated assets. The PRA has issued guidance on its expectations of firms investing in these types of assets within their matching adjustment portfolios. This focuses on how firms should carry out their internal credit assessments of the relevant assets. For Income Producing Real Estate assets in particular, but also more generally for illiquid unrated assets, the PRA reminds firms of the need to satisfy the prudent person principle in respect of all their investments, which is likely to involve carrying out a comprehensive risk identification exercise for the assets.
Beth Dobson	In May this year, the PRA finally published its supervisory statement on the prudent person principle. This followed a consultation published in September 2019. The PRA makes the overarching point at the beginning of the supervisory statement that compliance with the prudent person principle must be assessed on an objective basis, from the standpoint of the hypothetical prudent person in similar circumstances. The supervisory statement covers the following areas: investment strategy; investment risk management; risk concentration and diversification; outsourcing; exposures to non-traded assets; and intra-group loans and participations.

	The PRA expects firms to review their investment strategies to ensure that these consider the alignment of the strategy with the firm's business model, the board's risk appetite, risk tolerance limits and investment risk return objectives. The message is very much that prudential investment requirements should be integrated into the business strategy of the firm. Importantly, where the risks associated with assets held by an insurer are dependent on the performance of underlying assets, the risks of the underlying assets must be included within the scope of the investment risk management framework. Firms are also required to set their own quantitative investment limits for assets and exposures. The PRA will apply greater supervisory scrutiny to firms which it believes have excessive levels of concentration risk. An area to which the PRA devotes a large amount of attention is the use of intra-group loans and participations within the investment strategy of insurance groups. There is a concern that these will lead to conflicts of interest and will therefore not be in the best interests of policyholders. The PRA considers that it is unlikely, therefore, that intra-group assets will be appropriate for covering technical provisions, although in some circumstances they might be appropriate for other purposes.
Robert Chaplin	Finally, the impact of climate change is an important area for insurers to consider in their investment activities. In its supervisory statement on the prudent person principle, the PRA comments that firms should avoid excessive accumulation of unmanageable long-term risks such as financial risks arising from climate change. In an earlier supervisory statement on Enhancing banks' and insurers' approach to managing the financial risks from climate change, the PRA emphasized the importance of board oversight of these risks, and that risks should be identified and monitored through the firm's risk management framework including the ORSA. Climate change risks can arise on the liability side of the balance sheet but physical and transition risks arising out of investments are particularly significant. In 2019 EIOPA published an opinion on sustainability within Solvency II. Among other things, EIOPA recommended that insurers should be required to take into account the impact of their investment activity on sustainability factors, although it is not entirely clear how this would interact with insurers' more general prudential requirements. The Commission has not yet taken any action in response to the opinion. In conclusion, although the investment rules requirements under Solvency II are relatively "light touch" on their face, in practice there are a number of layers of different requirements and expectations which will influence the way in which insurers invest.

	This brings us to the end of this podcast. If you have any questions about investment rules please get in touch with either of us or your usual contact at Slaughter and May.