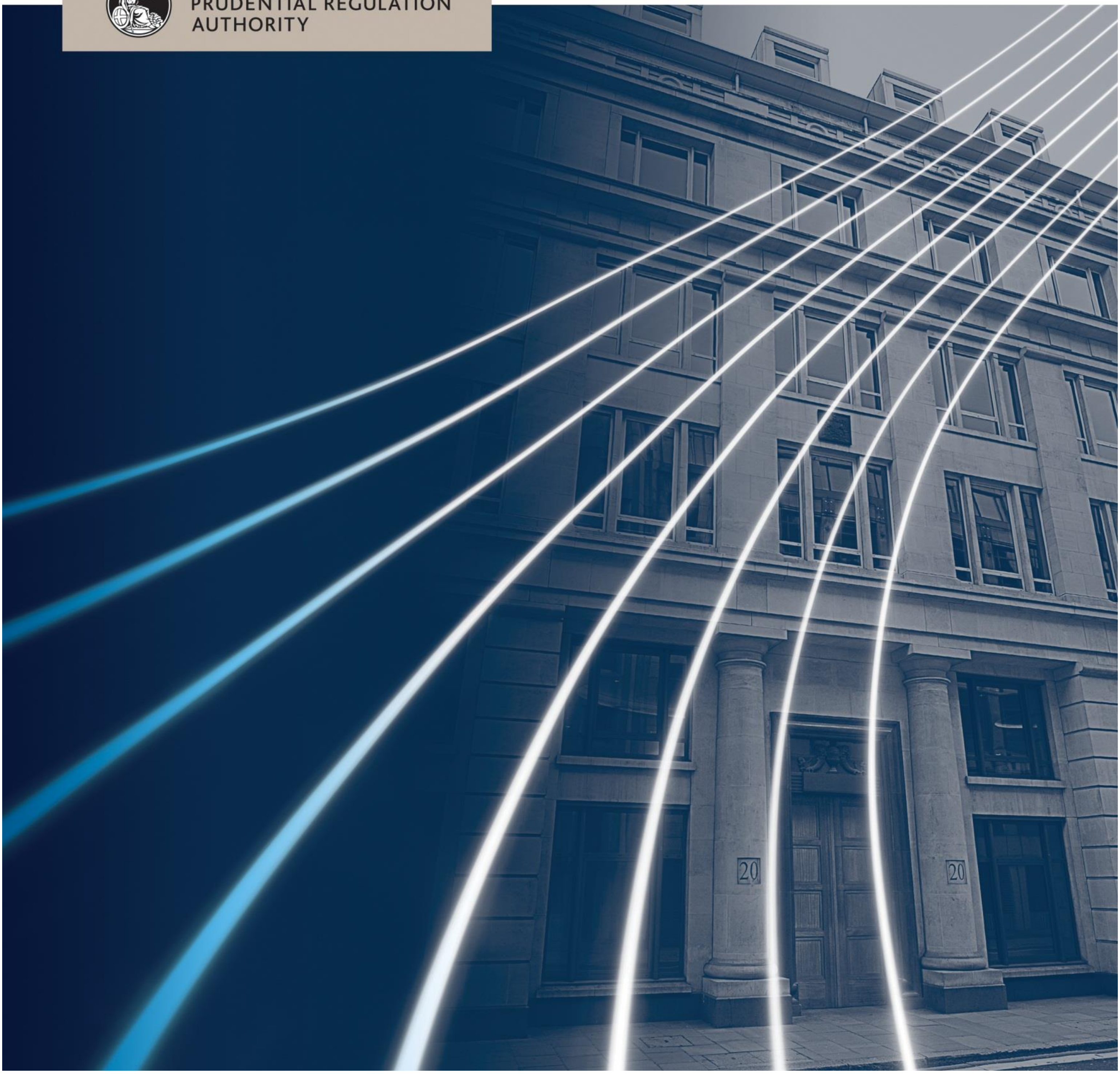
Policy Statement | PS14/20

Solvency II: Prudent Person Principle

May 2020

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



BANK OF ENGLAND
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Policy Statement | PS14/20

Solvency II: Prudent Person Principle

May 2020

Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 22/19 'Solvency II: Prudent Person Principle'.[1] It also contains the PRA's final policy in Supervisory Statement (SS) 1/20 'Solvency II: Prudent Person Principle' (Appendix 1).

1.2 This PS is relevant to all UK Solvency II firms (including in the context of provisions relating to Solvency II groups), mutuals, third-country branches, the Society of Lloyd's and its managing agents (collectively, 'firms').

Background

1.3 In CP22/19, the PRA sought views on a draft SS that set out the PRA's expectations for insurers' management of investment risk in line with the Prudent Person Principle (PPP). The draft SS covered:

- objective standards established by the PPP;
- development and documentation of an investment strategy;
- investment risk management including concentration risk, counterparty risk and the setting of internal investment limits;
- outsourcing of investment activities;
- exposures to non-traded assets;
- management of valuation uncertainty; and
- intragroup loans and participations.

Summary of responses

1.4 The PRA received seven responses to the CP. Respondents generally welcomed the PRA's proposals and made a number of observations and requests for clarification. Some proposals were challenged by respondents. The PRA's feedback to these responses is set out in Chapter 2.

Changes to draft policy

1.5 After considering the responses, the PRA has made some changes to the draft policy. The most significant amendments involve clarification of:

- objective standards;
- the extent of risk management and outsourcing expectations; and
- the distinction between valuation uncertainty at a point in time and uncertainty over the realisable value of an asset under stress.

Details of the changes are included in Chapter 2. The PRA has also made a number of minor editorial amendments and typographical changes to improve the clarity and readability of the SS.

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1 September 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-prudent-person-principle.

1.6 Following supervisory conversations with firms, the PRA has also clarified in the SS that the PPP applies to reinsurance arrangements. This is discussed further in Chapter 2.

1.7 The PRA does not consider that these changes and editorial amendments alter the substance of its expectations. Accordingly, the impact of the changes for firms is not considered to be significant, or to differ in respect of mutuals.

Implementation

1.8 The expectations set out in the attached SS1/20 will come into effect upon the publication of the PS on Wednesday 27 May 2020. The PRA reminds firms of its 'Approach to Insurance Supervision', in particular, the focus on 'those issues and those firms that, in our judgement, pose the greatest risk to the stability of the UK financial system and, in the case of insurers, to policyholder protection'.[2] It also refers firms to the published measures aimed at alleviating operational burdens on PRA-regulated insurers in the wake of the Covid-19 outbreak.[3]

1.9 The policy set out in this PS has been designed in the context of the UK's withdrawal from the European Union and entry into the transition period, during which time the UK remains subject to European law. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework at the end of the transition period, including those arising once any new arrangements with the European Union take effect.

1.10 The PRA has assessed that the policy would need to be amended under the EU (Withdrawal) Act 2018 (EUWA). Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018'[4] for further details.

1.11 The final SS attached to this PS should be read in conjunction with SS1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU'[5] and the joint Bank and PRA Statement of Policy (SoP) 'Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU'.[6]

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2 October 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/pras-approach-to-supervision-of-the-banking-and-insurance-sectors.

3 March 2020: https://www.bankofengland.co.uk/news/2020/march/boe-announces-supervisory-and-prudential-policy-measures-to-address-the-challenges-of-covid-19.

4 April 2019: https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.

5 February 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras-approach-after-the-uks-withdrawal-from-the-eu-ss.

6 February 2019: https://www.bankofengland.co.uk/paper/2019/interpretation-of-eu-guidelines-and-recommendations-boe-and-pra-approach-sop.

2 Feedback to responses

2.1 The PRA has considered the responses received to the CP. This chapter sets out the PRA's feedback to those responses, and its final decisions.

2.2 The sections below have been structured broadly along the same lines as the chapters of the CP, with some areas rearranged to better respond to related issues. The responses have been grouped as follows:

- general expectations and objective standards;
- investment strategy;
- investment risk management;
- outsourcing;
- non-traded assets;
- valuation uncertainty;
- intragroup transactions; and
- reinsurance (new).

General expectations and objective standards

2.3 The draft SS referred to the fact that the PPP sets objective standards for investment.

2.4 Five respondents commented on this to request clarity or to argue that the PPP's standards are not objective. Two respondents asked for more clarity on the two examples of case law cited, while another respondent asked how a third party could determine prudence as a fact. Respondents also asked how qualitative standards could be objective when decisions are made by subjective decision makers, and suggested discretion should be prioritised over any objective limits.

2.5 These responses reflect a general uncertainty as to the meaning of the messages that the PRA intended to convey in this context. The PRA considers that the PPP set out in Article 132 of the Solvency II Directive prescribes an objective test by which to assess the prudence of firms' investment management. The PRA considers that compliance with the requirements of the PPP must therefore be assessed on an objective basis, from the standpoint of the hypothetical prudent person in similar circumstances (taking into account all relevant factors case-by-case), rather than a firm's subjective view about the prudence of its investment standards. In taking this view, the PRA notes that interpreting the PPP as setting a subjective test would render it meaningless because in that case, no matter how irrational, unreasonable or imprudent a firm's investment standards might be, they would satisfy the PPP provided the firm perceived them to be prudent. The PRA also notes that the objective test set by the PPP is broadly similar to the objective 'reasonable person' test that applies in the criminal and in the civil law contexts.

2.6 Applying the PPP on an objective basis does not mean that a firm's views about the prudence of its investments is irrelevant or would be disregarded. Indeed, firms are required to make their own judgments about the prudence of the way they manage their business for the purposes of the risk management requirements in Solvency II. Nor does the objective basis upon which the PPP must be understood imply that the same investment policy, or the same quantitative investment limits, ought to apply to different firms with different business strategies and risk profiles. Accordingly, the PRA has amended the wording of the SS to clarify this. The PRA has used the cited court cases to illustrate that, where the PPP has been used in regimes other than Solvency II, the courts have been prepared to rule on what constitutes a prudent investment strategy from the perspective of a hypothetical 'prudent person', even if the regime does not set quantitative investment limits.

2.7 One respondent asked how the PRA measures PPP compliance. The PRA can confirm that its framework for supervising compliance with the PPP does not include quantitative benchmarks. As discussed in paragraph 2.5, the PRA considers that compliance with the requirements of the PPP must be assessed on an objective basis, from the standpoint of the hypothetical prudent person in similar circumstances (taking into account all relevant factors case-by-case).

2.8 One respondent suggested stress testing and capital models should be sufficient to demonstrate meeting an objective standard. The PRA considers that stress testing and capital models are not sufficient to assess PPP compliance, and notes that Rule 3.1(2)(b) of the Conditions Governing Business Part of the PRA Rulebook explicitly recognises that not all risks are captured in the Solvency Capital Requirements (SCR) calculation. Additionally, it is generally accepted that not all risks can be reliably modelled; and the use of models relies heavily on assumptions, which introduces risks. Under Solvency II, a firm's risk management framework must capture all risks – including those arising from the modelling process, those which might not be quantifiable and those which are not (or not fully) included in the calculation of the SCR.

2.9 One respondent suggested that reference to the definitions of assets of primary and secondary liquidity used in SS5/19 'Liquidity risk management for insurers'[7] would be welcome. The PRA has amended the SS to include reference to SS5/19, which was published while CP22/19 was in consultation phase. The PRA has not made explicit reference to assets of primary or secondary liquidity, as it considers that these are sufficiently covered in SS5/19.

2.10 One respondent asked the PRA to ensure that the freedom of investment set out in Article 133 of the Solvency II Directive is maintained. The PRA considers that there is nothing in its SS that is inconsistent with this principle as it applies in the Solvency II regime. The PRA notes that a firm's freedom of investment under Solvency II is not absolute but is constrained by all the requirements of the Solvency II regime, including the PPP.

2.11 One respondent requested that the SS refer explicitly to the proportionality principle of Solvency II. The PRA considers that there is nothing in the SS on PPP that is inconsistent with this principle, and notes that the principle of proportionality is relevant to the way in which requirements are applied, but cannot be relied upon as a basis for dis-applying requirements altogether.

2.12 The PRA proposed that paragraphs 3.4–3.23 of Chapter 3 (investment risk management) and the entirety of Chapter 5 (non-traded assets) of the SS should not apply to assets covering unit-linked business. Two respondents called for additional guidance on PRA expectations for unit-linked business, with-profits and direct shareholder investment funds. One respondent asked for confirmation that Chapter 6 (valuation uncertainty) does not apply to linked long-term contracts

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

except for assets covering guaranteed benefits. Another respondent suggested that the PRA should consider valuation uncertainty to apply to all long-term contracts including unit-linked business.

2.13 The PRA has considered these responses. Although the risks specific to unit-linked business mean that certain requirements of the PPP are only relevant to linked business,[8] and certain requirements of the PPP are not relevant to linked business other than in respect of guaranteed benefits,[9] valuation uncertainty is relevant to a firm's ability to properly identify, measure, monitor, manage, control and report the risks arising from its investments for the purposes of the requirements in Rule 2 of the Investments Part of the PRA Rulebook. This rule applies to all Solvency II firms, regardless of the nature of their business. Accordingly, the PRA considers that the expectations in the SS relating to valuation uncertainty are relevant to all Solvency II firms, including in respect of linked insurance business.

2.14 One respondent argued that the reputational and cash flow risks of unit-linked business underperforming should be considered by firms. The PRA considers that specific identification of individual risks, such as reputational risk associated with unit-linked business, is a matter for firms.

2.15 A number of respondents suggested that certain requirements referred to in the draft SS should apply only on a whole portfolio basis or on an asset class basis, rather than on an individual asset basis (such as the expectations set out in Chapter 5 on non-traded assets, or those relating to the monitoring of derivatives). These respondents requested clarification as to the level of granularity that firms should apply for the purpose of satisfying the expectations in the SS. The PRA notes that the expectations set out in the SS do not amend the scope of the requirements that apply under Solvency II rules in the PRA's Rulebook and under directly applicable EU regulations. 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. In some cases, the rules or regulations apply at a portfolio level. For example, Investments 2.1(2) requires consideration of the security, quality, liquidity and profitability of a firm's assets at a whole portfolio level. Accordingly, whether the expectations in the SS should be applied at a portfolio level or at a more granular level 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.

Investment strategy

2.16 The PRA proposed that the investment policy that firms are required to develop and document should satisfy certain minimum criteria, including compliance with the PPP.

2.17 One respondent explicitly welcomed the PRA's expectation that PPP compliance should be actively considered when making new investments. Four respondents requested confirmation that the PRA did not expect PPP compliance to be detailed at the individual asset level. In accordance with Article 309 of the Solvency II Delegated Regulation, firms must, in their regular supervisory report, set out 'a complete list of assets and how those assets have been invested in accordance with the 'prudent person principle'.[10] As discussed in paragraph 2.15 of this PS, the PRA expects

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[8] Paragraph 3 of Article 132 of the Solvency II Directive.
[9] The requirements in paragraph 4 of Article 132 of the Solvency II Directive.
[10] Delegated Regulations (EU) 2015/35 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (Delegated Regulations 2015/35).

that, in line with the principle of proportionality under Solvency II, it may be appropriate for firms to consider PPP compliance at the asset class level in their supervisory reports.

2.18 Two respondents asked if a single report on PPP compliance was expected or whether aggregated separate documents could meet the documentation expectations. One respondent suggested requiring a standalone compliance document for the board in all cases would be inappropriate, suggesting the compliance framework within the own risk and solvency assessment (ORSA) could suffice. The PRA is not seeking to set additional reporting requirements in respect of the PPP, but considers that the board cannot make effective decisions if it receives information piecemeal. Accordingly, the PRA expects that firms document compliance in a way that enables the board to effectively engage with, understand and challenge the material.

2.19 Respondents suggested that oversight of the investment strategy could be left to one of a firm's senior-level committees rather than the board, and that board scrutiny of the investment strategy could be replaced with more board involvement in the ORSA process. The PRA considers that investment is a key function over which the board itself must have oversight. Board engagement with the ORSA process would not be an adequate substitute for board oversight of the investment function.

2.20 One respondent suggested that requiring an investment strategy at the asset class level was overly inflexible. The PRA considers that it would be very difficult for a firm to demonstrate that it is not placing excessive reliance on a single asset class in line with Investments 5.2(3)(a) if its investment strategy does not address or use asset classes.

Investment risk management

2.21 The PRA proposed several expectations relating to how firms manage their investment risk (including counterparty risk) and the functioning of their risk management systems.

Complex Risks

2.22 One respondent requested clarity on the term 'unmanageable risks' used in Chapter 3. The PRA was referring to the requirement for firms to manage all their risks in accordance with the rules in the Conditions Governing Business and the Investments Parts of the PRA Rulebook. In line with the requirements, firms must avoid exposures to risks that they cannot effectively manage. The PRA notes that some risks (such as climate transition risk and political risk) are complex and poorly understood and, therefore, will be more difficult to manage. The PRA expects firms to pay particular attention to such risks in their investment risk management policies, and has amended the SS to clarify this.

Credit Default Risk

2.23 One respondent requested clarification that credit default risk includes credit transition risk. The PRA agrees and has clarified this in the SS.

Liquidity Risk

2.24 One respondent suggested the SS should place more of a focus on liquidity risk management and suggested it could be combined with SS5/19. The PRA has considered this but does not agree. Liquidity risk affects both sides of the balance sheet whereas the PPP applies only to assets (for which liquidity is just one of several risks).

Political Risk

2.25 Another respondent suggested that the PRA provide more clarity on political risks including the risk of UK sovereign default.

2.26 The PRA notes that under the PPP, a firm must only invest in assets and instruments the risks of which it can properly identify, measure, monitor, manage, control and report. The PRA considers that assessment of sovereign default risk to which they are exposed is a matter for firms.

Concentration Risk

2.27 The PRA proposed several expectations for how firms will manage their investment concentration risk, including that they stress test their portfolios.

2.28 Respondents welcomed guidance that concentration risk should feed into firms' risk appetites, asked if the reference to underlying assets included securitisations, OEICs and derivatives, and suggested that paragraph 3.14 of the SS read as though individual limits should be placed upon single assets rather than asset classes. After considering the responses, the PRA has amended the SS to confirm that the reference to underlying assets includes securitisations, OEICs and derivatives. Paragraph 3.14 has been updated to clarify that limits should be placed at the asset class (not individual asset) level.

2.29 One respondent suggested that any internal investment limits should be treated as triggers for review rather than 'hard limits'. The PRA expects firms to have a clear policy in place for what would happen if a limit was breached that does not simply involve changing the limits.

2.30 Several respondents asked that the PRA ensure its guidance does not discourage investment in particular asset classes, such as infrastructure and investments that incorporate environmental, social and corporate governance factors (ESG). The PRA does not consider that the SS discourages investment in asset classes such as infrastructure and ESG investments. The PRA recognises the role of insurers in financing the transition to a low-carbon economy, but this transition will depend on a functioning, sound and stable financial system, to which the PPP contributes.

2.31 One respondent suggested it would be disproportionate for all firms to identify and manage correlation and contagion risk. The PPP is clear that all firms must avoid excessive accumulation of risk, so the PRA has not amended the expectations in the SS relating to correlation and contagion risk.

2.32 Three respondents specifically referred to the expectations proposed around stress testing and requested clarity on what would constitute a moderate or severe stress scenario. They suggested that the expectations were overly prudent; specifically, that they went beyond ordinary SCR requirements and general risk management principles. They also suggested that stress testing might be sufficient but should not be necessary to demonstrate meeting an objective standard. Additionally, at least one firm has asked supervisors to clarify the PRA's intended meaning when saying that the solvency of a firm should not be threatened under a severe stress scenario.

2.33 The PRA has considered these responses and amended the SS to be clear that what constitutes 'moderate' and 'severe' stress scenarios depends on the individual circumstances of a firm. The PRA considers that the expectations are in line with Article 44 of the Solvency II Directive (and Conditions Governing Business 3.1(2)(b)), which is clear that a firm's risk management system must explicitly cover the risks not captured in the SCR calculation. The PRA considers that stress testing is likely to be necessary, but not necessarily sufficient, to demonstrate proper diversification. The PRA has amended the SS to clarify that the PRA expects a firm to be able to demonstrate that the solvency of the firm is not threatened in a severe stress scenario, and that the firm is able to recover from a severe shock and restore compliance with all its regulatory requirements.

Outsourcing

2.34 The PRA proposed expectations relating to the outsourcing of investment activities, including that firms undertake appropriate due diligence in line with Article 274 of the Solvency II Delegated Regulation.

2.35 Two respondents asked the PRA to clarify if these expectations also apply to situations where only specific components of the investment function are outsourced, rather than the entire function. Both respondents suggested that it would be inappropriate to expect asset managers to formally certify PPP compliance, and suggested that the onus was on the insurer to set specific written standards that would meet the PPP for the asset manager to follow. One respondent suggested that the expectation that boards be 'fully aware' of any outsourced investment activity was overly onerous given the complexity of much investment activity, and suggested a delegate of the board could fulfil this function. Three respondents suggested that the expectations set in Chapter 3 around internal credit risk assessments were overly onerous in circumstances where external asset managers have already done this.

2.36 After considering these responses the PRA has amended the SS to clarify that the expectations apply equally in circumstances where only part of the investment function is outsourced. The PRA considers that the onus is on insurers to ensure that their asset managers invest in line with the PPP, though the detail of how they achieve this is a matter for firms.

2.37 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 requirement in Conditions Governing Business 7.2, which states that the outsourcing must not materially impair the quality of the firm's system of governance, unduly increase operational risk, impair supervision of the firm's compliance with its obligations or undermine service to policyholders. Ultimately, the outsourcing of any part of a firm's investment management does not discharge the firm of any of its obligations (Conditions Governing Business 7.1), and a firm is required to ensure that its governing body is ultimately responsible for the firm's compliance with its obligations (Conditions Governing Business 2.1). Therefore, at a minimum, a firm's board should be satisfied that investment management arrangements are in line with the firm's strategy, strategic asset allocation and risk appetite. The SS has been amended accordingly.

2.38 Finally, the PRA considers that where firms outsource investment management activity, including credit risk assessments, they must have sufficient in-house expertise to appropriately monitor the risks associated with outsourcing. This may not always be the same level of expertise that would be required to manage the investments in-house. The SS has been amended accordingly.

Non-traded assets[11]

2.39 The PRA proposed several expectations relating to non-traded assets, including factors to consider in determining internal investment limits, levels of expertise of key persons and the treatment of these assets in internal models.

2.40 One respondent suggested that the wording in the draft policy implied that non-traded assets always have more heterogeneous risks than traded assets. The PRA has amended the SS to note that, in general, non-traded assets tend to be more complex than those traded on a regulated market or exchange and, as a result, often expose firms to additional risk.

11 The PRA uses the term 'non-traded assets' as defined in Investments 1.1(c) as assets not admitted to trading on a regulated market.

2.41 One respondent suggested that the SS was overly focussed on asset valuation as opposed to management and realisation. The PRA agrees that investment risk management for non-traded assets requires consideration of issues that are not limited to valuation risk, and that are also captured under the requirements of the PPP and by other expectations in the SS (including those set out in paragraph 5.6, which refers to the expertise of key persons in relation to managing the complexity of non-traded assets).

2.42 Two respondents asked that the PRA explicitly recognise that there were various reasons beyond those stated which might incentivise insurers to invest in non-traded assets. The PRA has amended the SS to explicitly recognise that there are various incentives for investing in non-traded assets. For example, they might be a good match for a firm's liabilities, such as annuities and Periodic Payment Order liabilities for General Insurance firms.

2.43 Respondents challenged the assertion that non-traded assets expose firms to additional risks, suggesting that liquidity risk is the only 'additional risk' such assets create, and that even then no asset is truly illiquid. They suggested that the historical data that exists for risk drivers of non-traded assets may be more complete than the historical data for some liquid indices. One respondent suggested the term non-traded assets was unclear and suggested firms should be able to consider their assets at the portfolio level. Liquidity risk is not the only additional risk that arises from investing in illiquid assets. The management of other risks such as valuation uncertainty risk is particularly (but not exclusively) relevant in the case of non-traded assets, the value of which must be marked to model. Furthermore, while the PRA understands that the absence of market pricing does not mean an asset cannot be sold, it can and frequently does result in time delays and the application of haircuts to the value of the asset, the impact of which should be properly considered by firms. The PRA has amended the SS to note that pricing data is particularly difficult to obtain where there are no quoted prices in active markets for that asset. Firms may have historical records for their own assets but are unlikely to have access to historical data relating to the market as a whole. The PRA has defined non-traded assets. Questions about the granularity of expectations are addressed in paragraph 2.15 in this PS.

2.44 One respondent suggested that it was unreasonable to expect a firm to consider any inconsistency between its internal model and economic reality when setting internal quantitative investment limits. They requested clarity on how firms should manage any inconsistency, suggested that the internal model and the internal economic view have distinct objectives which do not need to align, and suggested that return on cost of capital should not necessarily be consistent with non-capital related economics in investment.

2.45 The PRA has considered this suggestion and has amended the SS to clarify that where firms use internal models, they should be able to justify any material differences in how investment risk is assessed for capital purposes and when applying the standard of the PPP, and manage any risks arising as a result of such differences.

Valuation uncertainty

2.46 The PRA proposed several expectations as to how firms should take valuation uncertainty risk into account when investing in non-traded assets.

2.47 Five respondents commented on the proposed expectations relating to valuation uncertainty. Several respondents said that it was not clear precisely what was meant by the term valuation uncertainty and suggested that the SS conflated the concept with the ability to realise the value of an asset under stress. Two respondents suggested that setting limits on valuation uncertainty was unnecessary given that Pillar 1 of Solvency II captures market, liquidity and valuation uncertainty risks.

2.48 The PRA considers valuation uncertainty at a point in time to be distinct from uncertainty about the value of an asset that will be realised under stress. The PRA has redrafted Chapter 6 of the SS to ensure clarity on this point. Article 44 of the Solvency II Directive, as transposed in Rule 3 of Conditions Governing Business, is clear that although not all risks are captured in a firm's SCR, all risks must be managed effectively.

2.49 Respondents suggested that the scope of the chapter be widened beyond non-traded assets, for instance to encompass circumstances where a material proportion of a specific asset's issuance is held. The less deep, liquid and transparent the market for a particular asset, the greater reliance a firm will have to place on alternative valuation methods, including modelled values, and hence the greater the valuation uncertainty. Firms are required to identify, measure and manage all of their risks, including those arising from valuation uncertainty.

2.50 Two respondents suggested amending the expectation that firms 'be able to quantify bounds on any valuation uncertainty at a granular level' with alternative wording. One respondent asked the PRA to specify how valuation uncertainty should be quantified. One respondent asked if valuation uncertainty could be monitored in aggregate and in proportion to exposure. Another respondent suggested limits should only be in place where there is a material exposure. One respondent asked if limits on valuation uncertainty should feed into limits on non-traded assets.

2.51 The SS has been amended to clarify that the PRA expects that firms will have effective systems and controls in place to limit and manage their exposure to valuation uncertainty, and that this should include a framework for quantifying or grading their exposure to this risk, to enable them to define appropriate internal investment limits (in line with paragraph 2.2 of the SS) in respect of their investment in assets that expose them to valuation uncertainty. The adequacy and appropriateness of that framework will depend on all the circumstances in each case, taking into account the principle of proportionality.

2.52 The PRA refers respondents to paragraph 2.15 of this PS which discusses whether the expectations in the SS should be applied at a portfolio level or at a more granular level. The PRA considers that it is for firms to consider the most appropriate way of quantifying or grading valuation uncertainty.

Intragroup transactions

2.53 The PRA proposed several expectations relating to intragroup loans and participations, including that it would be a high hurdle for firms to demonstrate that an intragroup transaction was in the best interests of policyholders and thus appropriate to back technical provisions.

2.54 Three comments from respondents referred to these expectations. One respondent asked for clarity that the 'high hurdle' referred to was not a blanket ban, and that cases would be considered on a case-by-case basis. One respondent suggested that the expectations should not apply to special purpose vehicles (SPVs) or other wholly owned asset-holding entities. One respondent suggested intragroup investments can benefit policyholders and that the 'high hurdle' referred to was overly cautious. They also suggested that mutuals would be particularly adversely affected if they could not use intragroup transactions to back their technical provisions.

2.55 After considering the responses the PRA has amended the SS to clarify that the expectations do not create an outright ban and that this should be assessed on a case-by-case basis. The PRA considers that while transactions with group SPVs may not create the same conflicts of interest that some intragroup investments do, the PRA expects firms to consider whether assets are held in the best interests of policyholders on a case-by-case basis. Given that there is no outright ban, the PRA considers it unlikely that mutuals will be particularly adversely affected by the expectations.

Reinsurance

2.56 The PRA proposed that firms consider the impact of material reinsurance cessions and associated counterparty credit risk when setting internal investment limits. It also proposed that the draft expectations set out in Chapter 7 of the SS (intragroup investments) would not normally apply to pure intragroup reinsurance arrangements. In response to these proposals, one firm has queried whether the PPP applies to reinsurance arrangements at all.

2.57 The PRA did not intend to put into question whether the PPP applies to outward reinsurance. The PRA considers that the PPP applies widely to all assets and investments, including outward reinsurance, and has amended the SS to clarify this. As with all assets, the requirements of the PPP must be considered in respect of reinsurance arrangements on a case-by-case basis, taking into account all relevant factors including risk-mitigation factors (such as collateral) when assessing whether a given arrangement meets the standards of the PPP. The PRA has set out its expectations in relation to firms' management of risk – particularly counterparty credit risk – in relation to their reinsurance arrangements in SS20/16, 'Solvency II: reinsurance counterparty credit risk'.[12] The PRA expects to have further dialogue with firms about the application of the PPP to reinsurance, alongside existing guidance.

[12] November 2016: https://www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-reinsurance-counterparty-credit-risk-ss.

Appendix

1 **SS1/20 'Solvency II: Prudent Person Principle', available at: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/solvency-ii-prudent-person-principle-ss**