

The Prudent Person Principle

AFM NED Conference

26 June 2023

Mutual *Respect*
Providing Added Value

Contents

- About me, Purpose of this session
- Prudent Person Principle – regulatory expectations
- What does the regulation say?
- The Prudent Person Principle
 - Investment Strategy
 - Investment Risk Management
 - Outsourcing
 - Unusual assets
- Time for an audit?

About me

What I learned at the regulator

- No such thing as better
- The rules cannot be interpreted
- Form not substance
- Language matters
- No interest in success/potential/tomorrow, just process/resource/documents/now



**COMPUTERS HAVE
LOTS OF MEMORY BUT
NO IMAGINATION**

PICTUREQUOTES.COM



PICTUREQUOTES.COM

About me

Publications

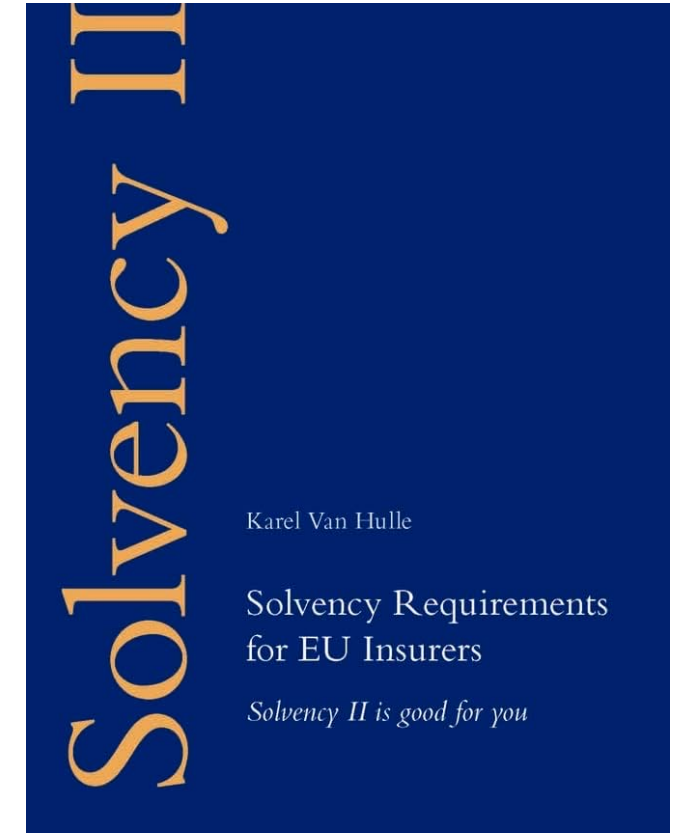
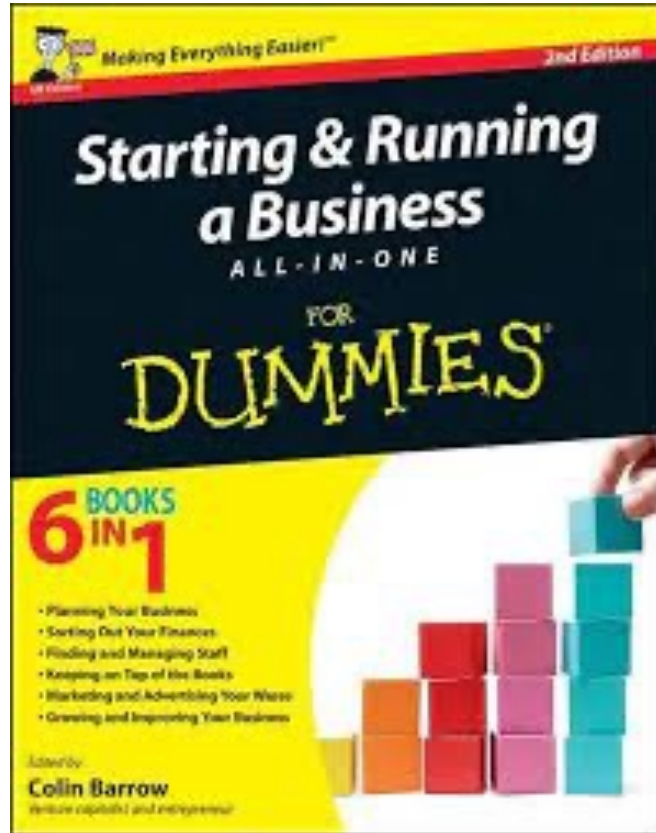
- The complete Risk Management System
- The 12-page ORSA Report
- AFM Guide for Non-Executives
- Assessing & Managing Culture
- What can actuaries bring to risk management?

What's today about?

- Aimed at Non-Executive Directors
- Covering the governance requirements for investments
- Are you compliant?
- What's worth checking?



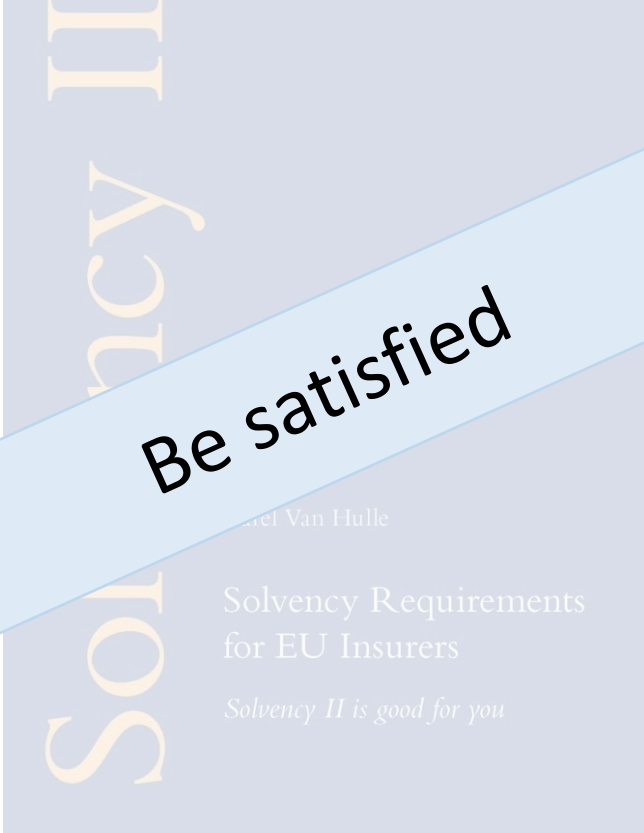
The Non-Executive Insurance Director



The Non-Executive Insurance Director



Challenge



Be satisfied

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What does the regulator want?



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What is Prudence?

watchfulness
considerateness judiciousness
forethought calculation heedfulness
discretion vigilance concern
circumspection judgment reasoning
coolness conservatism wisdom
providence austerity care frugality
tact foresight economy
prudence heed carefulness
diligence deliberation
conservation precaution
sagacity

What is Prudence?



The rear-view mirror approach

Any asset that has fallen in value?

- Equities when markets fall
- Bonds when interest rates rise
- Cash when banks fail
- Currencies when sterling appreciates

What is Prudence?



What the law says

"The duty of a trustee is not to take such care only as a prudent man would take if he had only himself to consider; the duty rather is to take such care as an ordinary prudent man would take if he were minded to make an investment for the benefit of other people for whom he felt morally bound to provide."

Judgement referred to in SS1/20

The Prudent Person Principle

First, only invest in assets where

You can:

- Identify
- Measure
- Monitor
- Manage
- Control, and
- Report the risks

Include the risks in the ORSA

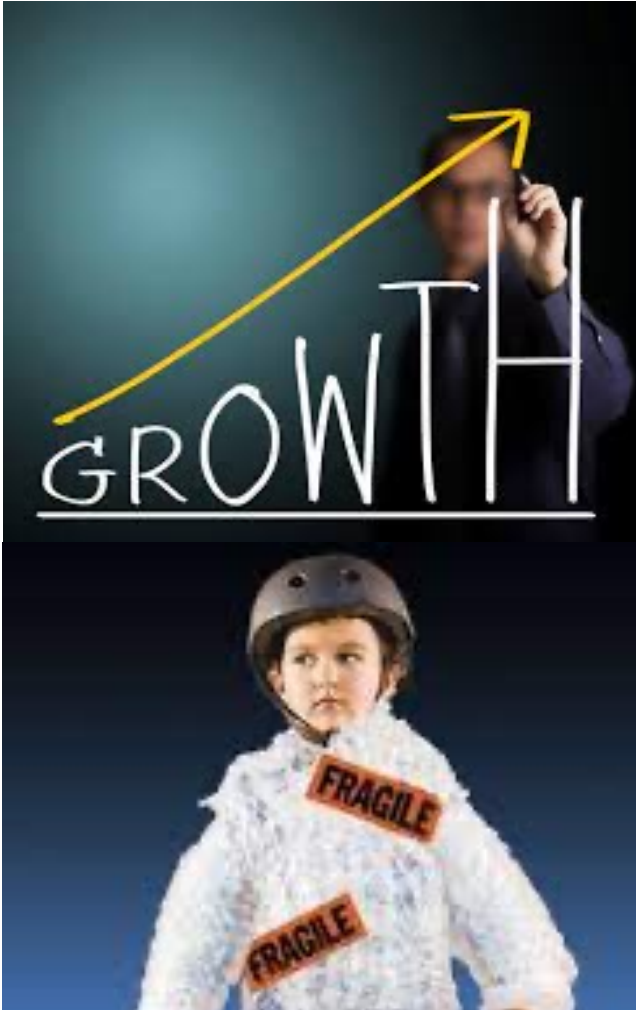
Second, invest to ensure

- Security
 - Quality
 - Liquidity
 - Availability, and
 - Profitability
- of the portfolio as a whole
- If a conflict of interest, policyholders first

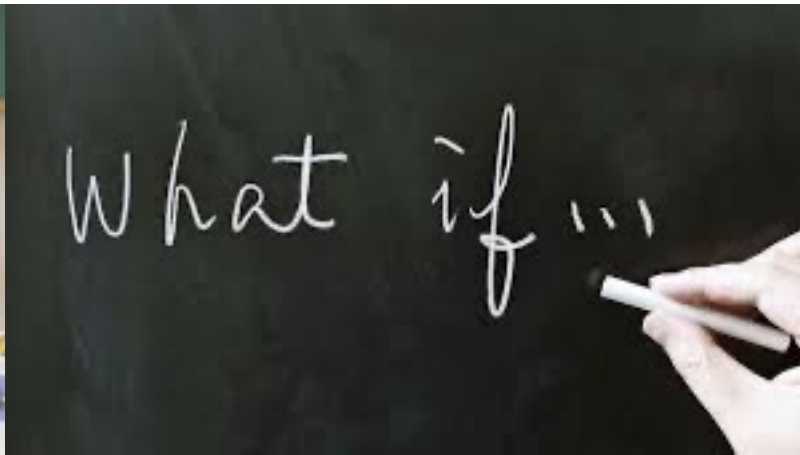
Third, make sure that

- Unit-linked assets are matched
- Derivatives reduce risks or increase efficiency
- Unmarketable assets are kept to prudent levels
- The portfolio is diversified
- Excessive concentration is avoided

What does the regulator not want/expect?



What does the regulator expect?



What does the regulator expect?



What does the regulator expect?

Too hard?



What does the regulator expect?



but



If you want to invest imprudently...

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The Prudent Person Principle

Supervisory Statement | SS1/20

Solvency II: Prudent Person Principle

May 2020



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The Prudent Person Principle



There are seven sections in the SS

1 each for strategy, outsourcing and risk management

4 deal with unusual assets

The Prudent Person Principle



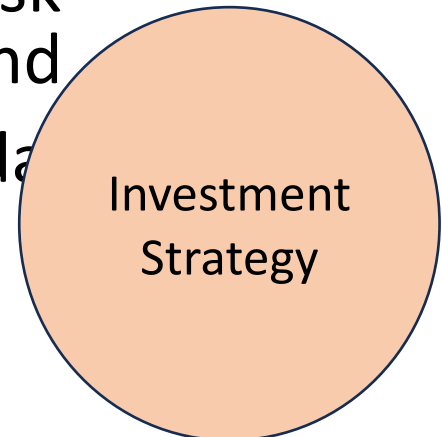
Where does investment governance fit?

No SMF for investment
Falls to risk function

Does the risk function have the skills?

Investment Strategy - Contents


- Investment objectives and strategic asset allocation
- Consideration of investment constraints when setting investment objectives and strategic asset allocation
- Alignment of the investment strategy with the business model
- How the investment strategy covers the nature and duration of liabilities and policyholder best interests
- Alignment of investment strategy with board risk appetite, risk tolerance limits and investment risk and return objectives, and
- A complete list of assets and how they are invested in accordance with the PPP (as per RSR requirements).



Does your investment strategy cover these requirements?

Investment Strategy Limits - Contents

- Nature and duration of liabilities;
- Nature and quantification of the risks of each asset category/asset
- Access to investment risk management skill proportionate to complexity (especially for new assets)
- Need for proper diversification of assets
- Impact of uncertainty on valuation and liquidity including under stress;
- Uncertainty of timing/source of investment risk, mitigations
- Reinsurance and correlations of counterparty credit risk
- Counterparty failure, counterparty weakness



Investment
Strategy

Investment Strategy In Practice

- Annually reviewed
- Challenged, approved and controlled by a Committee or Board
- Especially consider new asset classes, material non-routine investment or a material change to the portfolio's composition
- Asset classes should be approved by the Board
- For new asset classes, a comprehensive risk assessment

The CRO is responsible for ensuring that these control activities are in place...does investment always feature sufficiently on CRO agendas?



What the regulator wants

“While the PRA is not seeking to impose additional reporting requirements, it considers that a firm’s 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. Firms should be able to provide evidence of this compliance to the PRA on request.”

- 1. Worth a review of packs and minutes**
- 2. Should investment reporting be consolidated?**
- 3. Are you hitting the three blocks of the PPP**



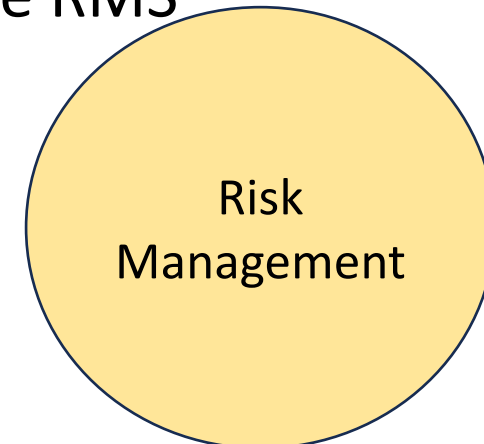
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Investment Risk Management

- Investments should be aligned with:
 - Risk appetite and risk tolerance limits
 - Risk management policies
 - Investment strategy
 - Overall business model (including profile of products and policyholders)
- The Risk Management System should ensure Block 1 obligations are met
- Where assets derive their value from other underlying assets, the RMS should monitor the underlying asset
- ORSA scenarios must take into account the nature of the assets

Useful to record how these requirements are fulfilled



How big a risk is investment risk?

Crash	Effect
1929 crash	25% fall in Dow in two days 89% of pre-crash high Recovered by 1954
Black Monday	22.6% fall in Dow Recovered within 2 years
Dotcom	Almost 80% fall over nine months
Global financial crisis	S&P losing nearly 60% of value. Recovered by April 2013
Pandemic	S&P lost 34% by end March, recovered by August

What's a reasonable ORSA test?

How big a risk is investment risk?

ORSA Scenarios

- Equities
- Bonds
- Cash
- Property
- Reinsurance
- Intra group loans
- Illiquid assets
- Interest rates
- Inflation
- Credit spreads

Where does the effect of climate change fit?

Where is political risk?

How big a risk is investment risk?

Second-order tests – are these needed?

- Concentration
- Geography
- Sector/Industry
- Counterparty
- Asset class

Depending on your business, these may be captured in the higher level tests, so not needed – but worth documenting this

Investment Risk Management

Monitor

- Value and volatility, assets and portfolio
- Changes in characteristics
- Changes of value or characteristics of underlying
- External environment changes that affect asset security
- Breaches of internal limits
- Concentrations (counterparty, class, geography, industry...)
- Changes that lead to asset/liability mismatch

Are these the headings in the regular investment report?



How big a risk is investment risk?

Increasing exposure to more exotic assets

Same rules, but more explicit application

- Derivatives
- Credit quality assessments
- Unrated assets

Is the approach documented?

Investment risk management policy

Policy must cover

- asset-liability management
- investment risk management
- liquidity risk management
- concentration risk management
- reinsurance and other insurance risk mitigation techniques

Are these required policies in place?

Investment risk management policy

Policy must have internal quantitative investment limits for assets by

- Asset class
- Geography
- Single name
- Sector
- Off-balance sheet exposures

These limits must be consistent with risk appetite and risk management, investment strategy and investment risk policies

Easy to document

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Investment Outsourcing

- No reduction in requirements
- Just more of them!
 - Risks of outsourcing
 - Does the outsourcer have sufficient risk management expertise?
- ALWAYS deemed critical and important
 - Requires pre-appointment notification

Is the investment report done by the outsourcer or by the firm?

Does the report – or, at the very least, do the minutes – confirm the required points?

Odd Assets

- Is it worth you holding them?

Can you demonstrate the competence to administer the asset or to oversee those who act on your behalf?

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- **Time for an audit?**

Time for an audit

- Investment Strategy
- Risk policies
- Regular risk reporting
- Oversight of outsourcing
- Reporting on investment performance

As a Non-Executive Director, are you completely satisfied that your firm is demonstrably adhering to the Prudent Person Principle?

The Prudent Person Principle

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THE END