FRS

Invest | Pro

Knowledge based software

www.frsltd.com

Research Update

July 2015

Assets GRC (Governance, Risk, Compliance) under Solvency II

This update is for:
Directors, CROs, and the Risk Management Function of life insurers...

George McCutcheon MSc FIA
discusses Assets GRC under Solvency II

Overview

The PRA has published its final rules [1] setting out how it will implement the prudent person principle provisions of the Solvency II Directive. In this research update, George McCutcheon reviews the assets GRC component in more detail.

Key messages for life insurers

Requirements

- The assets GRC rules are set out in PRA 2015/18 PRA Rulebook: Solvency II Firms: Investments Instrument 2015.
- Risk management rules are set out in and PRA 2015/20 PRA Rulebook: Solvency II Firms: Conditions Governing Business Instrument 2015.
- Regulatory requirements for risk management have to be applied on a continuous basis.
- Under Solvency II, life insurers have a ‘know your assets’ requirement on an economic substance basis i.e. irrespective of whether assets are held directly or indirectly through Collective Investment Undertakings (CIUs).
- Asset look-through is not optional e.g. it is required for the Pillar 2 system of governance requirements and the Pillar 3 reporting Assets D4 QRT.
- The exemption from quarterly reporting of the assets S.06.03 D4 QRT for insurers with less than 30% of their investments in CIUs doesn’t exempt such insurers from the ongoing risk management system of governance requirements and from the quarterly market risk SCR calculations on a look-through basis.

Timescales

- Insurers have to be fully compliant with the prudent person principle by 1/1/2016.
- PRA 2015/18 PRA Rulebook: **Solvency II Firms: Investments Instrument 2015 and PRA 2015/20 PRA Rulebook: Solvency II Firms: Conditions Governing Business Instrument 2015 both come into force on 1 January 2016.**

[1] PRA 2015/18 PRA Rulebook: Solvency II Firms: Investments Instrument 2015

Action Points

- The PRA expects firms to be able to explain what governance changes they need to make to satisfy the guidelines, how they plan to make those changes, what progress there has been to date and any particular difficulties they face.

Issues

- The Board is ultimately responsible for an insurer's compliance with the rules and all applicable laws, regulations and administrative provisions adopted in accordance with the Solvency II Directive.
- The system of governance was included in EIOPA's preparatory guidelines to ensure that supervisory authorities and firms are prepared for the implementation of Solvency II on 1 January 2016.
- The same standards of assets GRC apply equally to unit-linked business and other business lines and this has potentially significant litigation risks for insurers in respect of unit-linked investments.
- In an environment of increasing outsourcing by insurers of investment administration, the availability to the insurer's Solvency II risk management and compliance functions of browser based analytics capabilities with real-time unfettered access to asset data is of paramount importance.

Regulatory Background

Assets GRC rules relate to the provisions of Article 132 of the Solvency II directive.

The assets GRC rules are set out in the instrument known as PRA 2015/18 PRA Rulebook: Solvency II Firms: **Investments Instrument 2015**

The key principle is that insurers should only invest in assets and instruments the risks of which it can properly identify, measure, monitor, manage, control and report (IMMMCR) and appropriately take into account in the assessment of its overall solvency needs in accordance with Conditions Governing Business 3.8(2) (a) [2].

The assets should be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio of assets of the firm as a whole and localised such as to ensure their availability.

The investment of assets should be made in the best interest of policyholders.

Insurers must ensure that assets held to cover its technical provisions are 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.

In respect of unit-linked business, an insurer must cover its technical provisions in respect of its linked long-term liabilities as closely as possible by units or assets in the internal fund.

There are additional requirements where the investment risk is not borne by the policyholder under 5.2 where a firm must invest its assets in accordance with the following requirements:

(1) The firm must not invest in a derivative or quasi-derivative unless, and to the extent that, it contributes to a reduction of risks or facilitates efficient portfolio management

(2) Investments and assets which are not admitted to trading on a regulated market must be kept to prudent levels

(3) Assets must be properly diversified in such a way as to avoid:

(a) Excessive reliance on any particular asset, issuer, group of undertakings or geographical area

(b) Excessive accumulation of risk in the portfolio as a whole

(4) Investments in assets issued by the same issuer, or issuers belonging to the same group, must not expose the firm to excessive risk concentration

[2] PRA2015/20 PRA Rulebook: Solvency II Firms: Conditions Governing Business Instrument 2015- A firm must conduct an ORSA as part of its risk management system which must include the firm's overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the firm

Risks

There are a number of risk definitions in the Solvency II Directive.

- 'market risk' means the risk of loss or of adverse change in the financial situation resulting, directly or indirectly, from fluctuations in the level and in the volatility of market prices of assets, liabilities and financial instruments
- 'credit risk' means the risk of loss or of adverse change in the financial situation, resulting from fluctuations in the credit standing of issuers of securities, counterparties and any debtors to which insurance and reinsurance undertakings are exposed, in the form of counterparty default risk, or spread risk, or market risk concentrations
- 'operational risk' means the risk of loss arising from inadequate or failed internal processes, personnel or systems, or from external events
- 'liquidity risk' means the risk that insurance and reinsurance undertakings are unable to realise investments and other assets in order to settle their financial obligations when they fall due
- 'concentration risk' means all risk exposures with a loss potential which is large enough to threaten the solvency or the financial position of insurance and reinsurance undertakings

Component risks within market risk include interest rate risk, equity risk, property risk, spread risk, concentration risk and currency risk.

Risk Management Rules

Effective risk management system to IMMMCR risks on a continuous basis. This relates to Article 44(1) of the Directive.

Risk management rules are set out in the PRA Rulebook: **Solvency II Firms: Conditions Governing Business Instrument 2015**

Under 3.1.1, a firm must have in place an effective risk-management system comprising strategies, processes and reporting procedures necessary to identify, measure, monitor, manage and report on a continuous basis the risks, at an individual and at an aggregated level, to which it is or could be exposed, and their interdependencies.

The risk management system must be effective and well integrated into the organisational structure and decision-making processes of the firm with proper consideration of the persons who have key functions. It must cover investment (in particular derivatives, quasi-derivatives and similar commitments), liquidity risk and concentration risk management and operational risk management.

This relates to Article 44(3) of the Directive under which insurers are required to comply with Chapter VI Section 6 which includes Article 132 (the 'prudent person principle').

Under 3.4, as regards investment risk, a firm must demonstrate that it complies with the Investments Part of the PRA Rulebook.

Under 3.5, a firm must provide for a risk-management function that is structured in such a way as to facilitate the implementation of the risk-management system.

For the purposes of 3.8(2) (a) (i.e. assessment of overall solvency needs), the firm must:

(a) Have in place processes which are proportionate to the nature, scale and complexity of the risks inherent in its business and which enable it to properly identify and assess the risks it faces in the short and long term and to which it is, or could be, exposed

(b) Demonstrate the methods used in that assessment

Outsourcing provisions include requirements for no material impairment of system of governance and effective access to data.

Under 7.2, a firm must not outsource a critical or important operational function or activity in such a way as to materially impair the quality of the firm's system of governance or unduly increase the operational risk.

Under 7.4, a firm outsourcing a function must ensure that the firm has effective access to data related to the functions or activities that are the subject of the outsourcing.

With-profits funds

The PRA Supervisory Statement SS14/15 Supervisory Statement for with-profits funds includes "5.1When setting an investment strategy for a with-profits fund, the PRA expects firms to take into account regulatory requirements, including the prudent person principle set out in Article 132 of the Solvency II Directive and RFF requirements in the Solvency II Regulations."

ORSA

The ORSA represents the insurer's own view of its risk profile and the capital and other means needed to address these risks. The main purpose of the ORSA is to ensure that the undertaking engages in the process of assessing all the risks inherent to its business and determines the corresponding capital needs. It is crucial that the insurer's board is aware of all material risks the undertaking faces, regardless of whether the risks are captured by the SCR calculation and whether they are quantifiable or not.

Key ORSA Requirements

- A fundamental tenet of the ORSA is the recognition of the link between the risk profile, the approved risk tolerance limits and the overall solvency needs (G4)
- The undertaking should provide a quantification of the capital needs and a description of other means needed to address all material risks irrespective of whether the risks are quantifiable or not (G7)
- The undertaking should assess whether its risk profile deviates from the assumptions underlying the SCR calculation and whether these deviations are significant (G12)

The design of the overall solvency needs assessment reflects the way the undertaking proposes to manage the risks that it faces through capital needs or other risk mitigation techniques. This takes into consideration the risk profile, the approved risk tolerance limits and the business strategy. The determination of the overall solvency needs is expected to contribute to assessments of whether to retain or transfer risks and of how best to optimise the undertaking's capital management.

An undertaking cannot simply rely on the regulatory capital requirements to be adequate for its business and risk profile.

An essential part of risk management is the undertaking performing its own assessment of the own funds (including amount, quality, etc.) it needs to hold in view of the particular risk exposure and business objectives.

ORSA will also allow the undertaking to determine the adequacy of its regulatory capital position. The undertaking is also expected to consider whether the SCR, calculated with the standard formula or an internal model, would be appropriate according to the undertaking's risk profile.

In its assessment of the overall solvency needs an undertaking could decide not to use capital as a buffer for all its quantifiable risks but to manage and mitigate those risks by other means.

The undertaking is expected to identify and assess the extent to which non-quantifiable risks are part of its risk profile and to ensure that they are properly managed

The ORSA must reflect the insurer's management practices, systems and controls, including the use of risk mitigation techniques and assess the quality of processes and inputs, in particular the adequacy of the undertaking's system of governance, taking into consideration risks that may arise from inadequacies or deficiencies;

Risk management and compliance functions

The risk management and compliance functions will need browser based unfettered access to real-time investment data on a look-through basis.

A crucial component of the technological solution will be the seamless transfer of data between asset managers (and on a continuous basis and not just quarterly for QRTs and SCR calculations).

This technological solution will empower the risk management and compliance functions providing them with the data that they require and in the format that they need i.e. powerful analytics capabilities with customised dashboards, rules and breach monitoring. This empowers risk and compliance personnel to do their job. This will also provide the required datasets for the regulatory QRTs.

Technology solutions

Invest|GRC™ (Governance, Risk & Compliance).

This is an asset reporting product that can consume data from the company's investment and financial systems, from outsourcers and from other external data sources. It empowers senior finance, risk, audit, ops and admin staff to monitor risks and mandates, do rules management, manage breach occurrences, assist corrections and crucially produce asset reports (both regulatory reports and also risk management function reports).

There are three main strands: 1. Solvency II asset QRTs, 2. Risk management metrics, rules monitoring, breach management and compliance and 3. Analytics

Biography; George McCutcheon MSc FIA:

Mr. McCutcheon is a graduate of University College Dublin in Mathematical Science and is a Fellow of the Institute of Actuaries. He is a director and co-founder of Financial Risk Solutions (FRS). He has presented a number of papers at the Life Convention of the Institute of Actuaries and has co-authored a number of papers for the Society of Actuaries in Ireland.

About Financial Risk Solutions (FRS)

Financial Risk Solutions Ltd (FRS) is a leading provider of unit pricing and fund administration software to the life assurance and pensions industries. Its Invest|Pro™ product family is a recognised leading benchmark in the investment fund administration area and customers in life assurance and third party administration include MetLife, Zurich, Aegon, SEB, Charles Taylor, IFDS, and Accenture Managed Services.

Invest|GRC™ (Governance, Risk & Compliance).
This is an asset reporting product that can consume data from the company's investment and financial systems, from outsourcers and from other external data sources. It empowers senior finance, risk, audit, ops and admin staff to monitor risks and mandates, do rules management, manage breach occurrences, assist corrections and crucially produce asset reports (both regulatory reports and also risk management function reports). There are three main strands: 1. Solvency II asset QRTs, 2. Risk management metrics, rules monitoring, breach management and compliance and 3. Analytics

Invest|Pro™ manages unit pricing and portfolio valuations, asset/liability unit matching, box management, trade order management, investment accounting, tax, financial reporting and compliance with investment mandates in a single application. Product types covered include unit linked funds, portfolio bonds, self-invested/directed pensions, shareholder funds and with-profit funds. Invest|Pro™ was specifically designed to securely automate complex fund administration processes.

Invest|OPS™ (Outsourcing Partner Supervision) automates the validation of operational activity performed by outsourcing partners. It provides methods for assessing the standard of performance of the service provider; enables the investment firm to supervise the outsourced functions and to manage the risks associated with outsourcing. It also provides the firm with effective access to the data associated with the outsourced activities.

FRS

Knowledge based software

For more information contact frank.carr@frsltd.com or visit www.frsltd.com

Financial Risk Solutions
2 – 4 Clanwilliam Terrace
Grand Canal Quay
Dublin 2
Ireland

Telephone:
Ireland +353 (0) 1 234 0000
UK +44 (0) 203 598 4484

Fax:
+353 (0) 1 234 0001

Email:
frank.carr@frsltd.com

Registered in Ireland
Registration no. 318216