Investments of unit-linked life insurance assets, with a focus on exotic assets

Gillian Tucker, FSAI
Alison Walsh

Introduction

There are a lot of regulations and other items for life insurance companies to consider when deciding how to invest the assets of unit-linked funds. In this briefing note we discuss some of the main points we have identified for consideration in the decision-making process:

- Prudent person principle (PPP)
- Investment risk management policy
- Other Solvency II governance requirements
- Capital requirements
- Policyholder reasonable expectations
- Packaged retail and insurance-based investment products (PRIIPs) regulation
- Conduct risk

After discussing each of these points we will turn our focus to exotic assets and consider whether it may be appropriate to consider using them in unit-linked funds under the Solvency II regulations. Please note that the information in this briefing note is not intended as investment advice.

Prudent person principle

The Solvency II regulations contain the concept of the PPP for all investments. This is covered in Article 132 of the Directive and developed in the Level 3 Guidelines on System of Governance.

While the regulations regarding the PPP do not specify specific assets which can or cannot be held, companies will need to make sure they can satisfy the guidelines in respect of any assets they want to invest in.

Article 132 provides details on the PPP, noting the following:

- *"With respect to the whole portfolio of assets, insurance and reinsurance undertakings shall only invest in assets and instruments whose risks the undertaking concerned can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs…"*
- *"All assets, in particular those covering the Minimum Capital Requirement and the Solvency Capital Requirement, shall be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole. In addition the localisation of those assets shall be such as to ensure their availability."*
- *"Assets held to cover the technical provisions shall also be invested in a manner appropriate to the nature and duration of the insurance and reinsurance liabilities. Those assets shall be invested in the best interest of all policy holders and beneficiaries taking into account any disclosed policy objective."*
- *"In the case of a conflict of interest, insurance undertakings, or the entity which manages their asset portfolio, shall ensure that the investment is made in the best interest of policy holders and beneficiaries."*

The Article also describes how "*assets held in respect of life insurance contracts where the investment risk is borne by the policy holders*" (i.e., unit-linked business) should be matched as closely as possible between the assets and liabilities.

The Level 3 Guidelines expand further on how undertakings should ensure that the PPP is being met.

Investment risk management policy

Undertakings should ensure their investment risk management policies address how a policy is applied when considering investments held in unit-linked funds. This policy sets out a number of considerations which should be met prior to investing. The full set of requirements of what should be included in this policy are set out in Article 260 1.(c) of the Solvency II Delegated Acts and expanded on in the Level 3 Guidelines.

Article 260 1.(c) of the Solvency II Delegated Acts states that the policy should include actions to ensure the PPP is met, as well as actions to ensure that the investments are appropriate for the undertaking. These actions should consider the nature of the undertaking's business, its approved risk tolerance limits, its solvency position and its long-term risk exposure.

The Solvency II Level 3 Guidelines expand on the items which should be included in the investment risk management policy, for example stating that it should include:

- Target levels of security, quality, liquidity and profitability
- Quantitative limits on assets and exposures
- The procedure for appropriately valuing and verifying the investment assets
- How the assets are to be selected in the best interest of policyholders and beneficiaries

Other Solvency II governance requirements

Liquidity risk

Undertakings should consider liquidity risk, in particular with reference to their liquidity risk management policies, prior to investing. The full set of requirements of what should be included in the liquidity risk management policy are set out in Article 260 1.(d) of the Solvency II Delegated Acts and expanded on in the Level 3 Guidelines.

Article 260 1.(d) of the Solvency II Delegated Acts states that both short-term and long-term liquidity risk should be considered, and the composition of the assets should be appropriate in terms of their nature, duration and liquidity, in order to meet the undertaking's obligations as they fall due.

The Solvency II Level 3 Guidelines expand on the items which should be included in the liquidity risk policy, including. for example. the procedure for determining the level of mismatch between the cash inflows and the cash outflows of both assets and liabilities.

Concentration risk

Undertakings should also consider concentration risk, in particular with reference to their concentration risk management policies, prior to investing. The full set of requirements of what should be included in the concentration risk management policy is set out in Article 260 1.(e) of the Solvency II Delegated Acts. It states that relevant sources of concentration risk should be identified to ensure that risk concentrations remain within established limits.

The concentration risk policy is mainly focussed on shareholder assets but parts may also apply to policyholder assets.

Capital requirements

Undertakings should consider capital requirements prior to investing unit-linked funds. The type of assets invested in may have an impact on the calculated Solvency Capital Requirement (SCR). For example, under the standard formula, equities classed as Type 2[1] have a higher stress than those classed as Type 1,[2] and therefore will result in a higher SCR.

The company will also need to ensure it can get the required look-through data so that the assets can be stressed appropriately. If full look-through data cannot be sourced then the company may end up applying a higher shock to the assets in the SCR calculation as they may need to be classed as Type 2 equities. In addition, the asset look-through can be a challenge for populating Solvency II Quantitative Reporting Templates (QRTs).

Policyholders' reasonable expectations

The concept of "policyholders' reasonable expectations" (PRE) is not defined in the Solvency II regulations. However, it might be interpreted to include the following:

- Policyholder returns will be broadly in line with product illustrations and any deviations between actual and illustrative product performance can be reasonably justified by the company.
- Investment risks will be properly explained.
- There will be no surprises with regard to charges, i.e., charges will be disclosed in a transparent manner.

These and any other interpretations of PRE should be considered prior to investing unit-linked funds.

PRIIPs

PRIIPS regulation applies to manufacturers of investment products marketed to retail investors, including insurance-based investments (unit-linked and with-profits products). The PRIIPS regulation sets out rules for the content and format of the Key Information Document (KID), which aims to make it easier for retail investors to understand the key features and risks of retail investment products.

The key challenges in producing the KID, which should be considered prior to investing in funds, are as follows:

- Multiple documents: A document is needed for every investment option under every product. For example, 100 fund options would require 100 KIDs. There is an alternative option of having one overall product KID and shorter supplementary KIDs for each of the fund options, but this can be even more complicated to produce.

[1] See Type 2 equities in https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0035&rid=1.

[2] Ibid., Type 1 equities.

- Recommended holding period: A decision will need to be made on how long the recommended holding period should be.
- Performance history: The recommended holding period plus an additional five years of past performance should be used to set projection growth rates. If this data is not available (e.g., for a new fund), performance from a suitable proxy can be used.
- Costs: Entry, exit, transaction costs, “other ongoing costs,” performance fees and carried interest all need to be disclosed.
- Risk indicators: There is a fairly straightforward formula to calculate the market risk measure for unit-linked business but it will need to be built. If there are guarantees with the product then the calculation is more complex, involving multiple simulations, i.e., stochastic runs. A credit risk measure[3] process is needed also.
- Projection engine: Maturity values need to be projected at a number of time periods and for a number of prescribed scenarios.
- Target market: The target market will need to be identified and the KID must be appropriate for this target market.
- Ongoing monitoring: Ongoing monitoring is required to ensure the KIDs are kept sufficiently up to date.

Conduct risk

Conduct risk is defined by the International Association of Insurance Supervisors as:

“the risk to customers, insurers, the insurance sector or the insurance market that arises from insurers and/or intermediaries conducting their business in a way that does not ensure fair treatment of customers.”

A key aspect in managing conduct risk relates to Product Oversight and Governance (POG). The Insurance Distribution Directive (IDD) sets out POG requirements, which are aimed at ensuring the interests of customers take prime importance during product design and throughout the life cycle of the product. These requirements set out the need for a product approval process, which should specify an identified target market for each product, ensure that all relevant risks to such identified target market are assessed, ensure that the product is compatible with the needs, characteristics and objectives of customers in that target market and ensure that the intended distribution strategy is consistent with the identified target market. If the proposed funds are particularly risky it may limit the target market to which the product should be marketed.

Another area of the IDD which may be relevant is the requirement to consider potential conflicts of interest from incentives that could result in customer detriment. This applies to both potential conflicts in the distribution of end products but also in areas such as payments between fund managers and product manufacturers.

Following concerns raised by some European national competent authorities in recent years in relation to the sale of unit-linked products, the European Insurance and Occupational Pensions Authority (EIOPA) published a supervisory statement on 30 November 2021 on the assessment of value for money of unit-linked insurance products under POG. Following on from this, the Central Bank of Ireland (CBI) is reviewing value for money in unit-linked products. The initial focus of the CBI has been on the deduction aspect of value for money (e.g., charges). However, further considerations on other issues such as benefits (including investment performance) may be included in the future. Requirements relating to value for money in the country in which the products will be sold should also be considered.

Other considerations

Environmental, social and corporate governance (ESG) policies

The IDD and Solvency II regulations have recently been amended to integrate ”sustainability” or ESG considerations and factors into key activities, including investment advice, product oversight and governance, risk management and suitability assessment procedures.

Under Solvency II, insurance companies will now be required to integrate sustainability considerations into the PPP, by:

- Including sustainability risks in the assessment of their investment risks
- Ensuring that their investment strategies and decisions take into account the impact of the strategy and decisions on sustainability factors and clients’ sustainability preferences

Under the IDD, sustainability factors, risks and preferences will need to be integrated into product oversight and governance requirements for insurance companies and into the conduct of business rules and investment advice for insurance-based investment products.

These new regulations will need to be considered when companies are deciding how to invest unit-linked funds’ assets.

[3] Ibid., Credit risk assessment.

Investing in exotic assets

We will now consider each of the points above in relation to investing in exotic assets, taking cryptocurrencies as an example. Cryptocurrencies are digital currencies that are not regulated by a central authority, and instead use technology to record transactions in a decentralised system. Blockchain technology is key to this mechanism, using digital blocks that act as a virtual ledger. Once data is entered in a blockchain, it cannot be reversed, making cryptocurrency particularly secure and difficult to counterfeit. Cryptocurrencies such as Bitcoin and Ethereum have grown in prominence in recent years, with the global crypto market capitalisation now exceeding $1 trillion, up from $200 billion in January 2020.[4] Despite their growth, cryptocurrencies are not yet being widely used as investments in the insurance industry.

Please note that this briefing note uses cryptocurrencies as an example to highlight the difficulties associated with incorporating exotic, high-risk assets into insurance products. This briefing note is not intended to suggest or recommend these assets as a form of investment or otherwise.

Prudent person principle

A key aspect of the PPP is that the risks can be properly identified, measured, monitored, managed, controlled, reported and appropriately considered in the assessment of overall solvency needs. Compliance with this could be a challenge for several types of cryptocurrencies as the risks may be difficult to quantify and control.

It may also be difficult to satisfy the requirement that assets should be invested in the best interest of all policyholders, due to the risky nature of cryptocurrencies. This would be particularly hard to satisfy for policyholders who are risk-averse, or who do not properly understand the inherent risk.

Investment risk management policy

Companies' investment risk management policies could be a potential barrier to investing in crypto-assets for unit-linked insurance products. As the charges on unit-linked policies rely on the value of the underlying assets, it is important to consider the investment risk management policy.

The significantly risky nature of cryptocurrency means it may not be in line with the risk appetite of many companies. This would be a particular issue for companies that had set their investment risk management policies under Solvency I, which was often more prudent than Solvency II and which may preclude investment in certain assets.

Other Solvency II governance requirements

Liquidity risks must be considered under Solvency II Governance Requirements. There is a liquid market where cryptocurrencies can be traded online on digital currency exchange sites. More than $20 billion in crypto-assets are being traded daily as of June 2023.[5]

However, cryptocurrencies face significant liquidity risk as a result of being exposed to extreme price movements. "Crypto whales" are investors that hold large volumes of cryptocurrency, therefore influencing its value and ability to be bought or sold. The volatility of cryptocurrency and its associated liquidity risk would have to be considered with respect to a company's liquidity risk management policy before any investment in cryptocurrency could be made.

Capital requirements

The EIOPA Feedback Statement on its Discussion Paper on Blockchain and Smart Contracts[6] (the Feedback Statement) indicated that there is a lack of clarity associated with the treatment of cryptocurrencies. For example, there is uncertainty around how to calculate a 1-in-200-year shock on these assets. Other issues mentioned by stakeholders include the lack of distinction between the different types of cryptocurrencies as well as "*lack of clarity of the accounting and prudential treatment of crypto-assets.*"

The uncertainty surrounding the treatment of cryptocurrencies under the current regulations may deter companies from offering unit-linked products investing in these assets.

PRIIPs

Companies offering unit-linked products investing in cryptocurrencies may face challenges in producing the associated KID due to the lack of historical data available for cryptocurrencies. The new regulations that came into force last year require a price history greater than the recommended holding period of the product. This may not be possible for some of the more recently created cryptocurrencies. Suitable proxies may also be difficult to identify given the unusual nature of this asset class.

Conduct risk

The high-risk nature of crypto-assets means that the POG requirements would significantly limit the size of the appropriate target market for products investing in this asset class. The product would have to be marketed towards high-net-worth, financially sophisticated individuals who understand the underlying risks. In particular, as the majority of crypto-assets are currently unregulated in the EU, it would be important that the target market recognise the lack of protection associated with these assets. The Markets in Crypto-Assets (MiCA) regulations[7] coming into effect

[4] See https://coinmarketcap.com/charts/.
[5] Ibid.
[6] EIOPA (6 May 2022). Feedback Statement on Blockchain and Smart Contracts in Insurance. Retrieved 16 October 2023 from https://www.eiopa.europa.eu/publications/feedback-statement-blockchain-and-smart-contracts-insurance_en.
[7] The full text of the regulations is available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2023:150:TOC.

next year will, however, provide greater protection for individuals investing in cryptocurrencies, therefore reducing this issue.

Companies would also have to give consideration to the general goods requirements in the country in which the products will be sold. In doing this, the views of the regulator would have to be taken into account. For example, in Ireland, the CBI has expressed that it does not believe that funds intended for retail investors should provide exposure to crypto-assets.[8]

Other considerations

ESG policies

Investments in cryptocurrency may conflict with companies' ESG policies due to the high energy consumption associated with their processing. With a greater focus on sustainable investments and with an emphasis on climate-related disclosures, firms may conclude that investments in cryptocurrencies are not aligned with their targets and policies in this space.

Conclusion

As discussed in each of the above sections, it is evident that investments in cryptocurrency for unit-linked funds are not straightforward. There are many challenges presented under each of the above areas of consideration.

The Feedback Statement notes that most stakeholders expect investments in crypto-assets in the insurance industry to increase as a result of the MiCA regulations which will lead to greater protection and certainty for investors.

While there are currently many challenges associated with investing in cryptocurrency for unit-linked funds, increased demand could lead to the development of solutions. However, even if some of the above constraints are addressed, the inherent volatility and risk with investments in cryptocurrency means that the target market would be limited.

CONTACT

Gillian Tucker
gillian.tucker@milliman.com

Alison Walsh
alison.walsh@milliman.com

[8] CBI (26 March 2019). Opportunities, risks and challenges: Considering financial regulation and technological innovation. Remarks by Gerry Cross, Director, Financial Regulation – Policy & Risk. Retrieved 16 October 2023 from https://www.centralbank.ie/news/article/opportunities-risks-and-challenges-gerry-cross.