MILLIMAN WHITE PAPER

# Prudent Person Principle for (Re)insurers

## Are your investment and risk management policies up to the challenge?

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As (re)insurers attempt to balance the search for yield with prudent risk management, regulators are reviewing the application of the Prudent Person Principle to ensure it remains appropriate in the light of market trends in investment strategies. In this paper, we summarise the key developments that (re)insurers need to be aware of to ensure their investment and risk management strategies remain up to the challenge.

## Prudent Person Principle

### EU SOLVENCY II

Under the EU's Solvency II regime, the Prudent Person Principle (PPP) refers to the requirement that a (re)insurer should invest its assets as a prudent person would do, with a view to ensuring that policyholder obligations can be met.

Article 132 of the Solvency II Directive includes the following requirements:

- *"…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."*
- *"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."*

The Guidelines include further details on these topics, including requirements relating to derivatives, securitised investments and assets that are not traded on regulated financial markets.

### SOLVENCY II REVIEW

The review of Solvency II that is currently underway amends Article 132 of the Directive to require (re)insurers to take account of *"possible macroeconomic and financial markets' developments, when they decide on their investment strategy'*, and the *'impact of sustainability risks on their investments and the potential long-term impact of their investment decisions on sustainability factors when they decide on their investment strategy."* (Re)insurers should already be considering what updates are needed to their investment and risk management strategies and policies to address these requirements.

Additionally, supervisors can request (re)insurers to "take account of macroprudential concerns when they decide on their investment strategy and assess the extent to which their investment strategy may affect macroeconomic and financial markets' developments and have the potential to turn into sources of systemic risk, and incorporate such considerations as part of their investment decisions." The associated consultation paper[1] from the European Insurance and Occupational Pensions Authority (EIOPA), which considers the criteria for selecting insurers to carry out this macroprudential analysis, notes that "the expansion of the PPP could help mitigating two main sources of facing risks which could potentially generate indirect macroprudential outcomes, i.e. the risk of excessive concentrations and the involvement in certain activities or products with greater potential to generate indirect macroprudential impacts."

1. EIOPA (17 October 2024). Consultation Paper: On the Proposal for Regulatory Technical Standards on Applicability Criteria for Macroprudential Analysis in Own Risk and Solvency Assessment and Prudent Person Principle. Retrieved 28 January 2025 from https://www.eiopa.europa.eu/document/download/7addf511-654a-495d-9804-4536f141239a_en?filename=EIOPA-BoS-24-321_CP%20on%20RTS%20on%20macroprudential%20analysis%20in%20ORSA%20and%20PPP.pdf.

Quantitative[2] and qualitative criteria are proposed to determine to which firms these requirements would apply—the qualitative criteria include:

- Interconnectedness
- Type of activity performed
- Substitutability
- Liquidity risk
- Insufficient information available in the Own Risk and Solvency Assessment (ORSA) and application of PPP at group level
- Assessment in relation to duration mismatch
- Assessment on the use of synthetic leverage
- Assessment of factors related to approach to valuations of asset classes, which include at least the exposure towards assets that are illiquid or are difficult to value or have an opaque and complex structure

**SOLVENCY UK**

The UK version of the Prudent Person Principle, set out in Supervisory Statement SS1/20 from the Prudential Regulation Authority (PRA), "Solvency II: Prudent Person Principle,"[3] was first formally adopted by the PRA in the UK in 2020.

The PPP in the UK is built on the same foundation as the analogous version under Solvency II. In particular, the principle looks to ensure that a firm's actions align to those of a hypothetical prudent person across the various facets of investment, including asset-liability matching, diversification, the use of financial derivatives and management of concentration risk. However, the UK version of the PPP does introduce several additional detailed expectations. In particular, while the individual circumstances of a firm should feed into its own judgements about appropriate investment practice, the UK version of the PPP intends to achieve an objective application of prudence across the industry.

The obligations of firms under the PPP in the UK include:

- Firms must document and regularly update a detailed investment strategy that takes into account their liabilities, risk appetite and business model.
- Firms must monitor and measure investment risks, including the quantification of investment risks across various scenarios, and in particular changes in credit spreads and default risk.
- Firms must maintain an investment risk management policy that defines explicit limits such as those to asset class, geographies, single-name counterparties and sectors. These limits should take into account several defined factors including the firm's risk appetite, the nature and duration of the liabilities, investment capabilities and the need for diversification.
- Additional consideration should be given to non-traded assets, including the validation of the valuation methodology and the internal rating framework of such assets. In particular, any uncertainty in the valuation of such assets should be limited and managed.

While there have been wider reforms to Solvency UK (the UK's version of Solvency II) over the past couple of years, the UK's version of the PPP has not undergone any major revision as part of these changes. We note that there is no explicit reference to long-term sustainability risks as per the proposed EU Solvency II addition, however insurers are reminded to consider Supervisory Statement SS3/19[4] in conjunction with the PPP, which requires the incorporation of the financial risks from climate change into existing financial risk management practice.

**BERMUDA REGULATORY FRAMEWORK**

The Bermuda Monetary Authority (BMA) also notes that the PPP is an integral part of (re)insurers' risk management with regard to investment risk.

The Insurance Code of Conduct states that the *"prudent person principle requires that an individual entrusted with the management of a client's funds may only invest in instruments that any reasonable individual with objectives of capital preservation and return on investment would own. In relation to the insurer, this principle requires that the insurer, in determining the appropriate investment strategy and policy, may only assume investment risks that it can properly identify, measure, respond to, monitor, control and report while taking into consideration its capital requirements and adequacy, short-term and long-term liquidity requirements, and policyholder obligations. Further, the insurer must ensure that investment decisions have been executed in the best interest of its policyholders."* The Insurance (Group Supervision) Rules include similar requirements.

2. Based on the Financial Stability Reporting threshold of EUR 12 billion in total assets.

3. PRA (15 November 2024). SS1/20 – Solvency II: Prudent Person Principle. Bank of England. Retrieved 28 January 2025 from https://www.bankofengland.co.uk/prudential-regulation/publication/2020/solvency-ii-prudent-person-principle-ss.

4. Enhancing banks' and insurers' approaches to managing the financial risks from climate change. Supervisory Statement 3/19. Bank of England. Retrieved 5 February 2025 from https://www.bankofengland.co.uk/prudential-regulation/publication/2019/enhancing-banks-and-insurers-approaches-to-managing-the-financial-risks-from-climate-change-ss.

### BMA CONSULTATION

In December 2024 the BMA issued a consultation paper (CP) on the application of the PPP in the Bermuda market, noting that this was in the context of broad life and annuity sector trends that include *"increased investments in non-publicly traded, illiquid, less transparent, structured credit, off-balance sheet investments, alternative or non-traditional assets and related party-originated assets, among other forms of bespoke and complex assets."*

The proposed requirements are aimed at ensuring insurers manage investments prudently, through the following:

- Demonstration of effective asset-liability management (ALM) strategies considering portfolio characteristics such as public versus private, liquidity for all asset classes, sophistication and qualification of investment professionals, portfolio construction, concentrations and equity investments, including alternatives and real estate.
- Demonstration of the appropriateness of any investment leveraging activities.
- Assurance that investment decisions were executed in the best interest of policyholders, and investment risks assumed must be appropriately and effectively identified and managed.

The CP notes that insurers' boards of directors and senior management are responsible for ensuring that the insurer complies with the PPP. The CP notes that the insurer's risk management framework plays a significant role in ensuring that the PPP requirements are met. Specific requirements are:

- Insurers should only invest in assets whose risks they can correctly identify, measure, monitor, manage, control and report upon.
- When insurers invest in asset structures or other instruments where the risk exposure is dependent on the performance of underlying assets (e.g., structured assets and derivatives), they should also include the risks of these underlying assets within the scope of their investment risk management frameworks.
- Insurers should perform stress testing to consider the impact of potential scenarios on the insurer's capital, short-term and long-term liquidity and policyholder obligations. Stress scenarios should impact the monitored risk measures, and insurers should consider management actions in response to the various scenarios.

Other aspects considered by the CP include:

- Additional considerations for investing in complex and non-publicly traded assets
- Additional disclosures and attestation in the Solvency Self-Assessment (SSA)
- Assessment of whether the standard capital charges remain appropriate
- Use of derivatives and other financial Instruments
- Appropriate oversight and governance around external investment managers, particularly around potential conflicts of interest.

### THE US

While the US does not have a formal PPP, its regulatory framework—guided by the National Association of Insurance Commissioners (NAIC) and implemented through state model laws—aligns closely with PPPs in other jurisdictions. In particular, the following is highlighted:

- The NAIC Model Investment Law provides a regulatory framework for life insurance companies' investments, emphasizing safety, soundness and alignment with policyholder obligations. The model law requires that insurers must, amongst other things, invest in a manner consistent with their abilities to meet policyholder obligations. Insurers must ensure that the portfolio overall is prudently managed.
- While the NAIC provides overarching guidance, each state enforces its own investment regulations, often incorporating PPP-like principles. For example, the annual liquidity and severe mortality reporting of the New York Department of Financial Services (NYDFS) assesses insurers' preparedness for scenarios involving significant mortality events and evaluates the liquidity of assets backing liabilities. The focus on liquidity management and ALM aligns closely with the principles of the PPP, emphasizing prudent investment practices to safeguard policyholder interests.
- The NAIC also provides guidance on how insurers manage nontraditional or higher-risk investments (e.g., private equity, hedge funds or real estate), emphasizing oversight, transparency and prudent management. These asset classes often involve higher volatility, illiquidity or valuation challenges, prompting regulators to impose stricter reporting and capital requirements.

Overall, the US regulatory framework emphasizes principles that align with PPP, including prudent decision-making, diversification, risk-based oversight and alignment of investments with liabilities. Although the US does not have a formal PPP, the regulatory frameworks of the US, EU Solvency II, Solvency UK and Bermuda all share the same ultimate goal: ensuring insurers prudently manage investments to protect policyholders.

## Conclusion

Given the current challenging global economic environment, and insurers' rising allocations to private assets, investment risk management and disclosure are increasingly critical for insurers. Consequently, regulators are placing an enhanced focus on the PPP. Insurers need to continue to demonstrate that their investment and risk management strategies and policies are up to the challenge.

## How Milliman can help

Milliman consultants have extensive experience in insurance risk and investment management and can support you in meeting the PPP requirements, including:

- Carrying out a "gap analysis" to compare current risk and investment policies to the PPP requirements.
- Advising on concrete steps you can take to demonstrate compliance with the PPP requirements, including:
  - Approach to investment risk measurement and management
  - Approach to ALM, stress and scenario testing
  - Capital modelling of investments
  - Investment and risk disclosures
  - Setting investment risk indicators and tolerances consistent with risk appetite and return requirements

For further information, contact any of the authors or your usual Milliman contact.

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