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The Standard Formula: A Guide to Solvency II

April 2024

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Chapter 6
Investment Rules

Introduction

This chapter discusses and analyses the investment rules that apply to Solvency II insurers and reinsurers in the United Kingdom.

In particular, this chapter will outline the "prudent person principle" and discuss the relevant guidance from EIOPA and the PRA on how the prudent person principle should be applied in practice. Further, specific asset categories will be explored, including how the Solvency II investment rules apply in relation to each. Finally, this chapter will analyse the relationship between the environmental, social and governance (ESG) movement and investment rules.

It should be noted that the Solvency II investment rules are not the only factor that insurance undertakings consider when developing their investment strategies. Most insurers and reinsurers aim, and indeed the PRA expects firms, to hold sufficient capital above and beyond the strictly prescribed coverage ratios to increase their investment flexibility, obtain enhanced credit ratings or pursue other agendas, such as being a leader in sustainable investment.

1. What Is the Prudent Person Principle?

Pre-Solvency II

The pre-Solvency II framework around investments centered around the "admissible assets" regime, whereby insurance firms (but not reinsurance firms) were required, among other things, to invest technical provisions in admissible assets. Examples of admissible assets under the pre-Solvency II regime were debt securities (such as bonds), loans, land and real property.[161] Commodities, for example, were not included under GENPRU 2, Annex 7, and therefore insurers could not count these assets toward their regulatory solvency calculation. Under the previous regime insurers also had to comply with limits on exposures to particular counterparties, groups and asset types (*e.g.*, there was a 10% limit on investments in unlisted securities). Additionally, the pre-Solvency II regime controlled only assets held to cover capital requirements (as opposed to all assets).

A different set of rules applied to reinsurers and in relation to linked business.

Post-Solvency II

Since the introduction of Solvency II, a less prescriptive, and principles-based approach, with a market-focused regime, applies to firms within the Solvency II perimeter. The same rules apply to insurance as well as reinsurance undertakings, other than in relation to linked business and with one other exception for securitisations. Under the Solvency II

[161] *FCA Handbook*, GENPRU 2, Annex 7.

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regime, insurance firms have greater investment freedom and flexibility to determine how to invest their assets. They must invest in accordance with the prudent person principle (discussed below), which ensures that this flexibility is exercised responsibly.

Solvency II – Prudent Person Principle

The prudent person principle, which sets objective standards for prudent investment, is set out in Article 132 of the Solvency II Directive, as adopted in the Bank of England's *PRA Rulebook*.[162] An insurance firm (hereafter meaning insurers and reinsurers) must invest its assets in accordance with the following requirements:

- The firm must only invest in assets and instruments the risks of which it can properly identify, measure, monitor, manage, control and report and appropriately take into account in the assessment of its overall solvency needs in accordance with Conditions Governing Business 3.8(2)(a) (as set out in the *PRA Rulebook*).
- All of the assets of the firm must 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.
- In the case of a conflict of interest the firm must, or must procure that any third party which manages its assets will ensure that the investment of assets is made in the best interest of policyholders.[163]

In addition to meeting the requirements set out above, insurance firms must make sure that assets held to cover 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.[164]

Furthermore, all assets other than those held in respect of life insurance contracts where policyholders bear the investment risk (*i.e.*, linked business) (other than in relation to assets held to cover the technical provisions for a guarantee of investment performance or some other guaranteed benefit) must comply with the requirements set out in Article 132(4) of Solvency II, as adopted in the *PRA Rulebook*:[165]

- Investments in derivative or quasi-derivative instruments shall only be permitted to the extent that they contribute to a reduction of risks or facilitate efficient portfolio management.
- Investments in unlisted securities must be kept to prudent levels (as opposed to the pre-Solvency II regime where such investments were capped at 10%, as discussed above).
- Assets must be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer, group of undertakings or geographical area and excessive accumulation of risk in the portfolio as a whole.
- Investments in assets issued by the same issuer, or issuers belonging to the same group, must not expose the insurance firm to excessive risk concentration.

The prudent person principle also includes additional requirements for linked business, which are discussed in Section 5 below.

It is important to emphasise that Solvency II refers to the "whole portfolio of assets," meaning that the prudent person principle applies to an insurance firm's entire portfolio of investments, therefore including assets covering technical provisions, the minimum capital requirement (MCR) and solvency capital requirement (SCR), as well as any other assets.

The PRA notes that the prudent person principle sets objective standards for prudent investment. This means that compliance with these standards 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), rather than a firm's subjective view about the prudence of its investment standards.[166]

The prudent person principle is intention and competency-based, instead of being outcome-based. The prudency requirements are continuous, meaning the entire portfolio of assets must be governed and monitored on a routine basis to ensure compliance.

Limitations to Freedom Under Prudent Person Principle

Notwithstanding the increased freedoms to the investment regime since the introduction of Solvency II, it should be noted that:

- Different investment categories will attract different capital charges when calculating the SCR.
- An insurance 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 prudent person principle.[167]

2. Application of the Prudent Person Principle

The European Insurance and Occupational Pensions Authority (EIOPA) and the PRA have published guidance that must be considered in the application of the prudent person principle in practice.

[162] *PRA Rulebook*, SII Firms, Investments, 2.

[163] *PRA Rulebook*, SII Firms, Investments, 2.1.

[164] *PRA Rulebook*, SII Firms, Investments, 3.1.

[165] *PRA Rulebook*, SII Firms, Investments, 5.

[166] SS1/20 Solvency II: Prudent Person Principle, 1.3.

[167] PS14/20 Solvency II: Prudent Person Principle, 2.10.

EIOPA Guidance

EIOPA has published Governance Guidelines[168] that are relevant for this purpose and continue to apply in the UK (as confirmed by the Bank of England and PRA).[169] Guideline 29 states that insurance firms should regularly review and monitor the security, quality, liquidity and profitability of the portfolio as a whole by considering at least:

- Any liability constraint, including policyholders' guarantees, and any disclosed policy on future discretionary benefits and, where relevant, reasonable policyholders' expectations.
- The level and nature of risks that an insurance firm is willing to accept.
- The level of diversification of the portfolio as a whole.
- The characteristics of the assets, including the credit quality of counterparties, liquidity, tangibility, sustainability existence and quality of collateral, gearing or encumbrances and tranches.
- Events that could potentially change the characteristics of the investments, including any guarantees, or affect the value of the assets.
- Issues relating to the localisation and availability of the assets, including non-transferability, legal issues in other countries, currency measures, custodian risk, over-collateralisation and lending.

Where an investment is of a non-routine nature, the insurance firm should conduct additional due diligence, which should include an assessment of at least:

- Its ability to perform and manage the investment or the investment activity.
- The risks specifically related to the investment or the investment activity and the impact of the investment or the investment activity on the insurance firm's risk profile.
- The consistency of the investment or investment activity with the beneficiaries' and policyholders' interest, liability constraints set by the insurance firms and efficient portfolio management.
- The impact of this investment or investment activity on the quality, security, liquidity, profitability and availability of the whole portfolio.

The insurance firm should require that an investment or investment activity entailing a significant risk or change in the risk profile must be communicated in the risk profile to the firm's administrative, management or supervisory body.[170]

Further guidance from EIOPA on the application of the prudent person principle includes that insurance firms should not solely depend on the information provided by third parties (*e.g.*, financial institutions, asset managers or rating agencies). Insurance firms are required to develop their own set of key risk indicators in line with their investment risk management policy and business strategy. Additionally, when making its investment decisions, the insurance firm is required to take into account the risks associated with the investment without relying only on the risk being adequately captured by the relevant capital requirements (MCR and SCR).[171]

When assessing the profitability of an insurance firm's investment portfolio, the firm is required to establish targets for the returns it seeks from its investments taking into account the need to obtain a sustainable yield on the asset portfolios to reasonably meet policyholders' expectations.[172]

EIOPA advises that where investment assets are not admitted to trading on a regulated financial market or are complex products which are difficult to value, insurance firms should implement, manage, monitor and control procedures in relation to such investments. Equally, an insurance firm should treat assets which are admitted to trading, but not traded or not frequently traded, in a similar manner to assets not admitted to trading on a regulated financial market.[173]

The rules relating to assets covering technical provisions specifically include an obligation to invest assets in the "best interests" of policyholders. This is also the case where there are conflicts of interest. However, it should be noted that the concept of policyholders' 'best interests' is not a known concept in UK regulation and thus there is no specific guidance on what it might mean to invest in the best interests of policyholders or beneficiaries.[174]

PRA Guidance

In May 2020, the PRA published a policy statement[175] and a supervisory statement[176] setting out final guidance on the prudent person principle.

The supervisory statement[177] contains guidance on specific areas, which are discussed below:

- **Investment Strategy:** The PRA sets out expectations on insurance firms to develop and document an investment strategy which describes at least:
  - the investment objectives and strategic asset allocation;
  - consideration of investment constraints when setting investment objectives and strategic asset allocation;

[168] EIOPA: Guidelines on system of governance (EIOPA-BoS/14/253 EN).

[169] BoE and PRA Statement of Policy: Interpretation of EU Guidelines and Recommendations: Bank of England and PRA approach after the UK's withdrawal from the EU (Appendix 1).

[170] EIOPA Governance Guideline 28.

[171] EIOPA Governance Guideline 28.

[172] EIOPA Governance Guideline 30.

[173] EIOPA Governance Guideline 33.

[174] *Practitioner's Guide to Solvency II*, Sweet & Maxwell, Geoffrey Maddock, page 110.

[175] PS14/20.

[176] SS1/20.

[177] SS1/20.

- alignment of the investment strategy with the business model and, where appropriate, how the strategy takes into account the nature and duration of a firm's liabilities and obligations, and the best interests of policyholders;
- 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 those assets have been invested in accordance with the prudent person principle.

- **Investment Risk Management:** There are a wide range of requirements regarding the content of firms' risk management policies and monitoring frameworks. These include, among others:
  - investments should be aligned with the insurance firm's risk appetite, risk management policies, risk tolerance limits and investment strategy alongside the firm's overall business model (including its product and policyholder profile);
  - where investments are made in asset structures where the risk exposure is dependent on the performance of underlying assets (*e.g.*, derivatives or securitisations), those risks should be within the scope of the firm's investment risk management framework;
  - the investment risk management policy must include internal quantitative investment limits for assets and exposures; and
  - firms' investment risk monitoring should cover (among other things): changes in the value and volatility of investment portfolios and individual assets, changes in characteristics of the assets held, changes in the external environment that may affect the security of assets and changes in the value or characteristics of underlying exposures on which the performance of the asset(s) invested in depend.
- **Risk Concentration, Risk Accumulation and Lack of Diversification:** Firms that appear to have excessive levels of concentration risk will be subject to greater supervisory authority. The PRA expects that:
  - insurance firms will stress test their portfolios to demonstrate that they are not exposed to excessive risk concentration;
  - the solvency of an insurance firm, at a minimum, would not be impacted by any plausible crystallisation of a risk related to assets issued by the same issuer or by issuers belonging in the same group;
  - firms pay more attention to risks that are more complex and less understood (such as climate risk) and avoid overexposure to such risks;
  - firms pay particular attention to their exposure to political risks, particularly when investing in assets that are ultimately government-backed;
  - the investment risk management policy will articulate how the firm has identified and is managing any potential correlation or contagion risks between assets that would lead to excessive concentration of risk and any risks that are common to a material proportion of the firm's investment portfolio; and
  - firms, in determining their quantitative investment limits, should have due regard to concentration risk and set out the level of concentration exposure that they will not exceed.
- **Outsourcing of Investment Activities**: Importantly, insurance firms that wholly or partially outsource their investment function remain subject to the requirements of the prudent person principle. Therefore, firms must ensure that any external investment manager only invests their assets in accordance with the prudent person principle. The PRA expects that firms will undertake appropriate due diligence regarding outsourced investment activities. Insurance firms must be confident that any external party to whom they outsource any investment function has sufficient risk management expertise to comply with the supervisory statement. Where insurance firms outsource critical or important functions or activities, they become subject to an additional requirement of a written notification to the PRA prior to outsourcing such functions or activities.[178] The PRA has, through a supervisory statement,[179] set out the requirements of what a written agreement for material outsourcing must cover (as a minimum).
- **Exposure to Non-traded Assets:**
  - The PRA's guidance regarding exposure to non-traded assets does not apply to insurance firms' investments in assets covering technical provisions or linked long-term contracts of insurance, except where the assets are held to cover additional technical provisions in respect of policyholder liabilities.
  - The PRA notes that although investments in non-traded assets can be an appropriate match for insurance liabilities, they can also give rise to additional risks. For example, they can be difficult to value in the absence of regular market pricing and to sell in a timely manner, particularly under stressed market conditions.
  - The PRA expects that before investing in non-traded assets, when determining any internal investment limit, and as part of ongoing practice, insurance firms will consider and assess (among others): the appropriateness and robustness of the valuation methodology; the robustness, capability and maturity of the internal rating framework and the materiality of any embedded optionality; how time, stress or any other factor may affect the asset's risk profile.
  - The PRA expects that the level of expertise of key persons (including investment managers) and the robustness of risk management systems and controls would increase commensurate with any increases in the scale, complexity or concentration of investments in non-traded assets.

[178] Article 49 Solvency II.

[179] SS2/21: Outsourcing and third party risk management (*see* section 6.4).

- The PRA further sets out expectations that firms investing in non-traded assets should, at a minimum, be able to meet and demonstrate that key persons have sufficient experience to understand and manage risks involved, and that the suitability of an investment matching firms' liabilities has been assessed in light of suitably severe stress scenarios projected over suitably long horizons.

- **Valuation Uncertainty:** Valuation uncertainty with respect to assets is a key risk for non-traded assets as well as listed assets that are thinly traded. Therefore, the PRA expects that insurance firms take into account valuation uncertainty risk for the purposes of complying with the prudent person principle. The PRA further expects that insurance firms are able to demonstrate that they comply with the relevant risk management requirements.

- **Intragroup Loans and Participations:**
  - In respect of assets backing technical provisions, the prudent person principle requires that these must be 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.[180] This requirement is particularly relevant for certain intragroup transactions (*e.g.*, intragroup loans), which may be in shareholders' interests but not necessarily in the interests of policyholders.
  - The prudent person principle requires that in the case of a conflict of interest, assets are invested in the best interests of all policyholders. While this provision applies to all asset classes, it is of particular importance in the context of intragroup transactions. In such transactions, the relevant firms' boards should be satisfied that any conflicts of interest have been resolved in the best interest of policyholders before investing in an intragroup asset. The PRA further expects that any conflicts of interest that arise following investment in an intragroup transaction should also be resolved in the best interest of policyholders, which may mean ceasing to invest in that asset.
  - In relation to intragroup reinsurance, the PRA notes that such arrangements are less likely to present conflicts of interest and are usually different in substance economically, but nonetheless the PRA will look into the economic substance of those arrangements to determine whether any arrangements are effectively structured as loans, in which case the PRA will treat them as such.
  - The PRA expects that intragroup assets are subject to at least the same level of arm's length scrutiny and risk management as other assets, as well as proper governance and documentation with regard to conflicts of interest, concentration risk, credit risk, liquidity risk, legal and operational risk and further risks as set out in the supervisory statement.[181]

- **Outwards Reinsurance:** As stated above, the prudent person principle applies to all assets, including reinsurance arrangements. In considering whether such arrangements meet the prudent person principle standards, the PRA will adopt a case-by-case approach and will take into account a particular insurance firm's circumstances, including the impact of various risk mitigation factors, such as the use of collateral. The PRA has set out its expectations in relation to insurance firms' management of risk in relation to reinsurance arrangements in supervisory statement SS20/16.[182] Further, in relation to funded reinsurance arrangements, the PRA has proposed that insurers set limits on their exposure to funded reinsurance counterparties that should apply equally to multiple highly correlated counterparties. These limits are designed to ensure that an insurer's exposure is limited to a level that does not threaten the insurer's ongoing business model viability even if the reinsurance is terminated.[183]

3. Derivatives

As mentioned above, under the prudent person principle, investments in derivative or quasi-derivative instruments shall only be permitted to the extent that they contribute to a reduction of risks or facilitate efficient portfolio management. As such, a hedging derivative is more likely to be compliant in contrast to a purely speculative derivative.

EIOPA Governance Guidelines stipulate further guidance on the use of, and investment in, derivatives products by insurers or reinsurers. Guideline 34 provides as follows:

- The insurance firm should implement procedures in line with its investment risk management policy to monitor the performance of any relevant derivatives.
- The insurance firm should demonstrate how the quality, security, liquidity or profitability of the portfolio is improved without significant impairment of any of these features where derivatives are used to facilitate efficient portfolio management.
- The insurance firm should document the rationale and demonstrate the effective risk transfer obtained by the use of the derivatives where derivatives are used to contribute to a reduction of risks or as a risk mitigation technique.

Derivative instruments may be particularly useful when an insurance firm is required to hold assets to cover the technical provisions. Technical provisions comprise a best estimate of insurance liabilities plus a risk margin. Where future cash flows associated with the relevant insurance liabilities can be reliably replicated using a derivative instrument for which there is a reliable market value which is observable, there is no

[180] SS1/20, page 15.

[181] SS1/20, page 16.

[182] SS20/16, Solvency II: Reinsurance – counterparty credit risk.

[183] View our client alert "The PRA Tightens Expectations for Funded Reinsurance for the UK Bulk Purchase Annuity Market," 18 November 2023.

requirement to calculate a separate risk margin.[184] In such cases, the value of technical provisions associated with those future cash flows shall be determined on the basis of the market value of the relevant derivative instrument.

4. Repackaged Loans/Securitisation Positions

In addition to the prudent person principle, insurers and reinsurers must also comply with specific rules in relation to investments in tradable securities or other financial instruments based on repackaged loans, known as "securitisation positions" or "securitisations." The specific rules applicable depend on whether the securitisation position was issued before or on, or after 1 January 2019. This chapter focusses on the currently applicable, post-2019 regime.

Securitisations Issued on or After 1 January 2019

For securitisation positions issued on or after 1 January 2019, the rules are set out by Articles 5 to 7 of the EU Securitisation Regulation,[185] as partly repealed by the UK in the Securitisation (Amendment) (EU Exit) Regulations 2019.[186] Following up on a consultation in July 2023, the post-Brexit replacement of the EU Securitisation Regulation,[187] the UK Securitisation Regulations 2024[188] were made final on 29 January 2024. While certain of the provisions are in force as of that date, they will come fully into force alongside the new FCA and PRA firm-facing rules on securitisations[189] and the repeal of retained EU law on securitisation.[190]

While the Financial Services and Markets Act 2023 c.29 Schedule 1 Part 1 repeals the EU Securitisation Regulation, this schedule is not yet fully in force.[191] Importantly, repeals of articles 5 to 7 of the EU Securitisation Regulation have not yet commenced[192] and it is not yet clear when a commencement order will be published.[193]

Definition of "Securitisation Position"

The investment rules in the UK Securitisation Regulation only apply in relation to investments in a securitisation position, which means an exposure to a securitisation.[194] A securitisation is defined as follows:

> "Securitisation means a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics:
>
> - payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures;
> - the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme; and
> - the transaction or scheme does not create exposures which possess all of the following characteristics —
>   - the exposure is to an entity which was created specifically to finance or operate physical assets or is an economically comparable exposure;
>   - the contractual arrangements give the lender a substantial degree of control over the assets and the income that they generate; and
>   - the primary source of repayment of the obligation is the income generated by the assets being financed, rather than the independent capacity of a broader commercial enterprise."[195]

Risk Retention Requirements

The relevant risk retention requirements are set out in Article 6 of the EU Securitisation Regulation (which are currently retained in UK law, as mentioned above). The requirements include, among others, the following:

- The originator, sponsor or original lender of a securitisation shall retain on an ongoing basis a material net economic interest in the securitisation of not less than 5%. That interest shall be measured at the origination and shall be determined by the notional value for off-balance-sheet items. Where the originator, sponsor or original lender have not agreed among them who will retain the material net economic interest, it is then the originator that must retain the material net economic interest.[196] Article 6(3) contains further detail on what qualifies as a retention of a material net economic interest of not less than 5%.
- An entity shall not be considered to be an "originator" where the entity has been established or operates for the sole purpose of securitising exposures. By supervisory statement SS10/18[197] the PRA has confirmed that for the purposes of the EU Securitisation Regulation, a UK insurer and reinsurer can be treated as both an 'originator' and 'institutional

[184] Article 77(4) of Solvency II Directive.

[185] EU Securitisation Regulation 2017/2402.

[186] SI 2019/60.

[187] EU Regulation 2017/2402.

[188] The Securitisation Regulations, SI 2024/102.

[189] Expected in Q2 of 2024 following the conclusion of the consultation period.

[190] Section 1, Chapter 1 and Schedule 1 of the Financial Services and Markets Act 2023.

[191] Section 86(3) of the Financial Services and Markets Act 2023.

[192] The articles which have been repealed to date are the following: 11, 13, 16, 31-39, 41, 44-47.

[193] SI 2024/102, Regulation 2(2).

[194] SI 2024/102, Regulation 3.

[195] SI 2024/102, Regulation 3.

[196] EU Regulation 2017/2402, Article 6(1).

[197] SS10/18, "Securitisation: General Requirements and Capital Framework," October 2021.

investor' in securitisation, and in some cases the sole investor in the transaction. Consequentially, insurers and reinsurers should consider whether any transactions, such as those that aim to refinance loans, exposures or receivables by transforming them into tranched securities and any internal restructurings may be considered securitisations for the purposes of the EU Securitisation Regulation.[198]

- Originators shall not select assets to be transferred to the securitisation special purpose entity (SSPE) with the aim of rendering losses on the assets transferred to the SSPE, measured over the life of the transaction, or over a maximum of four years where the life of the transaction is longer than four years, higher than the losses over the same period on comparable assets held on the balance sheet of the originator.
- The risk retention requirements of Article 6(1) will not apply where the securitised exposures are exposures on or exposures fully, unconditionally and irrevocably guaranteed by, among others,[199] central governments or central banks, or securitised exposures to institutions to which a 50% risk weight or less is assigned under the standardised approach set out in the Capital Requirements Regulation.
- Article 6(1) risk retention requirements shall also not apply to transactions based on a clear, transparent and accessible index, where the underlying reference entities are identical to those that make up an index of entities that is widely traded, or are other tradable securities other than securitisation positions.

Due Diligence Requirements

Article 5 of the EU Securitisation Regulation sets out the due diligence requirements that insurers and reinsurers must comply with, both prior to holding a securitisation position and on an ongoing basis for the duration of their exposure.

Before becoming exposed to a particular securitisation, insurers and reinsurers must:

- Ensure the structure is risk retention compliant.[200] The relevant requirements differ where the originator or original lender is established in the EU/UK or in a third country. The requirements include:
  - verification that the credits giving rise to the underlying exposures are granted on the basis of sound and well-defined criteria and clearly established processes for approving, amending, renewing and financing those credits; and
  - where relevant, verifying that the originator, sponsor and/or SSPE comply with the applicable disclosure obligations.
- Conduct a due diligence assessment that enables the insurer or reinsurer to assess the risks involved. That assessment shall consider at least:
  - the risk characteristics of the individual securitisation position and of the underlying exposures; and
  - all the structural features of the securitisation that can materially impact the performance of the securitisation position, including the contractual priorities of payment and priority of payment-related triggers, credit enhancements, liquidity enhancements, market value triggers, and transaction-specific definitions of default.[201]

Non-Compliant Investments in Securitisation Positions

If an insurer or reinsurer becomes aware that any of the above-mentioned requirements for investments in securitisation positions are not complied with, it must inform the PRA immediately. Where the requirements are not complied with as a result of negligence or omission of the insurer or reinsurer, the PRA shall impose a proportionate increase to the SCR in accordance with Article 257(3).[202] Risk factors will be progressively increased with each subsequent breach.

STS Securitisation

The EU Securitisation Regulation sets out a regulatory framework for two classes of high quality securitisations, namely (collectively STS):

- Simple, transparent and standardized securitisations.[203]
- Asset-backed commercial paper programmes (ABCP Programme) (meaning a programme of securitisations the securities issued by which predominantly take the form of asset-backed commercial paper with an original maturity of one year or less).[204]

The framework includes due diligence requirements that apply to insurance firms investing in STS securitisations.

Following EU Regulation 2018/1221, investments in STS securitisations attract preferable capital treatment when calculating an insurance firms SCR coverage (as compared with non-STS securitisations).

Prior to investing in STS securitisations, insurance firms must carry out additional due diligence as to whether the securitisation meets the STS criteria as set out in the EU Securitisation Regulation (above and beyond the due diligence requirements

[198] SS10/18, "Securitisation: General Requirements and Capital Framework," October 2021, Paragraph 2.6.

[199] *See* Article 6(5) of EU Regulation 2017/2402 for the complete list.

[200] EU Regulation 2017/2402, Article 5(1).

[201] EU Regulation 2017/2402, Article 5(3).

[202] Commission Delegated Regulation (EU) 2015/35, 10 October 2014.

[203] *See* Section 9 of the UK Securitisation Regulations 2024 for a more specific definition of STS securitisation.

[204] *See* Article (7) EU Regulation 2017/2402 and Article 3(1) in UK Securitisation Regulations.

discussed above in relation to securitisations). Institutional investors may rely to an appropriate extent on the STS notification and on the information disclosed by the originator, sponsor and SSPE on the compliance with the STS requirements, without solely or mechanistically relying on that notification or information.[205] For fully supported ABCP Programmes, insurers and reinsurers shall also consider the features of the programme and the full liquidity support as part of the insurance firms' due diligence process.[206]

EIOPA Guidance

Where the insurance firm invests in securitised instruments, it should ensure that its interests and the interests of the originator or sponsor concerning the securitised assets are well understood and aligned.[207]

5. Unit Linked Funds

Unit linked funds or linked contracts are life and long-term insurance contracts where the investment risk is borne by the policyholder and where the benefits are wholly or partly to be determined by reference to the value of, or income from, property of any description or by reference to fluctuations in, or in an index of, the value of property of any description.[208] The prudent person principle applies to linked funds with some exceptions. The requirements set out in Article 132(4) of Solvency II with respect to derivatives, unlisted investments, diversification and counter-party concentration risk do not apply to assets held to cover benefits that are not subject to a guarantee of investment performance or other guaranteed benefit.

There are nonetheless additional close matching requirements set out in Article 132(2) of Solvency II, which provide as follows:

- Where the benefits provided by a linked contract are directly linked to the value of units in an UCITS, or to the value of assets contained in an internal fund held by the insurance undertakings, usually divided into units, the technical provisions in respect of those benefits must be represented as closely as possible by those units or, in the case where units are not established, by those assets.
- Where the benefits provided by a contract are directly linked to a share index or equivalent, the technical provisions in respect of those benefits must be represented as closely as possible, either by the units deemed to represent the reference value or, in the case where units are not established, by assets of appropriate security and marketability which correspond as closely as possible with those on which the particular reference value is based.

These close matching rules aim to ensure that the insurer or reinsurer is not exposed to investment risk, as the insurance firm is required to hold the same assets, as closely as possible, as those by reference to which the policyholder benefits are calculated.

It must be noted that where the benefits provided under the linked policy include a certain guarantee of investment performance or another guaranteed benefit, the linked assets must continue to comply with the requirements set out in Article 132(4) of Solvency II with respect to derivatives, unlisted investments, diversification and counter-party concentration risk.

Restrictions on Investment

Generally, under Article 133 of Solvency II, the UK shall not require insurance and reinsurance firms to invest in particular categories of assets and shall not subject their investment decisions or those of its investment manager to any kind of prior approval or systematic notification requirements. However, under Article 133(3) of Solvency II, there is a carve-out from this prohibition to allow the UK to impose restrictions on the types of assets or reference values to which policy benefits may be linked. This carve-out is subject to two limitations:

- Where the investment risk is borne by a policy holder who is a natural person.
- Restrictions shall not be more restrictive than those set out in the Recast UCITS Directive.[209]

In the UK, the FCA in its *FCA Conduct of Business Sourcebook* (*COBS*)[210] has set out limitations on the linked business that an undertaking can invest in on behalf of policyholders that are natural persons in order to protect them. In particular, COBS 21.3.1 sets out a specific list of "permitted" linked assets that an insurer or reinsurer may invest in where the policyholder is a natural person. This list includes approved securities, listed securities, land and property, loans and derivatives.[211]

Although the above restriction is formally only applied to policyholders who are natural persons, the former Financial Services Authority (FSA) (succeeded by the PRA in this regard) stated that it intended to adopt a relatively flexible approach toward who a policyholder is for these purposes, which would include trustees of defined contribution pension schemes. This is because the underlying scheme members are natural persons bearing the investment risk. In particular, the FSA commented that:

> "Individual policyholders who hold, for example personal pensions, whole-of-life plans, insurance bonds, and also members of DC occupational pension schemes invested in

[205] Article 5(3)(c) of EU Regulation 2017/2402.

[206] Article 5(3) of EU Regulation 2017/2402.

[207] EIOPA Governance Guideline 35.

[208] *PRA Rulebook*, Glossary, "linked long term."

[209] Note while Solvency II Article 133(3) makes reference to Directive 85/611/EEC, this has been repealed and replaced by the Recast UCITS Directive by virtue of Article 117 of the Recast UCITS Directive.

[210] *See FCA Handbook*.

[211] FCA COBS 21.3.1.

unit-linked life assurance policies bear all of the investment risk inherent in the assets backing their policy benefits. We consider restrictions on the assets that can be used to determine their benefits to be appropriate to meet out statutory objective of consumer protection."[212]

The EIOPA Governance Guidelines do not provide further guidance on investments in linked assets to cover linked business. However, they do provide some guidance on investment in unit-linked and index-traded investment by an insurer or reinsurer itself:

- The insurer or reinsurer should ensure that its investments in unit-linked and index-linked contracts are selected in the best interest of policyholders and beneficiaries taking into account any disclosed policy objectives.
- In the case of unit-linked business, the insurer or reinsurer should take into account and manage the constraints related to unit-linked contracts, in particular liquidity or any contractual or legal transferability constraints.[213]

6. ESG Movement and Its Impact on Investment Rules

It is widely understood that risks arising from sustainability impact the balance sheets of insurance and reinsurance undertakings. The increase in severe weather events predicted by most climate scientists is likely set to significantly impact the insurance industry by affecting the ability of underwriters to measure, predict and apportion risks.

General insurers and reinsurers, for example, are exposed to the direct risks of climate change, covering loss related to tsunamis, wildfires or typhoons. Life insurers and reinsurers are also under mounting pressure from consumers, shareholders and climate activists to diversify their asset portfolios and reduce their investments in non-sustainable businesses as well as lower their commitments in carbon-intensive industries.

Sustainability Risks

There are different types of sustainability risk that the PRA has identified as to which the insurance sector is exposed: physical risks, transition risks and liability risks. The PRA reported its findings in Supervisory Statement SS3/19, "Enhancing Banks' and Insurers' Approaches to Managing the Financial Risks From Climate Change."[214] Each type of sustainability risk is explained further below:

- **Physical Risks:**[215] These are risks that arise from a number of factors and relate to specific weather events (*e.g.,* floods, wildfires and storms) and longer-term shifts in the climate (*e.g.*, changes in precipitation, sea level rise and rising mean temperatures). Some examples of physical risks affecting insurers and reinsurers include:
  - increasing frequency, severity or volatility of extreme weather events impacting property and casualty insurance; and
  - increasing frequency and severity of flooding leading to physical damage to the value of financial assets or collateral held by banks, such as household and commercial property. This can lead to increased credit risks, particularly for banks, or to underwriting risks for liability insurers if it results in legal claims to recover financial losses from this physical damage.
- **Transition Risks:** These are risks that can arise from the process of adjustment toward the low-carbon economy. A range of factors influence this adjustment, including climate-related developments in policy and regulation, the emergence of disruptive technology or business models, shifting sentiment and societal preferences, or evolving evidence, frameworks and legal interpretations. Some examples include:
  - tightening energy efficiency standards for real estate impacting the risks in banks' lending portfolios;
  - rapid technological change, such as the development of self-driving cars and the widespread use of AI, affecting the value of financial assets in the automotive and other sectors; and
  - firms generally failing to mitigate, adapt or disclose financial risks from climate change that leads to them being exposed to climate-related litigation, which could impact their market value and/or lead to higher claims for insurers and reinsurers that provide liability cover to those firms.
- **Liability Risks:** These risks arise from parties who have suffered loss or damage from physical or transition risk factors seeking to recover losses from those they hold responsible. The legal risks from climate-related liabilities can be particularly important to insurance firms given these risks can be transferred through liability protection, such as directors' and officers' and professional indemnity insurance.

Application of the Prudent Person Principle

The prudent person principle requires insurance firms to diversify their asset portfolios in order to avoid excessive accumulation of risk. Therefore, insurers and reinsurers must as part of its alignment with the prudent person principle consider whether there is an excessive accumulation of financial risks from climate change (in particular risks likely to come into effect via the transition risk factor discussed above) in their investment portfolio. Further, insurers and reinsurers must consider possible mitigants when this is the case.[216]

[212] CP11/23, FSA: Solvency II and linked long-term insurance business (November 2011).

[213] EIOPA Governance Guideline 32.

[214] SS3/19, PRA, "Enhancing Banks' and Insurers' Approaches to Managing the Financial Risks From Climate Change," April 2019.

[215] SS3/19 (page 6).

[216] SS3/19 (paragraph 3.11).

The PRA expects an insurance firm's response to the financial risks from climate change to be proportionate to the nature, scale and complexity of its business. As a firm's expertise develops, the PRA expects the relevant firm's approach to managing the financial risks from climate change to mature over time.[217]

The PRA intends to run a dynamic general insurance stress test in 2025[218] that will aim to:

- Assess the insurance industry's solvency and liquidity resilience to a specific adverse scenario.
- Assess the effectiveness of insurers' risk management and management actions following an adverse scenario.
- Inform the PRA's supervisory response following a market-wide adverse scenario.

Results of this exercise will be disclosed at an aggregate industry level.

Green Investing

In 2015, the PRA produced a report on the impact of climate change to the UK insurance sector as part of the second round of climate change adaption reports requested by the Department for Environment, Food and Rural Affairs. The report identified a number of climate change-related opportunities for insurance firms that include new sources of premium growth, such as renewable energy project insurance, supporting resilience to climate change through risk awareness and risk transfer, investments in green bonds and providing financial sector leadership on climate change.[219]

[217] SS3/19 (paragraph 3.1).

[218] PRA statement on the dynamic general insurance stress test in 2025 (3 October 2023).

[219] PRA Climate Change Adaption Report 2021.

A number of European insurers have already publicly committed to lowering carbon-intensive investments and replacing such investments with low-carbon alternatives. Such commitments include investing in green bonds aiming at funding projects that have positive environmental benefits and phasing out coal from investment portfolios. For example, a large UK-based composite insurance group has announced its plan to become a net zero carbon emissions company by 2040 and to cut 25% in the carbon intensity of its investments by 2025 and 60% by 2030.[220]

Integration of Sustainability Risk Into Prudent Person Principle at EU Level

On 24 May 2018, as part of its Action Plan on Financing Sustainable Growth, the EU Commission adopted a package of measures on sustainable finance.[221] The package contained several proposals aimed at:

- Establishing a harmonised EU classification system on sustainable economic activities.
- Improving and clarifying disclosure requirements on how institutional investors, such as asset managers and insurance firms, integrate ESG factors in their investment and advisory processes.
- Creating a new category of low-carbon benchmarks that will help investors compare the carbon footprint of their investments and facilitate better alignment with the Paris Agreement.

As a result of the action plan, changes were made to legislative instruments in August 2021, including the Solvency II Level 2 Delegated Regulation. However, these changes will not apply in the UK as they do not affect the post-Brexit onshored Solvency II regime.

[220] "Aviva Becomes the First Major Insurer Worldwide To Target Net Zero Carbon by 2040," Aviva, 1 March 2021.

[221] "Sustainable Finance: Making the Financial Sector a Powerful Actor in Fighting Climate Change," European Commission, 24 May 2018.