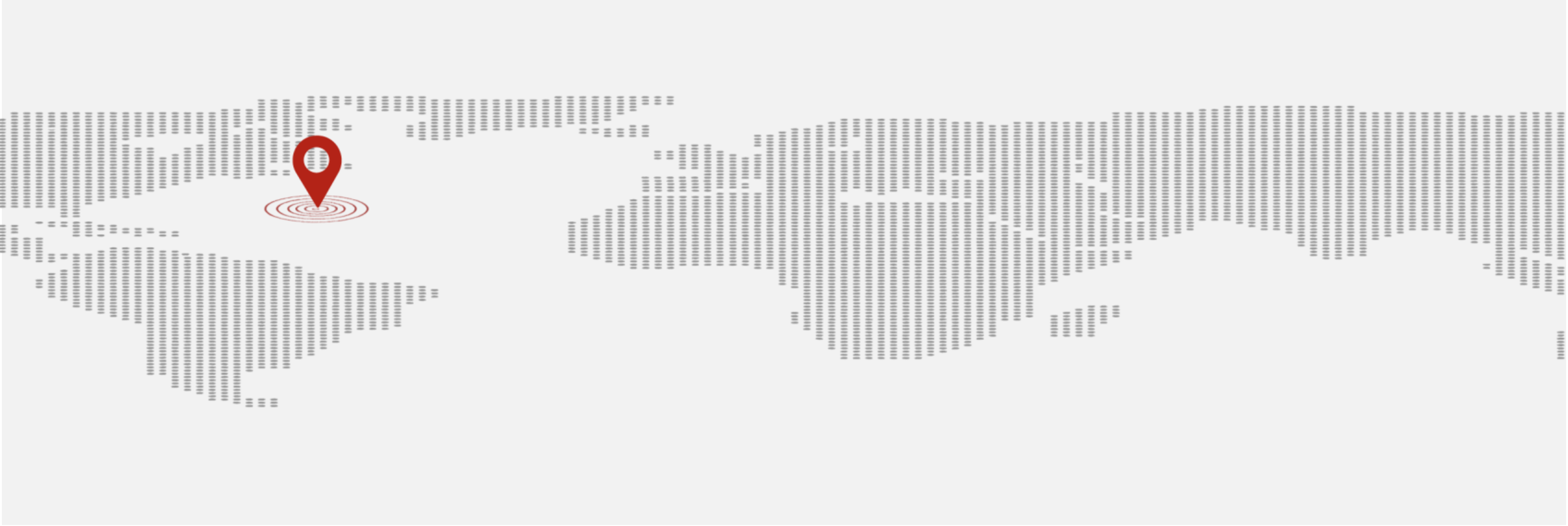
BMA
BERMUDA MONETARY AUTHORITY

Wednesday, 4 December 2024

CONSULTATION PAPER

Proposed Instructions and Guidance on the Application of the Prudent Person Principle

Comments to be received by Wednesday, 5 February 2025



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Introduction

Global insurers, particularly those in the life and annuity sector, have experienced significant structural shifts over the past several years, including increased allocation to illiquid, hard-to-value assets that are non-publicly traded and can be more complex than liquid traded assets. The Bermuda Monetary Authority (Authority or BMA) has increased its supervisory oversight of Bermuda's commercial insurers towards obtaining evidence that the risks associated with these shifts, including but not limited to increased allocation to illiquid investment strategies, are adequately understood, managed and governed.

Examples of the BMA's increased supervisory measures include:

1. Enhanced supervisory collaboration with regulators of ceding insurers, e.g., joint on-site inspections and the sharing of key risks, supervisory concerns and issues with the relevant cross-border supervisors;

2. Supervisory engagement with insurers focused on key investment risks, e.g., targeted in-depth on-site inspections;

3. Development of the recovery planning regime;

4. Enhanced asset and liquidity exposure reporting, including new (liquidity) stress tests;

5. Application of a broad range of powers of intervention and enhanced supervisory measures, e.g., requiring higher capital to be maintained, skilled-person reviews and exposure limits; and

6. Regulatory approval of long-term block reinsurance transactions.

In terms of regulatory tools and public disclosure, the BMA has identified opportunities to enhance and enact the following aspects of its regime (among other things):

1. Scenario-Based Approach (SBA) – modelling, governance, validation, stress testing and reporting requirements have been enhanced and the requirement to obtain prior regulatory approval of the SBA model was introduced. The ongoing publication of standardised 'default and downgrade costs' for assets with publicly available default data was also introduced;

2. Risk Margin – the risk margin calculation of Insurance Groups was changed to be on an unconsolidated basis (i.e., to be determined as the sum of legal entity risk margins);

3. Regulatory Approvals – introduced the need for affiliated investments to be approved, as well as, within the context of SBA, all non-publicly traded or structured assets; and

4. Risk Sensitivity - increased the risk-sensitivity for lapse and expense risks in the Bermuda Solvency Capital Requirement calculation.

Building on the above, the BMA proposes to issue Instructions and Guidance to set out its expectations relating to the application of the Prudent Person Principle (PPP) by commercial insurers[1] and insurance groups.

The Insurance Code of Conduct (Code) and Insurance (Group Supervision) Rules 2011 (Group Rules) require insurers[2] to implement the PPP as an integral part of their risk management framework with regard to investment risk. This Consultation Paper (CP) sets out the BMA's proposed expectations for insurers when adopting the prudent person principle.

Overview of proposed expectations

1.1. The proposals are addressed to all commercial insurers registered under Section 4 of the Insurance Act 1978 and Bermuda insurance groups.

1.2. The proposals in this CP reflect the BMA's supervisory experience and engagements with commercial insurers, particularly long-term insurers. This is in the context of their 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. Insurers should be prepared to demonstrate effective Asset Liability Matching (ALM) strategies. The preparation should consider portfolio characteristics such as public versus private, liquidity for all asset classes, sophistication and qualification of investment professionals, portfolio construction, concentrations, equity investments including alternatives and real estate. Insurers should also be prepared to demonstrate the appropriateness of any investment leveraging activities.

1.3. The PPP, as outlined in the Code[3] and Group Rules[4], requires that an individual entrusted with managing a client's funds may only invest in instruments that a reasonable individual who aims for capital preservation and return on investment would consider owning. 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 on 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 (and beneficiaries). While this principle applies to all asset classes, special care may be warranted for assets with specific characteristics (e.g., private, affiliated, complex or highly illiquid assets). Market conditions may also necessitate special care for other more risk-sensitive assets, such as real estate equity, concentrated lower investment grade corporate positions and exposure to highly correlated assets.

[1] Classes 3A, 3B, 4, C, D and E.

[2] In this document, the term “insurers” includes “reinsurers” and “insurance groups” for which the BMA is the group supervisor.

[3] Paragraph 46 of the Code.

[4] Paragraph 12 (2) of the Insurance (Group Supervision) Rules 2011.

1.4. Compliance with the PPP shall continue to be considered on a case-by-case basis notwithstanding the provisions in the Group Rules, the Code and this Instructions and Guidance. Based on its business strategy and risk profile, what is prudent for one insurer may not be prudent for another. When applied to a particular insurer's circumstances, the PPP's standards are likely to allow for a range of reasonable investment strategies. In line with the BMA's supervisory approach to insurance regulation, the BMA will exercise its independent and objective assessment in this regard. If the assessment concludes that an insurer is not meeting the PPP's standards, senior management and the board are expected to take remedial action.

1.5. In addition to outlining the proposed expectations in detail, the BMA reminds insurers of the responsibilities resting with the board, senior management and control function holders, including but not limited to implementing the PPP. Senior management, including the chief executive officer, chief investment officer, chief finance officer, chief actuary, chief risk officer and other appropriate members of senior management, is responsible for ensuring that the insurer complies with the PPP. Additionally, the head of internal audit is responsible for the independent assurance of the adequacy and effectiveness of prudent person processes and procedures.

1.6. The proposals in this CP should be read in tandem with the Code and Group Rules, with particular attention paid to paragraphs 45-50 of the Code.

Proposals

Investment Strategy

1.1. An investment strategy that appropriately reflects the PPP should contain the following features as a minimum:

- Capital preservation and return on investment objectives
- Evidence of how the strategy considers the nature (including liquidity and predictability) and duration of an insurer's liabilities and the best interests of policyholders
- A strategic asset allocation that includes appropriate and effective exposure limits by asset type, counterparty, sector, credit risk rating, geographical area and currency
- An asset selection process that pays due consideration to the risk profile of the insurer and its liquidity needs across different time horizons and stress scenarios
- A plan for the insurer's use of derivatives that considers the insurer's capital requirements and adequacy, short-term and long-term liquidity requirements, and policyholder obligations

- It has been established in the context of effective risk management and governance
- Where applicable, include a plan (including valuation) tailored to the insurer's use of non-publicly traded, illiquid, less transparent, structured credits, off-balance sheet exposures and related party-originated assets, among other bespoke and complex assets

Investment Risk Management

1.2. A robust investment risk management framework is necessary for insurers to adhere to the PPP when managing their investments. Compliance with PPP embeds investment activity into the broader risk management framework.

1.3. Insurers should only invest in assets whose risks they can correctly identify, measure, monitor, manage, control and report upon.

1.4. When insurers invest in asset structures or other instruments (*e.g.*, structured assets and derivatives) where the risk exposure is dependent on the performance of underlying assets, they should also include the risks of these underlying assets within the scope of their investment risk management framework.

1.5. Insurers should demonstrate that they can effectively monitor their investments, including adherence to their set limits. Insurers' investment risk monitoring should cover, but not be limited to:

- Changes in value or characteristics of the assets, derivatives and other instruments held, including the underlying/look-through risks and exposures
- Changes in the external environment that may affect the security of assets
- Changes in concentrations to common risk drivers in the portfolio (asset type, counterparty, sector, credit risk rating, geographical area, and currency)
- Asset/liability mismatch, including liquidity mismatches of assets and liabilities
- Defaults, credit rating transitions and changes in credit spreads

1.6. 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.

1.7. For investments whose risks pass through to the policyholder, such as variable annuity separate accounts and index-linked contracts, insurers should, where applicable (i.e., where it is within their powers), ensure that the following requirements are met:

- The set of investment options offered to the policyholders, e.g., the set of funds that can be linked to a policy, consists of investments that can be generally considered to be in the best interests of policyholders (taking into account the different risk-return profiles of the investments offered) and their suitability for the targeted (retail) audience

- The risks associated with each investment option offered are disclosed by law where the products are sold, allowing policyholders to make informed investment decisions that align with their risk appetite and investment objectives given the set of investment options offered and the nature of those investments

1.8. Insurers should appropriately manage any conflicts of interest arising from any investments that back the kinds of policies mentioned in paragraph 1.7 above. Conflicts of interest in this context could occur, for example, through management fees earned by an affiliated asset manager, management fee kickbacks earned by the insurer, sharing arrangements with the insurer or potentially through the funds offered to policyholders investing in affiliated assets. While potential conflicts of interest are most likely to occur at the level of the direct or primary insurer, it is also possible they could occur in the reinsurance context, e.g., if the reinsurer and the insurer design a product together (including deciding the investment options), or if the reinsurer otherwise influences the selection of the investment options offered to the primary policyholders.

Governance

1.9. The ultimate responsibility for sound and prudent governance and oversight of the insurer rests with its board. Although effective governance is essential to all insurers, those insurers with investment strategies that include illiquid, hard-to-value assets that are non-publicly traded and can be more complex than liquid traded assets, should expect the BMA to exercise close ongoing supervisory scrutiny of their governance. To comply with PPP and in recognition that certain risks may only be addressed through governance requirements, insurers must establish strong and effective investment-specific governance, which must, in turn, be an integral part of the insurer's broader governance system. Such investment governance may be accomplished through the insurer's risk management function. The purpose of this section is to identify specific areas of governance that the BMA expects the board to devote particular attention to with respect to its responsibilities for oversight of the insurer's compliance with the PPP. These include:

- Establishing adequate governance systems, including an investment-specific governance framework, in a manner that clearly takes into account compliance with PPP requirements

- Setting and overseeing the implementation of an appropriate business strategy, including an investment strategy. The business strategy must be supported by a clear and measurable statement of risk appetite (including investment limits) and must be owned and overseen by the board. The BMA expects to see clear evidence that the board pays particular attention to compliance with PPP

- Reviewing and approving significant policies and procedures that promote effective investment governance

- Identification and transparent disclosure of affiliated and related party exposures, including in financial statements, Generally Accepted Accounting Principles (GAAPs) and Financial Condition Report

- Ensuring the insurer establishes and implements policies, processes and procedures to identify and manage conflicts of interest. Excessive reliance on disclosures without adequate consideration of how conflict may be appropriately prevented or managed is not permitted. For example, overreliance on disclosures of a specific conflict of interest when there are more effective ways to address that conflict appropriately is not permitted. Insurers should use disclosures only when their administrative arrangements cannot reasonably ensure that conflicted transactions are effected on arms' length terms

- Ensuring appropriate structures, policies and procedures (e.g., conflict committees, disclosure, etc.) exist to deal with conflicts of interest effectively, especially in the context of the situations stated below (as a minimum):-

    - Related party asset management and origination activities

    - End-to-end fees charged or extracted by the related asset manager, originator or structure

    - Managing the accumulation of risks due to potential conflicts of interest with related party asset managers and/or originators

1.10. Insurers must govern the terms of the asset manager arrangement, including the role and suitability of the level of discretion (if any) granted to the asset managers. To comply with PPP, the Authority expects insurers that grant discretion to asset managers (including affiliated asset managers) to exercise appropriate risk management and oversight, particularly in relation to non-publicly traded, illiquid, non-traditional assets and other bespoke and complex assets.

1.11. Insurers must embed an effective risk culture, including (but not limited to) ensuring that the senior management compensation structure is, where applicable, aligned with the long-term nature of insurance liabilities. It must also consider the nature of the insurer's investments, including, where applicable, the lack of or limited historical data, the illiquid and complex nature of the investments.

1.12. When an insurer outsources investment management activities, whether to external third parties or affiliated entities, the board must ensure oversight and clear accountability. This should be handled as if the investments were managed internally by adhering to the insurer's own standards for governance and internal controls. The board should also ensure that the investment management agreement and any associated contractual arrangements include terms on compliance with applicable laws and regulations. Agreements should also not hinder the insurer from complying with the Insurance Act 1978 and related regulations. Where the assets are governed under laws from the ceding jurisdiction, but the insurer has the economic exposure, the investment activities, policies, guidelines and control mechanisms shall be implemented in a manner that complies with the requirements outlined in these Instructions and Guidance.

1.13. To be effective, the board needs to include individuals with a suitable and up-to-date mix of skills and experience that covers the major business areas, including investments, to make informed decisions and provide effective oversight of the risks. This also requires robust and well-targeted management information.

1.14. The board should include an appropriate number of non-executives who are independent and non-conflicted and who, among them, have sufficient enough breadth of understanding of the insurer's investment strategy to provide effective challenge to the executives[5]. The BMA expects to see evidence of effective challenge, relevant knowledge and experience, including the ability to solicit appropriate professional advice with in-depth expertise in the asset classes being pursued by the insurer.

Outsourcing of investment-related services

1.15. Insurers that wholly or partially outsource the investment management function must ensure that any external asset manager is aware of and complies with the requirements of PPP. The insurer must communicate its investment strategy and policy to any external asset manager to accomplish this. The insurer must also ensure that its investment risk management framework is effectively implemented.

1.16. The insurer should have access to the requisite knowledge and skills to assess and manage the risks of its investments. When an external investment service provider is used, the insurer should retain adequate investment risk expertise in-house, as it has the ultimate responsibility for its investments.

1.17. The insurer should have a good understanding of the different parties involved in its investments and how they impact the creation, extraction and diminution of value in the investment chain. These parties could include the investment advisor, asset manager, asset originator, special servicer, asset custodian, etc. Any potential conflicts of interest should be fully identified and mitigated in a manner that is in the best interest of policyholders. The insurer should consider the

[5] Refer to Paragraphs 15 and 16 of the Code for more details

possibility of cash or assets being withheld by some parties e.g., holdbacks by a special servicer such that assets are not available to meet policyholder obligations as and when they arise.

1.18.The insurer should also take into account that when loans default, it is not always evident whether the optimal strategy for recovering value for investors is to sell the asset at current market prices, wait for an improvement in prices or pursue other options such as foreclosing on the underlying collateral. These decisions are particularly challenging in volatile market conditions with significant fluctuations in valuations, where the insurer may have limited influence. It is, therefore, essential to evaluate whether the other parties involved have sufficient motivation to act in the best interests of policyholders and that any relevant conflicts are managed appropriately. Insurers should carry out due diligence and monitor and review the performance of outsourced investment service providers on an ongoing basis, focusing on identifying any material changes or deficiencies that may impact the insurer's investment portfolio or risk profile.

1.19.Insurers should establish clear contractual agreements with service providers, that outline the scope of the services, performance metrics and obligations of each party. These contracts should include provisions for regular reporting, oversight mechanisms and remediation measures in the event of non-compliance or underperformance.

1.20.Insurers should evaluate the potential impact on their investment portfolios and risk management capabilities in the event that a service provider becomes unable to fulfil its obligations. This assessment includes identifying critical dependencies and analysing the potential consequences of service disruption or cessation.

1.21.Insurers should prepare contingency plans to mitigate the risks of dependency on a single service provider. This may involve diversifying service-provider relationships, establishing contingency systems or processes or developing exit strategies for transitioning services to alternative providers when necessary.

1.22.Investments held by entities within a group are sometimes managed centrally by an investment management function, with all entities relying on its expertise. In such arrangements, the insurer and/or group should ensure the investment management function has the requisite knowledge and skills to assess and manage the risks of these investments. The investments should be managed with due regard to the needs of individual entities in addition to the group as a whole.

1.23.Insurers should conduct thorough due diligence on fee arrangements, assessing their alignment with the value provided by service providers and industry standards. This includes scrutinising fee structures for transparency, reasonableness and consistency with market norms. Insurers should establish clear policies and procedures for the review, approval and monitoring of fee arrangements, as well as disclosing fee structures and potential conflicts of interest to the BMA and other stakeholders as may be relevant.

Match to liabilities

1.24. PPP requires that the insurer's investments be made in consideration of the nature, duration, risks and cashflow profile of its obligations to policyholders to ensure there is adequate asset-liability matching. In this regard, insurers should assess the materiality of any embedded optionality in proposed assets and the extent to which such optionality may erode the match to liabilities and introduce additional risks, e.g., reinvestment risk. The assessment should also consider how the optionality may vary over time and under stress conditions across different asset classes.

1.25. As liability cashflows are often uncertain or there are not always assets with appropriate cash flow characteristics, the insurer is usually not able to adopt a completely matched position. However, to the extent that assets and liabilities are not well matched, the extent of mismatching should not expose policyholders to risks that cannot be effectively managed by the insurer.

1.26. When assessing how assets match liabilities and establishing internal investment exposure limits, the insurer should consider gradual and sudden changes in lapses and other policyholder behaviours that could impact guarantees and options. This should include those lapses of separate account products.

Risk Concentration, Risk Accumulation and Diversification

1.27. An insurer's investment policy and limits should be such that individual investments and exposures to different asset classes and risk factors are held and maintained at prudent levels.

1.28. An insurer should ensure there is no excessive risk concentration whereby a significant portion of the investment portfolio is exposed to a specific risk or a narrow set of risks. This requires the insurer to identify and mitigate such common risks that may be material to part of its investment portfolio.

1.29. An insurer's risk assessment should go beyond individual investments to consider the whole portfolio, including any unforeseen emergent properties of the portfolio. An insurer may still accumulate risks even if it holds diverse, individually sound assets. These assets may collectively pose a higher level of risk due to correlations or dependencies during adverse market conditions.

1.30. An insurer should ensure its portfolio is well-diversified to limit volatility to levels that are consistent with the overall risk appetite and appropriate risk management, with consideration given to the profile of its policyholder liabilities. This should be both across asset classes and within asset classes, sectors and risk factors, counterparties and geographies, such that the portfolio is not overly reliant on the performance of a single investment, a small set of investments or a specific market segment. Effective diversification requires careful consideration and ongoing monitoring that acknowledges that correlations between asset classes can change or break down and that the performance of seemingly unrelated assets may become more correlated during conditions of stress.

1.31. An insurer should demonstrate through comprehensive stress testing and scenario analysis that its investment portfolio is well-diversified and not exposed to undue risk concentration and accumulation. Stress testing and scenario analysis should be forward-looking, avoid bias and not be limited to what has happened in the past. They should include reverse stress testing and be disclosed in the Commercial Insurer's Solvency Self-Assessment (CISSA) and Group Solvency Self-Assessment (GSSA).

1.32. The BMA expects insurers to set explicit individual and aggregate limits for assets that meet any of the following criteria: non-publicly traded, complex, unrated or rated below investment grade. In particular, specific prudent limits should be in place for complex instruments, structured/securitised and private assets, including loans and bonds.

Complex and Non-Publicly Traded Assets

1.33. In considering investing in complex investments, insurers should comprehensively assess the inherent risks that may be present, including the heightened risk of large, sudden, or unexpected losses due to limited transparency and information flow, volatility misestimation and difficulties in identifying and reflecting changes in risk profile before significant deterioration.

1.34. When assessing investment opportunities for non-publicly traded assets, an insurer should carry out an assessment of its capabilities and resources to determine whether it can appropriately identify, measure, monitor, respond to, control, and report on the risks and complexities unique to non-publicly traded assets.

1.35. The Insurer shall carry out appropriate and holistic due diligence to ensure an adequate understanding of the risks before the insurer invests in non-publicly traded assets and assumes these risks. In practice, this requires adequate investment in appropriate infrastructure, people, tools and systems to ensure the necessary due diligence and research over non-publicly traded assets is carried out. This due diligence should be holistic and include an assessment of tail risks and their implications. For example, the insurer would need to consider the resources and expertise required for workouts in case of default on complex assets. This would also include considering that the insurer may have to hold and manage the underlying collateral if there was a default and whether capabilities exist to do so without adverse impact on the insurance business, e.g., management of movable and immovable collateral. The results of the due diligence and research should inform the identification of necessary infrastructure and resources, as well as the policies and limits that need to be established. Specifically, the policy requirements and the level of detail regarding limits should correspond to the risks, uncertainties, and weaknesses identified during the due diligence and research process. Additionally, there should be sufficient investment in people, infrastructure, and other resources to support these efforts.

1.36. The insurer should not place blind reliance on ratings provided by rating providers. The BMA would expect insurers to demonstrate that due diligence is being carried out on both the assets and the chosen rating providers to assess if the rating providers have adequate expertise in rating the specific asset type in question. Insurers must also perform their own assessment of the credit risk of investments and monitor it on an ongoing basis. Where the assessment indicates a level of credit risk that is not consistent with the external ratings provided, the insurer should have mechanisms in place to ensure that the level of capital it holds is not materially understated. Where an asset has a rating from only one rating provider, the BMA expects the insurer to demonstrate an understanding of the asset class, the individual assets and the potential ratings 'jump risk' that could result from any new developments on the rating provider. For enhanced transparency of the conduct of the insurance business and associated investment activities the BMA expects insurers to use publicly issued ratings over privately issued ratings by default, where feasible, and otherwise to demonstrate, with clear justification, why the insurer is unable to use public ratings.

1.37. In setting investment limits and policies on investing in non-publicly traded assets, the insurer should consider whether, under moderate to severe stress scenarios, it would be a forced seller of such assets in order to meet rapidly rising liquidity needs e.g., increased lapses or margin calls on derivatives. This requires an assessment of the insurer's normal and stressed liquidity requirements across different time horizons. The liquidity stress testing should also consider the tail impact of asset funding commitments and the fact that these may need to be fulfilled at a time when the insurer needs enhanced liquidity buffers. Such commitments, where they exist, shall be kept at prudent and manageable levels.

1.38. The Authority expects investment limits to be set so that liquidity needs under both normal and stress conditions can be met without forced sale of less liquid non-publicly traded assets. Insurers will be expected to demonstrate this to the BMA, including as part of the CISSA and GSSA process.

1.39. Liquidity positions should be assessed not only at the entity level but also for relevant non-fungible balance sheet pockets, e.g., assets in collateral accounts, where liquid assets and other sources may not be fungible across accounts. In practice, this means an insurer's liquidity assessments should be a combination of both top-down and bottom-up approaches.

1.40. A key feature of non-publicly traded assets is uncertainty on the values assigned to such assets, i.e., valuation uncertainty. The proper application of PPP places the onus on the insurer to ensure the valuation process is conducted in a manner that is consistent with achieving prudent outcomes for policyholders and compliance with Economic Balance Sheet and GAAP financial statements requirements.

1.41. An insurer is expected to have, either through outsourcing or internally, sufficient infrastructure and expertise to independently value non-publicly traded assets, to measure and monitor the associated uncertainty in valuation, and to have policies and procedures on how this should be reflected in the reported values. Insurers must demonstrate independence in the valuation process and that effective controls are in place to manage any potential conflicts of interest (in the valuation process) between different stakeholders involved in the overall management of the assets. Where unavoidable, the role and input of the asset manager into the valuation process, especially for hard-to-value assets, must be subject to good governance, transparency and meaningful controls over potential conflicts of interest. With appropriate controls, insurers may rely on the independent valuation by their asset manager(s). This does not remove the responsibility of the insurer to adequately assess and manage valuation uncertainty risk, including through independent valuation, regardless of whether the valuation function is outsourced or performed in-house.

1.42. Assessments should be carried out on the potential impact valuation uncertainty could have on the insurer's solvency position under different adverse conditions or scenarios.

1.43. The impact of valuation lags in non-publicly traded assets should also be considered as part of the overall due diligence, asset class research, policy and limit setting, as well as the ongoing monitoring of risk. For example, the insurer should consider the potential distortion in asset allocations due to the numerator and denominator effects. If the market values of publicly traded assets rise, for example, the numerator effect may create a false sense of reduced exposure to some non-publicly traded assets. If not appropriately considered within the investment risk framework, this may result in imprudent risk-taking. Similar considerations should be applied to challenges arising from the denominator effect. For example, a significant drop in publicly traded asset prices held in an investment portfolio may result in the relative value of non-publicly traded assets exposure increasing significantly as a proportion of the total assets. This effect could be further increased by continued new investment into non-publicly traded assets, e.g., due to a drawdown on existing commitments. When combined with the rebalancing and illiquidity risks, this may result in the forced sale of such assets in order to bring exposures within limits.

1.44. The BMA will assess the independent internal and external valuation performed by insurers, in particular for complex and/or non-publicly traded investments.

Affiliated, related and connected party assets

1.45. Paragraph 33 of Part 4 of the Insurance (Prudential Standards) (Class C, Class D and Class E Solvency Requirement) Amendment Rules 2024 requires prior written regulatory approval from the Authority for all assets with counterparty credit exposure to an affiliate, related party or connected party of the insurer (collectively, "affiliated assets").

Commercial Insurer Solvency Self-Assessment and Group Solvency Self-Assessment

1.46. Insurers' own risk and solvency self-assessment should evidence and attest to their application of PPP and the considered impact on their solvency and liquidity positions.

1.47. The assessment and attestation should consider the expectations outlined herein, as well as other insurer-specific considerations.

1.48. Insurers are reminded that the standard capital requirement formula may be less suited to measure the risks of certain investments. As a result, the BMA expects insurers to self-assess the appropriateness of the standard capital charges and how these reconcile with the insurer's own estimates as derived from the implementation of its governance processes in the application of PPP. Material differences should be disclosed and explained.

1.49. Through this self-reflective process, insurers should identify areas of strength and weakness; the report should assess potential impacts and outline interim and final corrective measures with a clear summary of ownership and responsible governance. The assessment and attestation shall not be submitted separately. Instead, they shall be integrated into the solvency self-assessment filing.

Use of Derivatives and other Financial Instruments

1.50. An insurer choosing to engage in derivative activities should clearly define its objectives, investment and derivative strategy, governance mechanism and derivative use policies and processes. Derivatives should be considered in the context of a prudent overall asset-liability management strategy.

1.51. As part of its ongoing risk management, an insurer should be able to demonstrate that it can adequately recognise, measure and prudently manage the risks associated with the use of derivatives, including but not limited to hedge ineffectiveness, basis, replacement, credit, margin calls and residual risks.

1.52. Section 19 of the Insurance Act 1978 prohibits insurers from engaging in non-insurance business. Non-insurance business includes engaging in investment banking activities (among other things). Insurers shall not use derivatives for speculative purposes. This means that where derivatives are used, they are for risk management or portfolio management purposes, i.e., the purpose is to reduce risk and costs or generate additional capital or income with an acceptable level of risk.

1.53. An insurer should be satisfied with the suitability of derivative counterparties, the derivative collateral, the traceability of the derivative and, in the case of over-the-counter derivatives, the ability to value and close out the position when needed.

1.54. The collateral and liquidity risk implications should be adequately assessed under a variety of normal and adverse conditions.

1.55. When engaging in securities lending or repurchase agreements, an insurer should consider counterparty risk and reinvestment risk. The insurer should ensure the transactions are appropriately collateralised (with suitably frequent updating) and should recognise that these transactions do not mitigate the market or credit risk in the security since the security is returned to the insurer at the end of the transaction. Care should be taken by the insurer when investing the collateral, ensuring that the transactions are covered even under adverse market conditions.

1.56. When deciding whether to invest in off-balance sheet structures, the insurer should take into account its unique characteristics and risk exposures, including how these may correlate with on-balance sheet exposures under stressed conditions. For example, commitments to invest in a fund may be drawn down by the fund at a time when the insurer may want to reduce its exposure. This may undermine the effectiveness of its risk mitigation under stress.

Amendments to Insurance Code of Conduct and Insurance (Group Supervision) Rules 2011

1.57. The proposals contained herein will result in consequential amendments to the Code and Group Rules in relation to prudent person principle. Consultation on these amendments will occur in 2025.

Effective date

1.58. The Authority proposes that these Instructions and Guidance will enter into force on 1 July 2025.

- End of Consultation paper -

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