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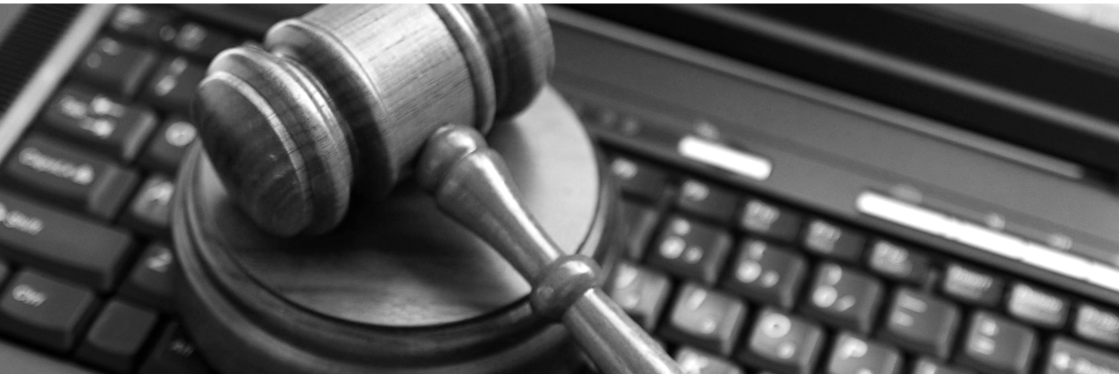

Research Update

June 2015

Litigation risk on unit-linked business under Solvency II

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

Overview

The introduction of the prudent person principle of Article 132 of the Solvency II directive will have far-reaching implications for insurers and will in particular affect the litigation risk on unit-linked business. In this research update, George McCutcheon reviews these issues in more detail.

Key messages for life insurers

Timescales

- With effect from 1 January 2015 insurers were expected to have the Solvency II risk management function (RMF) established.
- Insurers have to be fully compliant with the prudent person principle (PPP) by 1/1/2016

Issues for Insurers

Prudent person principle is a game-changer for insurers

- The introduction of the PPP under Solvency II will raise the bar on standards expected from insurers in respect of assets GRC (Governance, Risk & Compliance) and this will significantly increase the litigation risk on unit-linked business unless insurers put appropriate systems of governance in place
- The same standards of assets GRC apply equally to unit-linked business and other business lines. Whilst the market risk SCR calculation for unit-linked business takes full account of the level of unit matching, there is no distinction in the IMMMCR[1] risk requirements between investments where the insurer has the economic exposure and unit-linked investments where customers have the economic exposure.
- Insurers need to deploy appropriate risk mitigation tools to manage such litigation risks because otherwise significant additional regulatory capital will be required to cover the risks under Solvency II

[1] Identify, measure, monitor, manage, control and report

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Requirements

- The key regulatory requirement under the PPP is that insurers should only invest in assets and instruments the risks of which it can properly identify, measure, monitor, manage, control and report (IMMMCR) and appropriately take into account in the assessment of its overall solvency needs in accordance with Conditions Governing Business 3.8(2) (a)[2]
- This key regulatory Prudent Person Principle establishes the link between investment risks and capital needs under the ORSA
- Under Solvency II, life insurers have a 'know your assets' requirement on an economic substance basis i.e. irrespective of whether assets are held directly or indirectly through Collective Investment Undertakings (CIUs)
- Regulatory requirements for risk management have to be applied on a continuous basis

Litigation Risk

- There is an explicit recognition by EIOPA of the litigation risk on unit-linked business. In Section 5 of the Explanatory Text of the EIOPA Final Guidelines on the System of Governance, relating to the prudent person principle and Guideline 27, paragraph 2.136 (d)[3] emphasises that legal risk and operational risk resulting from a lack of care may impair an insurer's solvency and special emphasis is placed on unit-linked business.
- The PPP is likely to impact on the litigation risk in two contrasting ways. Firstly the risk should be reduced by the prospective application of the PPP in terms of the due diligence standards and monitoring standards expected for investments but secondly the risk would be increased from a retrospective application in assessing the IMMMCR requirements as applied to very poorly performing investments.
- The threat to the solvency of insurers arises from the possibility that insurers would be exposed to the tail downside risk on unit-linked investments from potential litigation. So it's not the small investment losses that might cause consequential litigation but the disastrous investments that on a retrospective assessment might have a prima facia difficult task satisfying the IMMMCR requirements.
- There's also the possibility of a significant financial impact arising from multiple simultaneous litigation on small investment losses.
- Even with the best standards of assets GRC, some investments will perform poorly and so litigation risk will arise. However successful litigation by customers in respect of poorly performing investments would require evidence of insurer failure to meet regulatory standards. The relative standards of assets GRC is what will differentiate the impact on insurers. If insurers can demonstrate compliance with best IMMMCR standards, then the litigation risk can be significantly mitigated.

Action Points for Board of an Insurer

> ***Insurers need to deploy risk mitigation tools to cover litigation risk on unit-linked business***

- The board needs to consider the litigation risk as part of the capital requirements for operational risk[4] as part of their ORSA.
- The insurer needs to decide whether litigation risk will be covered with capital or managed with risk mitigation tools or both.
- If the risks are to be managed with risk mitigation techniques, the insurer needs to explain by which technique and the underlying reasons.
- The board needs to look to the risk management function for risk mitigation solutions

Industry Issues

- Legal advice in respect of extent of litigation risk on unit-linked business
- Legal advice as to whether PPP would be considered by the courts to apply at individual unit-linked fund level
- More clarity is required from regulators on the scope of the PPP particularly in respect of self-directed business.

http://www.actuarialpost.co.uk/news/how-should-self-directed-investments-be-treated-under-ppp-7859.htm

[2] PRA Rulebook: Solvency II Firms: Conditions Governing Business Instrument 2015

[3] d) Duty to protect policy holders and beneficiaries' interest: The undertaking protects the policyholders' and beneficiaries' interests considering that risks such as legal risk, reputation risks, commercial risks, and operational risks resulting from a lack of care may also impair its solvency. A special emphasis on this point is made on unit-linked business.

[4] Per Article 13(33) of Solvency II, operational risk is the risk of loss arising from inadequate or failed internal processes, or from personnel and systems, or from external events. When computing SCR, per Article 101(4) operational risk includes legal risks.

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Issues for the CRO & Solutions

- The RMF needs to address assets GRC issues as a matter of urgency
- Insurers need to change their historic mind-set towards unit-linked assets – insurers need to manage unit-linked investments as if they had the downside economic exposure.
- If the risks are to be managed with risk mitigation techniques, the insurer needs to explain by which technique and the underlying reasons.
- Protection for insurers from litigation risks will come from compliance with the risk management rules.[5] Fundamental to that is an effective risk-management system comprising strategies, processes and reporting procedures for IMMMCR on a continuous basis. For this insurers will need new technology tools because the implementation of Pillar 2 system of governance and Pillar 3 asset reporting is not easy and it requires investment in new technology such as Invest|GRC™, an FRS dedicated Sol II asset warehouse and QRT reporting tool
- In an environment of increasing outsourcing by insurers of investment administration, the availability to the insurer's Solvency II risk management and compliance functions of browser based analytics capabilities with real-time unfettered access to asset data is of paramount importance.

Detailed Action Points for RMF

- Review of capabilities of RMF re assets GRC
- Review of technology tools available to RMF re assets GRC
- Review of assets GRC risks in respect of outsourcing arrangements
- Review of investment portfolio to identify investments that might fail the IMMMCR risk requirements with a view to replacement or restructuring or capability enhancement
- Review of market propositions to identify whether there are any products with opaque investment structures which might be considered to be incompatible with PPP
- Review of specialist funds to identify potential exposure to litigation risk and downside tail risk and carry out cost/benefit analysis e.g. compare and contrast compliance costs with product margins
- Document insurer's understanding of the scope of the PPP and seek regulatory clarification as required

Background

> ***Operational risk is potentially the single biggest threat to solvency of insurers transacting primarily unit-linked investment business and in particular the litigation risk***

Solvency II is intended to ensure the solvency of insurers. The PPP is key to the management of investment risk but it might also have unintended consequences. It will make it easier for customers to successfully sue insurers for investment losses on unit-linked business. Such compensation amounts could be significant and indeed substantially in excess of the operational risk SCR maintained in respect of unit-linked business and in extreme circumstances even threaten an insurer's solvency.

The prospective application of the PPP will be beneficial as it will require insurers to do proper due diligence and apply effective on-going assets GRC. However the retrospective application of the PPP could have very different consequences for insurers in facilitating customers to successfully sue for investment losses.

Regulatory Background

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

The assets GRC rules are set out in the instrument known as the PRA Rulebook: Solvency II Firms: Investments Instrument 2015 (which comes into force on 1 January 2016) The key principle is that insurers should only invest in assets and instruments the risks of which it can properly identify, measure, monitor, manage, control and report (IMMMCR) and appropriately take into account in the assessment of its overall solvency needs in accordance with Conditions Governing Business 3.8(2) (a).[6]

[5] as set out in the PRA Rulebook: Solvency II Firms: Conditions Governing Business Instrument 2015 (which comes into force on 1 January 2016)

[6] A firm must conduct an ORSA as part of its risk management system which must include the firm's overall solvency needs taking into account the specific risk profile, approved risk tolerance limits and the business strategy of the firm;

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Litigation risk

Right of customers to sue for losses due to failure to comply with regulations

Litigation risk is a major part of operational risk. The litigation risk arises primarily in the context of national primary legislation that prescribe either:

(a) Powers conferred on the regulator to direct a regulated financial service provider to provide redress to customers on losses arising due to failure in systems or controls

(b) That a failure by a regulated financial service provider to comply with any obligations under financial services legislation is actionable by customers who suffer loss or damage as a result.

In pre-implementation submissions, insurers had argued for certain exemptions for unit-linked business from the enabling provisions for Article 132 on the basis that risks have been boxed off if insurers have matched unit positions.

However EIOPA took a different view that Article 132 doesn't consider unit-linked business to be different from other business classes.

Hitherto some insurers may have operated on the basis that unit-linked customers bore the downside risk but that view is now questionable. Where large losses arise on unit-linked business, there is likely to be a post-mortem carried out by either regulators or customers with the first question being whether or not there was a failure of the insurer to follow the PPP. There might be a view that there is a prima facie case that large losses must involve some form of failure of the PPP.

The introduction of the PPP was not intended as a mechanism to provide a means of securing compensation for customers in respect of poorly performing investments. Even investments subject to the best standards of selection and monitoring can under-perform but as long as the insurer meets best IMMMCR standards then the case for customer compensation is weak.

Potential reasons for large losses on unit-linked business

- Whilst the insurer might have operated in good faith, there might have been an inadequate appreciation of the investment risks at the outset – potential litigants would claim a breach of obligation under a failure to 'identify' risks as part of due diligence.

- Whilst appropriate due diligence might have been carried out at the outset, the nature of the risk might have changed over time - potential litigants would claim a breach of obligation under a failure to 'manage, measure and control' risks

- Whilst a particular risk might have been identified, the magnitude of the risk might not have been appropriately understood - potential litigants would claim a breach of obligation under a failure to 'measure and control' risks

One just needs to look at the types of investment losses experienced during the financial crisis (misunderstood credit risks and credit spreads, losses on financial shares, falls in property valuations, effect of leverage, etc.) to see that there could be potential grounds for litigants to successfully sue for breaches of the IMMMCR requirements in a Solvency II world.

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Risk Management Rules

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

Risk management rules are set out in the PRA Rulebook: Solvency II Firms: Conditions Governing Business Instrument 2015 (which comes into force on 1 January 2016)

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

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

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

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

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

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

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

(b) Demonstrate the methods used in that assessment.

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

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

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

With-profits funds

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

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Risk management and compliance functions

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

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

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

Technology solutions

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

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

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

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Biography; George McCutcheon MSc FIA:

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

About Financial Risk Solutions (FRS)

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

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

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

Knowledge based software

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