Chapter 3

Market risk

3

3.1 Market risk in insurance

3.1.1 R ■ INSPRU 3.1 applies to an *insurer*, unless it is:

(1) a *non-directive friendly society*; or

(2) [deleted]

(3) [deleted]

(4) a *Solvency II firm*.

Purpose

3.1.7 G ■ INSPRU 3.1 addresses the impact of *market risk* on *insurance business* in the ways set out below:

(1) Any *firm* that carries on *long-term insurance business* is required to hold capital to cover *market risk*. ■ INSPRU 3.1.26R makes particular provision for assets invested outside the *UK*.

(2) *Firms* carrying on *long-term insurance business* that have *property-linked liabilities* or *index-linked liabilities* must cover these liabilities by holding appropriate assets. ■ INSPRU 3.1.57R and ■ INSPRU 3.1.58R set out these cover requirements.

(3) ■ INSPRU 3.1.61AR(1) applies to *pure reinsurers* "prudent person" investment principles in relation to the investment of their assets.

Market risk scenario for assets invested outside the United Kingdom

3.1.26 R Where the assets of a *firm* invested in a significant territory for the purposes of *PRA* Rulebook: Non-Solvency II firms: Capital Resources Requirements, 20.10, represent less than 0.5% of the *firm's long-term insurance assets* (excluding assets held to cover *index-linked liabilities* or *property-linked liabilities*), measured by *market value*, the *firm* may assume for those assets the *market risk* scenario for assets of that kind invested in the *United Kingdom* set out in *PRA* Rulebook: Non-Solvency II firms: Capital Resources Requirements, 20.10 instead of the other *market risk* scenarios set out in that provision.

Covering linked liabilities

3.1.57 R A *firm* must cover its *property-linked liabilities* with:

(1) (as closely as possible) the assets to which those liabilities are linked; or

(2) a property-linked *reinsurance* contract; or

(3) a combination of (1) and (2).

3.1.58 R A *firm* must cover its *index-linked liabilities* with:

(1) either:

(a) the assets which represent that index; or

(b) assets of appropriate security and marketability which correspond, as closely as possible, to the assets which are comprised in, or which form, the index or other reference of value to which those liabilities are linked; or

(2) a portfolio of assets whose value or yield is reasonably expected to correspond closely with the *index-linked liability*; or

(3) an index-linked *reinsurance* contract; or

(4) an index-linked *approved derivative*; or

(5) an index-linked *approved quasi-derivative*; or

(6) a combination of any of (1) to (5).

3.1.59 G For the purposes of INSPRU 3.1.57 R and INSPRU 3.1.58 R, a *firm* is not permitted to hold different assets and to cover the mismatch by holding excess assets.

3.1.60 G If a *firm* has incurred a *policy* liability which cannot be exactly matched by appropriate assets (for example the Limited Price Index (LPI)), the *firm* should seek to match assets that at least cover the liabilities. For example, an LPI limited to 5% per annum may be matched by an RPI bond or a fixed interest investment matching cash flows increasing at 5% per annum compound. Orders made by the Department for Work and Pensions under section 148 of the Social Security Administration Act 1992, and which are limited to 5% per annum, may also be matched by a fixed interest investment matching cash flows increasing at 5% per annum compound.

3.1.61 G In selecting the appropriate cover, the *firm* should ensure that both credit risk, and the risk that the value or yield in the assets will not, in all circumstances, match fluctuations in the relevant index, are within acceptable limits.

3.1.61-A G Where liabilities are linked to orders made under section 148 of the Social Security Administration Act 1992 the risks associated with the business may

3

be mitigated by holding assets to cover an alternative index which is reasonably expected to at least cover the section 148 order (e.g. RPI plus a margin) over the duration of the link. The *firm's* exposure to an order under section 148 exceeding this index should be appropriately limited by putting a cap on the liabilities linked to the order so that risks are within acceptable limits.

Pure reinsurers

3.1.61A R A *pure reinsurer* must invest its assets in accordance with the following requirements:

(1) the assets must take account of the type of business carried out by the *firm*, in particular the nature, amount and duration of expected *claims* payments, in such a way as to secure the sufficiency, liquidity, security, quality, profitability and matching of its investments;

(2) the *firm* must ensure that the assets are diversified and adequately spread and allow the *firm* to respond adequately to changing economic circumstances, in particular developments in the financial markets and real estate markets or major catastrophic events; the *firm* must assess the impact of irregular market circumstances on its assets and must diversify the assets in such a way as to reduce such impact;

(3) investment in assets which are not admitted to trading on a *regulated market* must be kept to prudent levels;

(4) investment in *derivatives* and *quasi-derivatives* must contribute to a reduction of investment risks or facilitate efficient portfolio management and such investments must be valued on a prudent basis, taking into account the underlying assets, and included in the valuation of the *firm's* assets. The *firm* must avoid excessive risk exposure to a single *counterparty* and to other *derivative* or *quasi-derivative* operations;

(5) the assets must be properly diversified in such a way as to avoid:

(a) excessive reliance on any one particular asset, *issuer* or *group* of *undertakings*; and

(b) accumulations of risk in the portfolio as a whole.

Investments in assets issued by the same *issuer* or by *issuers* belonging to the same *group* must not expose the *firm* to excessive risk concentration; and

(6) (5) does not apply to investment in government bonds.

Application of INSPRU 3.1 to Lloyd's

3.1.62 R