

PS 9/20 and updated SS 3/17: Illiquid and Unrated Assets

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Overview

On 2 April 2020, the Prudential Regulation Authority (“PRA”) published [Policy Statement 9/20](#) (“PS 9/20”), in which they provided feedback to the responses to the [Consultation Paper 23/19](#) (“CP 23/19”) on “Income producing real estate loans (“IPRE”) and internal credit assessments for illiquid, unrated assets.”

At the same time the PRA published the updated and final version of the [Supervisory Statement 3/17](#) (“SS 3/17”)¹, the name of which is now “Solvency II: illiquid unrated assets”.

In the PS, the PRA concluded that, based on the responses received, all proposed expectations as set out in the CP 23/19 would be maintained; and that no additional requirements were identified during the consultation stage. However, further clarification about certain individual sections has been made in the updated SS 3/17.

Implementation date

The original CP 23/19 had proposed a 31 March 2020 implementation date.

The effective date for the implementation of the updated SS 3/17 is immediate i.e. the date of the publication, 2 April 2020, since the PRA regards the requirements as necessary to comply with the Solvency II Prudent Person Principle.

If insurers had been waiting for the final supervisory statement in order to comply with the revised requirements, then this could present some operational strains, particularly given the operational challenges already associated with COVID-19. Although, in that regard, the PRA did highlight the previously announced [measures aimed at alleviating operating burdens for PRA regulated insurers](#) during the crisis; see [here](#) for Milliman’s take on this.

The PRA states that any firm that is concerned that it does not currently meet the updated expectations of SS3/17 should discuss with its supervisor an appropriate timescale for rectification.

Impact of the revised SS 3/17

The amendments made to the updated SS 3/17 can be split into two key areas:

1. **Internal credit assessment**, further clarification on detail of the PRA’s expectations, particularly the original section 2.8, of companies to evidence the robustness of their framework when they are considering and designing an internal credit assessment framework to rate illiquid and unrated assets for the purpose of assigning fundamental spreads; and
2. **Income producing real estate (“IPRE”) loans**; the PRA’s expectations around carrying out risk identification and modelling of this asset class inserted as a new section 4 to the SS.

Internal credit assessment

The majority of the amendments made to the section 2 of SS 3/17 are in respect of providing further clarification on the PRA’s detailed expectations around how companies may demonstrate that the internally designed credit assessment framework is robust.

In particular, the original section 2.8 has now been extensively expanded and replaced by 2.8A to 2.8N.

In our view, the key updated PRA’s expectations are:

1. **Identification of risks** – for companies which use a full or partial internal model for the Solvency Capital Calculation (“SCR”) calculation, PS9/20 clarifies that one common risk identification exercise needs to be used for both the internal model and the internal credit assessment to identify all potential sources of risk, both systemic and idiosyncratic, underlying the assets in question. This should also include consideration of any potential future risks, such as climate change
 However, it may be appropriate for a company to only select a subset of the identified risks for the SCR calculation, and a different subset for internal credit assessment, although it would need to clearly justify and explain the exclusions of any risks from either.
2. **Methodology and criteria** – if a company decides that its internal credit assessment methodology for a particular asset class should be based on an ECAI’s published credit rating methodology for the asset class, PS 9/20 makes it clearer that the PRA expects the ECAI’s stresses and methodology should be considered together.
 In particular, the PRA would not expect an ECAI methodology to be applied with adjusted stresses as this could lead to the risk of an upward bias in ratings. Hence

¹ Our [May 2019 paper](#) contains a summary of our views of the old SS 3/17 as applicable to equity release mortgages.

the selected ECAI's published methodology and their stresses should be applied in full.

3. **Data** – the potential risk arising from incomplete or missing data should be allowed for in the calibration of the internal credit assessment.
4. **Expert judgements** – key expert judgements applied in the designing of the internal credit assessment should be clearly identified, challenged, justified, well documented and governed for future reference. In our view, this expectation could also be applied to any material limitations identified within the internal credit assessment. Consideration needs also to be given to the possible circumstances in which such judgements would be overridden, or when they may no longer be appropriate.
5. **Potential conflicts of interest** – any conflicts of interest must be appropriately managed and minimised throughout the whole credit assessment process to ensure the independence of the credit assessment from the other relevant stakeholders involved in the overall management of the assets. PS 9/20 clarifies that these conflicts could arise internally as well as externally.
6. **Ongoing appropriateness** – key limitations and expert judgements should be appropriately identified and documented (see “expert judgement” point), to enable an ongoing, regular monitoring process to be carried out to ensure the continuing appropriateness and robustness of the internal credit assessment.

Income producing real estate loans

The definition of IPRE loans has been modified and expanded to be more consistent with [Basel rules](#) for banks (CRE30.15).

The new definition reads:

“IPRE lending refers to a category of funding to real estate where the prospects for ultimate repayment and recovery on the exposure depend primarily on the cash flows generated by

the underlying property asset(s). The primary source of these cash flows would usually be lease or rental payments from commercial tenants (generally for the payment of interest and any amortizing principal) and the sale or refinancing of the asset(s) (generally for the payment of any non-amortizing principal at maturity). The distinguishing characteristic of IPRE (versus other corporate exposures that are collateralised by real estate) is the strong positive correlation between the prospects for repayment of the interest and principal due on the exposure and the prospects for recovery in the event of default. Both primarily depend on the realisation of cash flows generated by a property, whether these are in the form of rental income or sale/refinancing proceeds.”

However, the PRA also makes it clear that this definition is useful rather than to be applied rigidly, and the requirements of PS9/20 would apply more widely to assets with similar features. The PRA therefore declined to give examples, and indeed removed those present in the Basel definition, to avoid creating too narrow an interpretation.

Conclusion

The PS does not impose any significant additional requirements over and above the original CP, although some of the clarifications from the PRA may alter firms' understanding of the PRA's requirements.

Given the immediate implementation date, insurers who haven't already done so will need to perform a near-term exercise to identify any gaps between their current processes and the PRA's expectations, and to develop a rectification plan. Milliman consultants are experienced with helping insurers implement internal ratings frameworks and governance procedures for IPRE loans, and would be pleased to assist with this process.

To discuss this note or illiquid and unrated assets in general please contact [Paul Fulcher](#), or [Sihong Zhu](#), or your usual Milliman consultant.

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