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Guidance on alternative investments and sound investment processes in light of the prudent person principle

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1. Introduction

The subject of this guidance is the Danish FSA's expectations for investment processes and management of investments in life insurance undertakings and multi-employer occupational pension funds (the undertakings).

The background is the introduction by the Solvency II directive of the 'prudent person principle' with which undertakings must comply when investing and managing their assets.

At its core, the principle is simple. One of the key elements is that each undertaking may only invest in assets with risks that the undertaking can understand and manage. It will be a violation of the principle if the conditions are not met, which makes the investment illegal.

The principle that the investment of policyholders' funds must be made on an informed basis and subsequently be manageable is not new as such. However, there may still be a need to unfold some further considerations regarding the use of the prudent person principle in practice. This guidance contains a general introduction to the prudent person principle, with a particular focus on the requirement that the individual undertaking must be able to *identify, measure, monitor, manage, control* and *report* the risks associated with its investments, hereinafter referred to as the 'PPP criteria'.

While the prudent person principle applies to all investments, the focus of this guidance will be on alternative investments in particular. The Danish FSA has chosen this focus, as undertakings have increased their share of alternative investments significantly in recent years. Furthermore, the investment case is often different in terms of the individual investments, and the investment process is often considerably more complex than traditional investments.

This guidance will begin with an introduction to the regulatory framework and subsequently touch upon the characteristics of alternative investments, followed by a description of the Danish FSA's expectations for undertakings' investment processes and management of alternative investments.

2. Regulatory framework

As regards the regulatory framework for the investment process, the Danish FSA finds that Sections 71 and 158 of the Financial Business Act, the Executive Order on Management and Control of Insurance Companies etc. (The Executive Order) and the rules on valuation in particular are of key importance. In addition to this, EU legislation and other international regulations apply. The Danish FSA remarks that the following constitutes a selection from the regulation considered particularly relevant to the topic. The review of the regulatory framework is not intended to be exhaustive.

2.1 The prudent person principle

Undertakings shall invest their assets in such a way as to safeguard the interests of the policyholders and beneficiaries to the best of their abilities. This is established by Section 158(1) of the Financial Business Act. The essence of this is that assets shall be invested in the best interest of all policyholders and beneficiaries. The aim is to ensure that undertakings' investment strategy reflects the prospects held out to customers. The provision is an implementation of Article 132 of the Solvency II Directive [1)], which establishes the prudent person principle. Danish life insurance undertakings and multi-employer occupational pension funds must therefore adhere to the principle as part of their compliance with Section

158(1) of the Financial Business Act.

The prudent person principle implies that the investment strategy and the actual investments must support long-term objectives, including ensuring the best possible return. The investment strategy must be robust against fluctuations in the financial markets.

The prudent person principle also implies that the individual undertaking may only invest in assets whose risk the undertaking concerned can *identify, measure, monitor, manage, control and report*. The prudent person principle applies to the undertaking's individual assets and on the portfolio level, where undertakings' focus must be on the *security, quality, liquidity and profitability* of the portfolio as a whole.

In addition, the location of those assets must be such as to ensure their availability, and the assets used to cover insurance provisions must be invested in a manner appropriate to the nature and duration of the insurance liabilities in order to ensure that the investments are made in the best interest of all policyholders and beneficiaries. In the case of a conflict of interest, undertakings shall ensure that their investments are made in the best interest of policyholders and beneficiaries. These conditions apply regardless of whether the policyholder or the undertaking bears the investment risk.

In this regard, the Danish FSA emphasises that all undertakings must meet the prudent person principle, regardless of the size of the investment.

As mentioned in the introduction, the focus of this guidance will be on the PPP criteria.

2.2 Relevant provisions on risk management

A financial undertaking must have effective governance arrangements in place, including sound administrative and accounting practices, as well as effective procedures to identify, manage, monitor and report the risks to which the undertaking is or can be exposed, cf. Section 71(1), nos. 2 and 4, of the Financial Business Act.

The Executive Order [2)] sets out additional requirements for processes and internal management documents, including in relation to investments. Here, 'internal management documents' is used as a collective term for the policies, guidelines and procedures which are a regulatory requirement for undertakings.

Section 5(2), no. 2, of the Executive Order requires undertakings to draw up a policy for market, counterparty and credit risks (the investment area), the details of which are extensively described in Annex 2 of the Executive Order. For example, in relation to the investment area policy, it follows from Annex 2 that the undertaking's risk profile must be established in accordance with the prudent person principle in Section 158 of the Financial Business Act. Annex 2 also sets out requirements for guidelines and procedures in the investment area.

In general, undertakings must establish adequate segregation of duties, cf. Section 12 of the Executive Order. In relation to the investment area, the segregation of duties specifically implies that employees involved in the conclusion of transactions and risk acceptance may not:

– be responsible for or perform the completion of transactions,
– perform internal controls,
– be responsible for the valuation and calculation of results and risks, or
– be responsible for the preparation of reports.

Where no segregation of duties is maintained, the individual undertaking must introduce adequate compensatory measures to ensure that the undertaking is not subjected to unnecessary risks or losses.

Furthermore, according to section 18(2) of the Executive Order, undertakings must have a risk management function, the overall responsibility of which is to maintain a comprehensive overview of the undertaking's risks and to assist the board of management in ensuring the effectiveness of the risk management system. Inter alia, the risk management function must ensure that all material risks faced by the undertaking, including in the investment area, are correctly identified, measured, monitored, controlled and reported, cf. Annex 6, no. 12.

In addition, there are a number of requirements for the risk management function's involvement in the investment area. The risk management function must perform detailed reporting on risk exposures and advising of the organisation on risk management matters, including in relation to strategic affairs and major investments, and must identify and assess emerging risks, cf. Article 269(1)(d) and (e) of the Solvency II regulation[3)]. It also follows from Annex 6, nos. 9, 16 and 20, of the Executive Order that the board of management must ensure that the person responsible for the risk management function is appropriately involved in assessing the basis for decision-making of the board of management and the board of directors. Moreover, the person responsible for the risk management function must be consulted in advance about significant decisions to enable the risk management function to comment on the risk beforehand. Finally, the person responsible for the risk management function must inform the board of management if an investment results in significant risk or a change of the risk profile.

2.3 Valuation

Valuation is governed by the Executive Order on Valuation[4)] as well as the Solvency II regulation.

Article 267(1) of the Solvency II regulation stipulates that undertakings shall have effective systems and controls to ensure that valuation estimates of their assets and liabilities are reliable and appropriate. Similarly, they shall have a process for regularly verifying that market prices or valuation model inputs are appropriate and reliable.

Furthermore, it appears from Article 267(2) of the Solvency II regulation that undertakings shall establish, implement, maintain and document clearly defined policies and procedures for the process of valuation, including the description and definition of roles and responsibilities of the personnel involved with the valuation, the relevant models, and the sources of information to be used. The Executive Order also sets out procedural requirements in relation to valuation, cf. e.g. Annex 2, no. 4 and no. 7(d).

Article 10 of the Solvency II regulation establishes the valuation hierarchy. The hierarchy means that, as a rule, undertakings must value assets using prices based on active markets[5)]. If there is no active market for the asset concerned (or an active market for similar assets), as is often the case for alternative investments, the undertakings shall use alternative valuation methods. In the assessment of the Danish FSA, no significant difference between the valuation hierarchy is set out in the Solvency II regulation and the valuation hierarchy divided into levels 1-3 established in IFRS 13 on fair value measurement.

3. Alternative investments

Alternative investments are usually illiquid (often unlisted) and differ, inter alia, from traditional investment assets, such as government and mortgage-credit bonds and listed shares, by not being traded in active markets.

The investment markets provide no clear definition of “alternative investments”, but the Danish FSA finds that the following assets, inter alia, could be seen as alternative investments:

- Level 3 assets according to the fair value hierarchy in IFRS 13 (illiquid/unlisted assets)
- Alternative investment funds[6)]
- Securitisations, cf. Chapter VIII of the Solvency II regulation.

Access to information supporting the value of the alternative assets is limited, unless the investor has acquired special rights. Alternative assets are generally not subject to the same stock exchange regulation, e.g. prospectus requirements and continuous disclosure obligations etc., as traditional investments in order to ensure that investors always have sufficient information to be able to make an informed investment decision. For alternative investments, investors must obtain the necessary information themselves, which calls for investors' analyses and for particular control by investors to verify the information presented and the underlying sources. Hence, alternative investments differ from traditional investments in terms of the quantity, quality and validity of public information about the investment in question.

The absence of an active market for alternative investments also means that the value of an alternative investment is not reflected in officially listed prices from a marketplace. Instead, investors themselves must regularly estimate the value of the investment based on thorough analyses of the external and internal factors that may affect the investment throughout the investment period.

At the same time, alternative investments, unlike traditional investments, are typically characterised by not being standardised, and they may include a large element of negotiation about contracts and terms.

Furthermore, alternative investments will often involve other types of risks compared to traditional investments, and they will typically be associated with increased complexity. Typically, these investments can be difficult and expensive to dispose of.

Besides, alternative investments assume, e.g. due to a lack of transparency and market valuation, that undertakings possess the necessary competencies to understand and manage alternative investments, thus enabling them to identify, measure, monitor, manage, control and report the risks associated with each investment.

Whether an investment is an alternative one will depend on the asset and the investment situation, which the undertaking must assess for the investment. For example, listed assets intended to be delisted or expected to be traded very rarely could have qualifying characteristics.

4. Investment process

4.1 General

The Danish FSA expects undertakings to have an investment strategy determining the investment assets that can be included in the portfolio, as well as the maximum weighting in the portfolio of said assets.

The investment strategy should be consistent with the prospects held out to customers.

The investment strategy chosen must appear from the undertakings' internal management documents, and, in practice, the undertaking's board of management must make investments in accordance with the frameworks and mandates set out by the board of directors.

The board of directors must decide on investments if these go beyond the mandate assigned to the board of management by the board of directors, if they fall outside the undertaking's investment strategy or policy, or in case of unusual transactions.

The specific design of the mandate for the board of management, the guidelines, naturally can and will vary from undertaking to undertaking. However, it is important that the guidelines are sufficiently specific to actually set a norm for the investments, and hence the risks, to which the board of directors wants the undertaking to be exposed. It is important to ensure that the mandate given to the undertaking's board of management is not too broad, as this could challenge the fundamental division of roles between the board of directors and the board of management established, inter alia, by the Executive Order. As alternative investments are less homogeneous than traditional investments and can be structured with very different risk profiles, more detailed guidelines and frameworks will generally be required for this area of investment.

In general, the Danish FSA expects there to be consistency between the competencies and the investments in the undertakings. For example, this applies to the competencies of the boards of directors and the complexity of the investments that the individual undertaking makes or wants to make. Among other things, the individual board of directors must possess competencies that enable it to independently assess the undertaking's investments and thus to challenge the board of management's investment recommendations and decisions in the investment area. In line with this, the Danish FSA has previously stated its belief that the investment area, among others, is so important for the undertakings that at least one board member must be able to cover the board of directors' knowledge and experience in this risk area[7)].

The board of directors' ability to independently assess and challenge recommendations and decisions is even more relevant in relation to alternative investments which, as described in Section 3, are subject to risks that are not necessarily found in traditional forms of investment. Hence, if the undertaking has a high proportion of investments in e.g. infrastructure assets, the Danish FSA will expect the board of directors' self-evaluation to address whether the board of directors collectively possesses the necessary competencies to assess and challenge the recommendations and ongoing reporting etc. in this area.

Example 1: Competencies of the board of directors

An undertaking wants to invest 5-10% of its assets in unlisted loans. It expects to do this by investing in funds based on bank loans, structured credit products, and by direct lending. This requires the board of directors to be able to define appropriate investment activity guidelines in its internal management documents to the board of management. It also requires the board of directors to be able to assess the investment recommendations presented to them and to challenge the organisation in this area.

The investment strategy should generally reflect the relevant competencies at the undertaking's disposal. Investing in an asset or instrument of which an undertaking has no knowledge or experience would be in conflict with Section 158 of the Danish Financial Business Act. In that case, the undertaking would not be able to assess the risks associated with the investment and should refrain from making the investment. The investment strategy may well contain new strategic investment areas where the undertaking does not yet possess the necessary competencies. In such cases, the Danish FSA expects the undertaking to have determined how the necessary competencies can be achieved in order to ensure that those competencies are present in the undertaking when the investments are made. These competencies may be both internal and external, and the undertaking can benefit from competencies gained from previous investments in areas where investments are similar.

Example 2: The undertaking must ensure that all competencies are available prior to investment

An undertaking wants to make an investment in a new area in which it has no previous experience. The undertaking assesses that, in some risk areas, the investment has similarities with assets with which the undertaking has prior experience, but also that the undertaking lacks experience in some areas. The undertaking must ensure that it has access to competencies in all areas before the investment in question is made.

If the undertaking uses external assistance in areas where the undertaking does not have the necessary internal competencies, the undertaking must ensure that it has the competencies to evaluate the performance of the outsourced tasks, as it remains the undertaking's responsibility to ensure that the outsourced tasks are adequately performed. If training and employment of competencies over time is included in the considerations of sound management of investments and compliance with the PPP criteria, it must be ensured that the competencies are acquired with sufficient speed and that compensatory measures are taken in the intervening period. In such cases, the Danish FSA expects undertakings to justify and document their compensatory measures.

Similarly, the undertakings' internal management documents as well as the organisational structure must be set up to cope with the prudent person principle, and thus the PPP criteria, before a given investment is made.

4.2 Structured process for investment and management

The Danish FSA expects undertakings to have established – and to adhere to – a structured process for investment decisions and for the subsequent ongoing management of the investments which ensures that the undertaking can meet the prudent person principle and the PPP criteria. This may include, for example, ensuring that the investment can be supported by the undertaking's systems and that the necessary processes and resources for managing the investment are in place. The process must be adapted to each of the types of investments made by the undertakings, such as indirect investments (e.g. via alternative investment funds) or direct investments.

The Danish FSA also expects undertakings to have a structured process for documentation and filing of all relevant material, correspondence and assessments in connection with the undertaking's investments and their risks. This will help ensure efficient processes concerning the prudent person criteria and strengthen the basis for assessing future investments.

The process of conducting appropriate due diligence to identify risks and prospects linked to an investment may be costly. Therefore, it is important that the resources spent on due diligence do not become a determining factor in the undertakings' investment decision. The key factor in deciding to invest should always be that the investment contributes to the best interest of policyholders and beneficiaries.

Prior to, and on a regular basis following the investment, it must be assessed whether the individual investment fits the undertaking's desired risk and return profiles, and whether the investment ensures the best possible return while taking into account the prospects held out to customers.

Figure 1: Example of a structured process for management of alternative investments

Phase 0 = **Pre- investment**	Phase 1a[8]: **'Initial assessment'**	Phase 1b: **Internal analysis**	Phase 1c: **Due diligence**	Phase 2: **Investment decision**	Phase 3: **Post-investment**
Before the investment opportunity is received/ sought out	First screening of the investment	In-depth internal analysis of the investment	Complete analysis of the investment	Overall investment assessment	Subsequent asset management
Internal management documents are prepared	Initial assessment of return vs. risk	Identification and measurement of risks	Further identification and measurement of risks	Decision made (to invest or not to invest)	I.e. continuous monitoring, control, management etc.
I.e. procedures, guidelines, processes etc.	Sources: the undertaking seeking capital	Sources: external (publicly available information)	Sources: advisors and experts	Sources: summary of all sources	Sources: external information + information from the undertaking

8) This phase (1a, 1b and 1c) includes investment analysis.

Source: The Danish FSA

A structured process helps break down the individual PPP criteria, enabling undertakings to ensure that each of these is met. The process should also help ensure adequate segregation of duties between the persons who take risks on behalf of the undertaking and the persons who must subsequently manage the risks. Thus, the Danish FSA expects undertakings to ensure that persons responsible for selecting an investment and making the investment decision will not also be subsequently responsible for the ongoing valuation and reporting. The segregation of duties must ensure that no conflicts of interest occur. It should be noted that the requirements for segregation of duties in the Executive Order apply regardless of the assets invested in.

Undertakings should be especially careful about the task performance and segregation of duties in connection with alternative investments, as the investment employee may have continuing tasks after the investment is made. One example could be regular follow-up on a portfolio manager in case of investment in alternative investment funds. In these cases, undertakings must be able to demonstrate clear delegation of responsibilities with respect to monitoring, valuation and reporting, showing, inter alia, that employees involved in risk-taking are not also responsible for valuation and reporting etc., but e.g. exclusively provide input explaining a calculated return.

The Danish FSA expects that, to the relevant extent, the undertaking's risk management function is an integral part of the assessment of risks, cf. Article 269(1)(d) and (e) of the Solvency II regulation and Annex 6, no. 12, of the Executive Order.

As a minimum (should not be considered exhaustive), the Danish FSA expects the risk management function to assess the investment prior to making investments that

- involve new, material and/or complex risks,
- deviate from previous investments,
- may potentially affect the risk profile of the respective portfolio,
- balance at the edge of the undertaking's investment strategy.

In such situations, the Danish FSA specifically expects the risk management function to make an independent assessment of the investment department's identified risks, and to assess whether there are any unidentified risks. The risk management function must ensure that the risk management system is able to manage the investment and to comply with the prudent person principle, including the PPP criteria and the requirements for the portfolio as a whole and its risk profile. The assessment is expected to form part of the overall decision-making basis providing the framework for the investment decision and to be included in the subsequent reporting when the investment has been made. In this way, the risk management function acts as a preventative and integral part of ensuring compliance with the prudent person principle, both before and after the investment is made.

4.3 The Prudent Person Principle criteria

As previously mentioned, an undertaking shall only invest in assets whose risk the undertaking concerned can *identify*, *measure*, *monitor*, *manage*, *control* and *report*.

This requirement applies regardless of whether alternative or traditional investments are involved.

As regards alternative investments, the requirement applies to the same extent, regardless of the investment structure employed by the undertaking. The specific processes are likely to differ, depending on whether the alternative investments are structured as:

– investments in funds
– co-investments
– direct investments in non-controlling interest shares
– direct investments in controlling interest shares (operational responsibility)
– direct loans and unlisted bonds
– securitisations
– direct real estate

Resource requirements and the approach to the prudent person principle for individual investments, e.g. in connection with due diligence and monitoring, will depend on the nature, scale and complexity of the risks inherent in the individual investment and the extent to which the risks are well known to the undertaking. For example, the approach to a fund may vary, depending on whether the fund is characterised by having few investors or otherwise resembles a direct investment, or whether the fund is an open fund with many investors.

Investment, e.g. through a fund, does not exempt the undertaking of its responsibility to ensure that the investment is in accordance with the prudent person principle. Therefore, the undertaking must assess whether the fund and its investments allow the undertaking to comply with the prudent person principle, including the PPP criteria, e.g. through an assessment of the fund's procedures for monitoring, management etc. If the fund is unable to comply with this, it will constitute a breach of the prudent person principle, and thus a violation of section 158 of the Financial Business Act.

The decision to invest in a fund based solely on historical results, team composition, strategy etc., without assessing the risks, the expected return and the undertaking's required return on the investment, will not be consistent with the prudent person principle.

Remarks for each of the PPP criteria will follow below. It should be kept in mind that the overall requirement under Section 158 of the Financial Business Act is for undertakings to invest their assets in such a way as to safeguard the interests of the policyholders and beneficiaries to the best of their abilities. This not only imposes requirements in relation to rates of return, but also to minimising the risk of losses. In the case of a conflict of interest, undertakings shall ensure that their investments are made in the best interest of policyholders and beneficiaries. Observance of Section 158 of the Financial Business Act is not simply a matter of complying with the PPP criteria, as those criteria are merely a subset of the obligations under Section 158, as described in section 2.

Example 3: Investment in a private equity fund

With a view to providing an investment commitment to a private equity fund, an undertaking conducts due diligence, risk analyses and assessments of the fund's business model, management team, strategy, history, contractual basis etc., as well as the return potential and risks associated with the investment strategy. In order for the undertaking to make the investment, it must find that the fund and its underlying investments will allow the undertaking to comply with the prudent person principle. The undertaking will then continuously have to monitor and reassess the investment as the fund makes the portfolio investments and the undertaking hereby gets more specific information on which to base its assessment.

The undertaking looks through to the fund investments in order to obtain sufficient information about the undertaking's exposure to e.g. currency risk, sector risk, country risk etc., just as the undertaking monitors the individual projects and whether these are executed in accordance with the fund's investment strategy and whether they can influence the risks, valuation and overall portfolio risk profile.

The undertaking is later offered a co-investment with the private equity fund and gains access to information about the co-investment and the strategic initiatives to be implemented during the private equity fund's ownership. The undertaking conducts its own due diligence and makes sure it gets the appropriate information about developments in the co-investment. On this basis, the undertaking assesses that, in this specific case, the co-investment meets the prudent person principle. The undertaking deems the co-investment to be a direct investment in nature, and manages the investment in the same way as direct investments – but taking into account that the information basis may be more limited than for the undertaking's own direct investments.

4.3.1 Identify

An undertaking may only invest if it can identify the risks associated with the investment.

Depending on what the undertaking invests in, it is possible to identify various risk factors. Some may be similar with respect to most investments, while others may be less frequent and associated with a specific type of investment. The latter will especially be the case for alternative investments.

Regardless of the type of investment involved, the Danish FSA expects undertakings to make a specific assessment of the proposed investment in order to identify the risks likely to be associated with the investment. These could be financial, legal, tax-related, technical, political and operational risks, as well as several other types of risks. The risks may be associated both specifically with the individual investment (i.e. at the micro level) and with external circumstances (i.e. at the macro level).

The identification of risks affects the investment decision, as the uncovering of risks is key to determining whether a given investment is attractive, as well as to the subsequent management of the investment. Typically, there will be an overlap between the factors that affect the valuation of a given investment and the most significant risks associated with the investment. Because of the characteristics associated with alternative investments, cf. section 3, the identification of risk and valuation will typically be more complex than for more traditional investments.

The identification of risks is not only relevant prior to an investment decision, but also to the extent that new risks subsequently emerge. The Danish FSA expects undertakings to seek to procure and take into account the relevant information through investment agreements, operator agreements, shareholder agreements etc., in order to assess the state and risks of the investment continuously and to follow up on these. For many alternative investments, it will be possible for undertakings to negotiate terms that undertakings should exploit to ensure e.g. sufficient transparency and scope for action over the lifetime of the investment.

It is the responsibility of undertakings to ensure that all relevant risks are identified. For alternative investments via funds, for example, this means that undertakings cannot simply rely on information about risks etc. received from the fund manager. Each undertaking will also have to verify whether the fund manager has conducted proper risk identification of the fund's (expected) risks.

For investments made together with other investors or operators, it will, for example, also be relevant to include the collaborative partners' situation in the identification of risks. The collaborative partners' financial situation and reputation, as well as any conflicting interests, may be of significance to the risks associated with a given investment for the undertaking.

4.3.2 Measure

An undertaking may only invest if it can measure the risks associated with the investment.

The measurement of risk is relevant to the decision to make an investment as well as, on an ongoing basis, after an investment decision has been made.

Measurement of risk is reflected in the required investment return, which is the return the undertaking deems it must achieve in order to assume the risk. As a rule, this is calculated by measuring the most significant identified risks specific to the investment, and translating these into risk premiums. The undertaking must include elements such as the asset's location in the capital structure, illiquidity, geographical risks etc. in the calculation of risk premiums. Specifically, the Danish FSA expects undertakings to be able to determine the investment's illiquidity premium, corresponding to the investment's lack of liquidity. The Danish FSA expects the quantification of individual risk premiums to be documented, and the required return to be included in the basis for the investment decision.

Alternative investments often involve an increased financial risk as result of a higher financial gearing ratio (for example, a high gearing ratio is often part of the business model for private equity funds). Therefore, the Danish FSA expects the specification of financial risk to be an integral part of the undertakings' calculation of required return.

Specifically, the Danish FSA expects undertakings to separate the calculation of financial risk from investment risk in order to assess the leveraged vs. unleveraged return/risk ratio of the investment and to be able to account for the specification of the required return with and without leverage.

In the subsequent risk measurement, it must be ensured that the basis for the measurement is correct, e.g. that the valuation takes place on an ongoing basis at fair value. The person responsible for the risk management function must be confident that the risk measurement takes place on a correct basis, e.g. that the valuation models reflect the risks identified for the investments, and that the valuation models can be used for risk management purposes.

4.3.3 Monitor

An undertaking may invest if it can monitor the risks associated with the investment.

This requirement means that undertakings must be able to monitor the development in the most significant identified risks associated with a given investment, thus continuously assessing the risk and value of the investment.

The monitoring is relevant to risks identified prior to an investment decision, as well as any unforeseen risks.

The monitoring of risks shall form the basis for the undertakings to continuously make informed decisions about the management of their investments. The Danish FSA expects undertakings to monitor on an ongoing basis and at a frequency sufficient to ensure that they can respond to both positive and negative developments in the investments.

If an investment develops negatively compared to what was assumed, the Danish FSA expects the undertaking concerned to intensify its monitoring of the investment. In case of a negative development, there may be a need for the undertaking to respond quickly to defend the value of the investment in order to safeguard the interests of the policyholders and beneficiaries to the best of its abilities.

When investing in alternative assets via funds, the undertaking must ensure that the fund remains within the mandate underlying the investment. Failing this, and should the fund move outside its mandate, it may result in the undertaking violating the prudent person principle. In order to ensure that the undertaking can continuously monitor the risks involved in the investment, undertakings must establish reporting requirements and the opportunity to gather information continuously to ensure that the undertaking is compliant with the prudent person principle.

4.3.4 Manage

An undertaking may only invest if it can manage the risks associated with the investment. In practical terms, this means that the undertaking will *actively consider and, as appropriate, respond* to developments in the risks associated with a given investment and the value of the investment itself.

The management of risks can be both a matter of ongoing adjustments to the investment (e.g. to realise a capital gain) and a matter of risk reduction (risk mitigation), including complete disposal of the investment. Whereas taking action is relatively uncomplicated in liquid listed securities that can be disposed of through the market, it will generally be more difficult with respect to alternative investments.

Therefore, before making the investment decision, the undertaking must consider its actual ability to manage the investment and the minimum courses of action required for the undertaking to be able to act in case the investment does not develop as expected, cf. the examples below. As an important element of that, undertakings must have adequate resources to carry out the identified actions. For example, this means that the individual undertaking is able to allocate employees to the management of a distressed investment without it affecting the quality of the undertaking's other investment activities.

Example 4: Actions that undertakings can take, depending on the individual investment and the agreements concluded

- Follow-up meeting with fund manager
- Investor advisory board processing
- Renegotiation of contracts
- Termination of collaboration with fund manager
- Influencing the board of directors
- Influence via an extraordinary general meeting
- Consider additional capital injection in the investment
- Test of covenants in loan agreements
- Take legal action (complaint case, market rent case, action for damages)
- Implement operational changes (in investments with controlling interest)
- Disposal or termination of the investment

With respect to the courses of action identified, the undertaking should assess the time aspect of the actions, the competencies and resources required to perform the actions and the associated costs.

The undertaking should also consider which events associated with each investment that could require action, and which of the identified actions that could be used. This will clarify when and how the investment organisation intends to manage the investment, and its actual ability to manage occurring incidents. The undertaking should consider how the investment might ultimately be realised as well as its options for an early exit. That way, the undertaking may react more quickly in the event of a situation arising. The undertaking's clarification of the various courses of action will also help give the undertaking an overall picture of the risks that should be taken into account when determining the required return.

4.3.5 Control

An undertaking may only invest if it is able to control the risks associated with the investment.

This requirement is relevant both when the undertaking needs to decide whether a given investment is to be made, and in relation to the process after an investment decision. The requirement should help the undertaking make investment decisions on the best possible basis and subsequently help the undertaking maintain an accurate picture of the risks and value of the investment.

The requirement for control means that the undertaking must control tasks performed in connection with the identification, measurement, monitoring, management and reporting of the investment. The undertaking must ensure that control processes are defined prior to the investment being made, and that sufficient resources are available in the organisation to perform the control on an ongoing basis.

Example 5: Controlling of performed tasks (not exhaustive)

- Has due diligence been conducted in accordance with the procedure?
- Has the valuation been performed in accordance with the procedure?
- Have the investment frameworks been respected?
- Are the reported data correct?
- Have deposits and withdrawals been made correctly, in a timely manner, and have they been accurately accounted for?
- Are the assets available?

The undertaking must also verify whether the assessments of underlying risks involved in the calculated valuation are correct, e.g. whether all relevant risks to an investment have been identified, cf. the risk management function's responsibilities described above.

Following an investment decision, the undertaking must regularly carry out controls at a frequency that ensures that the undertaking can respond to changes in the risk picture. The nature of the controls will depend on whether the investments in question are alternative or more traditional. If the control shows that the risk picture is not correct, the undertaking must assess whether there is a need to respond.

In relation to the valuation, the absence of active markets means that alternative investments are valuated based on inputs other than market-based inputs, i.e. inputs that may not be observable to the public (e.g. projected or budgeted data based on prior analyses). Therefore, alternative investments place greater demands on undertakings' internal systems and controls to ensure that the valuation is appropriate and reliable. This applies particularly to increased requirements for internal control processes. These control processes must ensure regular and independent reviews and control of the data input applied and the assumptions used in the valuation models, the results of the models and the model's suitability for valuation.

4.3.6 Reporting

An undertaking may only invest if it can report the risks associated with the investment.

The reporting requirement implies upward reporting in the organisation. The aim is to ensure that, at any time, the undertaking's management, particularly the board of directors, has an overview and understanding of the risks to which the undertaking is or considers to be exposed.

Using the internal management documents, the undertaking should ensure that clear reporting procedures are in place and that it has been decided what information is to be reported to management and at what frequency. In this regard, the Danish FSA expects the internal management documents to explicitly determine the need for reporting to management on e.g. alternative investments. The board of directors must decide what types of investments it wishes to be informed about on an ongoing basis. These may include e.g. complex investments, large investments, types of investments that are new to the undertaking, or investments made as result of a significant area of the undertaking's investment strategy.

The reporting must contain information associated with the undertaking's investments. Where appropriate, it should also contain information on specific investments. The reporting must enable management to decide on actions that become necessary as a result of development in the investments. In this context, the Danish FSA expects the reporting to include information on significant events that could affect the valuation of specific investments.

The purpose of the reporting requirement is the same, regardless of the nature of the undertaking's investments. Managements must have an overview and understanding of the risks associated with the investments and thus be able to assess whether the returns achieved match the risks involved. In practice, the characteristics of alternative investments, including the quantity, quality and validity of the information on the basis of which the investment is made, means that the requirements for the reporting of alternative investments are more extensive than for traditional investments.

The Danish FSA, 27 June 2018

C*arsten* B*rogaard*

/ Per Plougmand Bærtelsen

1) Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 (as amended) on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

2) Executive Order no. 1723 of 16 December 2015 on Management and Control of Insurance Companies etc., as amended by Executive Order no. 637 of 1 June 2017 and Executive Order no. 1169 of 31 October 2017.

3) Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

4) Executive Order no. 594 of 31 May 2017 on the valuation of assets and liabilities, including insurance provisions for group 1 insurance undertakings etc.

5) Defined as a market where transactions with the asset or liability occurs with sufficient frequency and to a sufficient extent to routinely provide pricing information. The definition comes from international accounting standards (IAS, IFRS 13) and has been implemented for insurance undertakings and multi-employer occupational pension funds in Annex 1, no. 0, in Executive Order no. 937 of 27 July 2015 on financial reporting for insurance undertakings and multi-employer occupational pension funds.

6) For this, see Executive Order no. 782 of 26 June 2013 on alternative investment funds in the EU area. Corresponding funds outside the EU area are also regarded as alternative investments. When in this guidance, reference is made to funds, in this context these are funds which have the characteristics described in section 3.

7) Boards of directors are strengthened by new requirements, cf. link: http://www.finanstilsynet.dk/da/Nyheder-og-Presse/Pressemeddelelser/Arkiv/Presse-2013/Bestyrelser-styrkes-efter-nye-krav