HYMANS ROBERTSON

Newsflash

The PRA has published its guidance on funded reinsurance, effective immediately

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The Prudential Regulation Authority (PRA) published its Dear CEO letter along with the finalised supervisory statement SS5/24 on 26 July 2024, setting its expectations for insurers that currently hold or are entering into funded reinsurance (FundedRe). In this newsflash, we discuss the PRA's letter and changes to the finalised guidance. The supervisory statement can be found here.

Overview

This newsflash follows on from the PRA's proposed expectations for life insurance firms in regards to FundedRe, which we discussed in a previous newsflash. The changes in the finalised supervisory statement mainly impact on areas of risk management and limits, as well as internal model considerations.

The PRA has been clear in its Dear CEO letter that there is some way to go for the industry to meet its expectations. The SS5/24 policy has been brought in with immediate effect, with an end-October 2024 deadline for Boards to report on their firm's compliance and set out remediation plans.

There have been some pragmatic amendments to the supervisory statement. These vary from having more potential to gain diversification benefit across arrangements to the removal of the requirement for the Board to approve recapture plans. At the same time the PRA has, however, continued to require a prudent approach to dealing with uncertainty.

Compared to the original proposals there may be some more potential to gain benefit from enhanced models and processes, but the regulatory bar to achieve this remains high.

Dear CEO letter

The letter demonstrates the PRA's continued focus on FundedRe. The key points are laid out below.

- The PRA is concerned about the potential for a rapid build-up of risks in the sector due to the possible underestimation of counterparty risks, that capital requirements are not appropriately captured for FundedRe arrangements, as well as the risks of recapturing assets in the event of counterparty default.

- The PRA does recognise that insurers have made positive steps towards addressing its concerns, including developing their risk management practices. However, it also notes that further improvements are still needed for insurers to ensure compliance with SS5/24.

- The PRA will continue to closely monitor FundedRe transactions, including volumes and characteristics of arrangements, quality of collateral, and the risk management frameworks and practices. In addition, one of the exploratory scenarios of the Life Insurance Stress Test in 2025 will feature a FundedRe recapture event.

- SS5/24 is effective immediately and the PRA has warned that failure to maintain compliance with its expectations could lead to regulatory actions such as restrictions on the amount and structure of FundedRe arrangements, or measures to address underestimations of risk.

Immediate action for insurers

For insurers that have entered or are considering entering into FundedRe transactions, the PRA expects boards to report by end-October 2024 on the following.

- A self-assessment of the insurer's risk management practices against the expectations in SS5/24.
- A summary of the FundedRe exposure limit.
- Level of confidence achieved on the internal model output, and how this is used to inform on FundedRe investment limits.
- Approach to setting risk appetite limits for size and complexity of FundedRe transactions, and a comparison against SS5/24.
- Remediation plan to address gaps between the insurer's current practices and expectations under SS5/24.

The PRA expects that the boards' assessment to be informed by an independent opinion of their Risk functions.

Key changes in final policy guidance

Whilst there have been no conceptual changes from the original proposal, there are a number of key amendments in SS5/24.

1. **Diversification**: The PRA has acknowledged the possible diversification benefits from FundedRe arrangements, for example due to differences in risk profile between the cedant and counterparty, and the regulatory guidance allows insurers to recognise these benefits. However, the PRA expects firms to be prudent when doing so and they highlight the potential for increased risks from FundedRe arrangements along with a heightened risk of uncertainty during a stress event.
2. **FundedRe Limits**: There are a number of clarifications to the approach insurers should take to setting limits, including:
    - For limits on recapture from a single counterparty, insurers should consider what would constitute a threat to their business model, in line with its risk appetite, risk management policies, risk tolerance limits and investment strategy alongside its overall business strategy.

- Single counterparty exposure limits should be set such that a single recapture would not threaten their ability to meet their solvency risk appetite or require “significant value destroying” management actions.
- Aggregate limits should be solvency based and consider the need for rebalancing and hedging activities, as well as the operational requirements, on recapture.

3. **Collateral Policy:** The PRA has clarified that the level of detail in the collateral policy should be proportionate to the size of exposures and can reference existing documentation or methodologies. The collateral policy should also detail investment management approaches on recapture under different circumstances, including how assets would be managed if they could not be easily sold.
4. **Recapture Plans:** The PRA has removed the requirement of Board approval for recapture plans. Whilst this is a pragmatic change, Board involvement will still be needed to approve the high-level principles underlying them.
5. **Internal Model / SCR**: The changes in SS5/24 include:
    - Requirements for insurers to document the level of confidence in their internal models’ capabilities for assessing counterparty risk that would allow effective support for management decisions relating to FundedRe. Where the level of confidence is not sufficiently high, insurers will need to put in place appropriate risk management and governance systems and policies to manage the increased uncertainty.
    - The PRA has provided an example approach for a validation process to explain the source of day one business gain.
    - Where insurers have approval to assume they can recapture collateral assets in their Matching Adjustment (MA) portfolio, the PRA has clarified that insurers should assume prudent rebalancing and trading costs, either through a reduced MA spread, or by allowing for these costs separately.
    - There are requirements to monitor ongoing compliance of the collateral assets against the insurer’s own MA approvals, with the guidance specifying that the regularity of monitoring should reflect the materiality and characteristics of the collateral assets.
6. **Collateral mismatch risk:** The PRA has removed wording that caused confusion as to the definition of “infrequent” margining. However, the PRA expects firms to justify the frequency of rebalancing when considering whether there is a risk that large shortfalls emerge at recapture and to take account of the potential size of those shortfalls in capital and limits.
7. **New contracts / structuring**: In relation to contractual mitigation, the PRA has clarified the circumstances under which it expects insurers to use clear risk based collateral haircuts or over collateralisation linked to the underlying risk.

What SS5/24 means for insurers

Whilst there are some practical changes, the finalised regulations may require insurers to further develop their risk management frameworks and processes in order to meet the PRA’s expectations. Internal model capabilities will also need to reflect the requirements to ensure appropriate assessment of FundedRe arrangements, and in particular to calculate a counterparty SCR at a granular level.

The key areas that insurers may need to focus on are:

- FundedRe limits: SS5/24 sets out a number of metrics that insurers will need to develop in order to set internal investment limits, including immediate recapture metrics and limits on recapture of single counterparties. These highlight the PRA's expectations of relatively sophisticated approaches to setting exposure limits for FundedRe.
- Clear Collateral Policies: Insurers should establish clear collateral policies as part of their risk management practices and these should be closely linked to the limit setting process. This will include requirements for insurers to detail their collateral's credit assessments, valuation treatment, SCR modelling and eligibility monitoring of such assets in the collateral pools.
- Robust Recapture Plans: SS5/24 requires insurers to have detailed recapture plans, including a comprehensive step-by-step assessment of future outcomes under stressed scenarios. Insurers may need to ensure that their stress and scenario testing capabilities can appropriately model FundedRe arrangements.
- Recaptured assets and liabilities: Insurers will need to assume that upon recapture, collateral assets will lie outside of their MA portfolio, unless it can be clearly demonstrated that the collateral assets would comply with MA approval conditions under both base and stress scenarios. For collateral assets that would be MA approved, insurers will need to consider the fundamental spread under stress of recaptured collateral assets.
- Quantitative risk assessment of contracts: Firms are expected to identify and measure the specific risks that might incur, such as basis risk and collateral mismatch risk, when negotiating FundedRe arrangements. This will likely add to the required processes during the contract negotiation phase.

How we can help

We continue to speak to a wide range of insurers across the UK and abroad about their priorities and the hot topics on their agendas. Our award-winning Insurance and Financial Services team can support you in a number of ways, including:

1. a gap assessment of current practices against the expectations under SS5/24, to aid in the Board's reporting to the PRA by 31 October 2024
2. supporting the development of calibrations, methodologies, and modelling for FundedRe SCR calculations as part of (partial) internal model
3. setting and devising risk frameworks and risk limits for the required FundedRe internal investment limits
4. supporting the development and assessment of recapture plans, working through the various requirements of the assessment in stress scenario and estimating trading activity and costs
5. undertake an independent assessment of your FundedRe risk management practices.

If you would like to discuss the content of this newsflash further or any aspects of FundedRe or SS5/24, please get in touch with one of the authors or your usual Hymans Robertson contact.

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