Newsflash

The PRA publishes their expectations of insurers using funded reinsurance

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On 16 November 2023, the PRA published Consultation Paper 24/23 including a draft Supervisory Statement on their proposed expectations for life insurance firms entering into or holding funded reinsurance arrangements.

Overview

The Prudential Regulation Authority (PRA) has published a Consultation Paper (CP), supplemented by a draft Supervisory Statement (SS), to address their concerns on the management of risks arising from funded reinsurance arrangements within the UK life insurance market. Funded reinsurance is a form of collateralised quota share reinsurance contract which transfers part or all of the asset and liability risks associated with a portfolio of annuities to a third party. This follows a thematic review and 'Dear CRO' letter on related matters earlier this year.

The PRA has observed a growth in appetite for the use of funded reinsurance arrangements, which are being used to support the writing of bulk purchase annuity (BPA) business in the UK market. It appears that the PRA are of the view that UK cedants who are increasing their exposure to counterparties are not adequately recognising the inherent uncertainties and risks involved in these transactions. The PRA also seem to be particularly concerned with the risk of excessive concentrated exposures to a small number of potentially correlated, credit-focused counterparties, and so have set out their expectations and proposals to address their concerns.

The CP/SS set out three overarching areas of focus:

1. **Ongoing risk management** – Detailed requirements for firms to have in place for current funded reinsurance arrangements, including approved investment limits and detailed collateral policies;
2. **Internal Model/SCR** – Specific and bespoke requirements for the Solvency Capital Requirement (SCR) that firms will need to consider for funded reinsurance; and
3. **New contracts and structuring** – More clearly defined requirements and minimum practices for entering into and structuring new funded reinsurance arrangements, including a prescribed quantitative assessment framework when negotiating new contracts.

Responses to the consultation paper must be submitted by **16 February 2024** with the new suite of proposed requirements to come into force during **Q2 2024**.

Summary of key changes

We expect the industry to be able to demonstrate that they are meeting some of the expectations set out, but we also expect firms to have to undertake additional activities to meet the PRA's requirements should the SS come into force as drafted.

We summarise some of the PRA's key requirements below:

1. Ongoing risk management:

- **Internal investment limits** – firms should have internally approved investment limits for funded reinsurance and ensure that exposure is limited to a level that does not threaten its ongoing business model viability in the event of recapture.
- **New 'immediate recapture' metric** – this has been introduced so that firms measure the impact of immediate recapture on their SCR ratio, whether that event is likely or not, and regardless of any management actions they may have. This metric can then be used to inform the setting of internal investment limits.
- **Counterparty considerations** – internal investment limits also need to consider the idiosyncratic risk of any one counterparty, as well as concentration and correlated risks of counterparties.
- **Clear collateral policies** – these are to be established, with new detailed requirements for the use of illiquids in collateral pools, and analysis on recapture of collateral should be undertaken to demonstrate Matching Adjustment (MA) compliance.
- **Recapture plan** – the Board approved recapture plan must contain content specified by the PRA, at a minimum, to demonstrate that a firm's business model can survive any single recapture event and multiple recaptures from correlated counterparties, by making robust forecasts of stressed scenarios and costs.

2. Internal Model(s)/SCR:

- **SCR assessment** – a specific assessment is required, and should capture all the material and quantifiable risks of funded reinsurance.
- **Counterparty credit risk in internal models** – the PRA's requirements set out a detailed assessment of the probability of default (PD) and loss given default (LGD) for funded reinsurance counterparties and contracts. Firms should now assess counterparties' PD and consider termination clauses for their PD calculation, and there are also new assumptions they should incorporate in their assessment of their LGD.
- **Collateral as risk mitigation** – there are additional expectations around the usual assumption of collateral as a risk mitigation tool which includes: look through, collateral mismatch risk, and re-collateralisation.
- **Recaptured assets and liabilities** – firms should assume these land outside the Matching Adjustments Portfolio (MAP), unless they can fully demonstrate that a recapture event will not result in non-compliance with the MA conditions under both base and stressed conditions.

3. New contracts and structuring:

- **New quantitative risk assessment of contracts** – the PRA has presented a four-step framework that they suggest firms carry out as part of negotiating and assessing the risks on proposed new funded reinsurance arrangements. Firms may also use a different approach as long as it covers the areas of the framework.
- **An approved internal contractual risk appetite statement** – firms are now required to state their risk appetite to clarify what their maximum acceptable loss at the individual funded reinsurance contract level is.
- **Time horizon** – the quantitative risk assessment mentioned above is expected to be performed for the full life of the contract, and at any potential contact termination ahead of contract maturity.
- **Internally approved minimum contractual terms** – these terms need to be put in place and be used when assessing the structuring and terms of a new funded reinsurance arrangement. The rationale behind firms' decisions needs to be documented for the minimum standards set.

Our key reflections

Based on our initial assessment, the papers present a detailed set of requirements for firms to implement, and could result in a more onerous evaluation of funded reinsurance on an insurers' regulatory balance sheet as a risk transfer technique.

It appears the PRA are concerned that the competitive pressures of the UK BPA drive a build-up of systemic risk exposures through the use of funded reinsurance and counterparties whose risks may be correlated with wider market credit risks.

The requirements are proposed to come into force during Q2 2024, and will provide further challenges for the industry to implement, especially because the ongoing proposals for the MA under Solvency UK reforms will need to be considered in parallel.

Below we discuss **five proposals** that particularly stood out to us, and we reflect that these may trigger new requirements for firms or could result in a more challenging assessment of funded reinsurance.

In depth analysis

I. New 'immediate recapture' metric

PRA's proposal: Adoption of an 'immediate recapture' metric to assist the setting of internal investment limits. The metric is to measure the impact on the SCR ratio in the hypothetical scenario where all ceded business with a counterparty is immediately recaptured, regardless of how likely recapture may be, and before any management actions are taken into account. The PRA believes that the usually reliable method of using market values to measure exposures and set limits is unsuitable for funded reinsurance, as UK cedants would experience an increase in capital requirements associated with the recaptured business.

Our view: This new metric should help firms with existing funded reinsurance to understand the potential impacts of the reinsurance on their balance sheet. Firms are not required to use this measure for other purposes however, such as in their recapture plan or collateral policy, so should not be too onerous a request.

II. Clear collateral policies

PRA's proposal: Firms should establish clear collateral policies as part of their risk management practices and these should be closely linked to the limit setting process. This is intended, and is expected, to allow firms to formulate an executable recapture plan under stressed conditions; and thus enable firms to have a reliable estimate of the impact of recapture given the value of, and quality of asset-liability matching of, recaptured collateral. The PRA also expects a detailed collateral policy for illiquid assets in collateral pools, and outline five minimum requirements such as firms' investment management approach on recapture.

Our view: The requirements around the use of illiquids in collateral pools seem to be a reasonable ask given the nature of the risks involved, although the implementation may be an arduous process as firms will need to detail their collateral's credit assessments, valuation treatment, SCR modelling and eligibility monitoring of such assets in the collateral pools.

III. Recapture plan

PRA's proposal: Firms should formulate and document a Board approved recapture plan for their funded reinsurance arrangements. This will need to include robust forecasts of the actions and costs under stressed conditions, and assess the ability to execute them using the financial resources that will be available.

Our view: The PRA has now specified detailed requirements of what needs to be included in such plans. These plans now require a lot of detail, including a comprehensive step-by-step assessment of future outcomes in stressed scenarios. Whilst firms have been developing recapture plans, plans will need to be reassessed against the requirements set out and ensure these have been approved by the Board.

IV. Recaptured assets and liabilities

PRA's proposal: Internal Model (IM) and partial IM firms should now assume that recaptured assets and liabilities lie outside of the MAP, unless it can be clearly demonstrated that a recapture event will not result in non-compliance of MA conditions in both base and stress conditions. Firms should also consider the stressed fundamental spread (FS) of the received collateral on recapture.

Our view: This appears to be a material lens for firms to assess the use of funded reinsurance through, and a high bar being set for firms to justify their assumptions and rationale for including the recapture business into the MAP. The requirements are also likely to result in more analysis required, such as stressed FS of collateral.

V. New quantitative risk assessment of contracts

PRA's proposal: Firms are expected to identify and measure the specific risks they might incur when negotiating the funded reinsurance arrangements. The PRA believes a comprehensive risk identification process should allow firms to implement adequate safeguards and suggest a four-step framework, detailed below, that may be helpful when carrying this out. Firms may use a different approach as long as it covers the areas of the framework.

Step 1: Identify all forms of basis risk and collateral mismatch risk that exist within the arrangement (reinsurance contract and collateral agreements).

Step 2: Stress the risk factors that would lead to basis risk and collateral mismatch risk identified at the appropriate magnitude and over the appropriate time horizon.

Step 3: Based on the outcome of the quantitative risk assessment, determine whether the new arrangement falls within the firm's approved internal contractual risk appetite.

Step 4: Where the result is outside of the firm's risk appetite, firms should consider all potential options, including reflecting this by seeking improved contractual protections in the reinsurance contract and collateral agreements.

Our view: This is likely to be a new activity for firms to undertake detailed quantitative assessment during the contract negotiations phased.

How Hymans Robertson can help

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 proposed regulatory requirements and any action plans required.
2. Supporting the development of calibrations, methodologies, and modelling for funded reinsurance SCR calculations as part of (partial) internal models.
3. Setting and devising risk frameworks and risk limits for the required funded reinsurance 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 funded reinsurance risk management practices.

If you would like to discuss any of these points further, please get in touch with your usual Hymans Robertson contact or any of the authors of this Newsflash.

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