

FUNDED REINSURANCE - PRA CONSULTATION

On 16 November the PRA published a [consultation \(CP24/23\)](#) on a new supervisory statement setting out the PRA's expectations in respect of life insurance firms entering into or holding funded reinsurance arrangements as cedants.

Key points

- No new rules are being introduced but a new supervisory statement is proposed, clarifying how the PRA expects firms using funded reinsurance to ensure compliance with existing standards
- Key points in the draft guidance include:
 - proposed (firm specific) limits on exposures to single or highly correlated counterparties
 - requirements for collateral policies and recapture plans in respect of funded reinsurance
 - guidance on how firms should assess both the probability of default and loss given default for the purposes of calculating the SCR
 - restrictions on the extent to which firms can assume that assets will be recaptured within the MA portfolio when calculating the SCR
 - guidance on how firms should assess the overall risks associated with entering into a funded reinsurance arrangement for the purposes of the prudent person principle.

What is funded reinsurance?

Funded reinsurance is the transfer of both asset/investment risk and longevity risk to a reinsurer. Typically, a large upfront premium representing the assets supporting the underlying liabilities is transferred to the reinsurer and collateral is put in place to secure the reinsurer's obligations to the cedant. The transfer of these assets means that the cedant has a large counterparty risk exposure to the reinsurer, which is only partly mitigated by the posting of collateral.

Background to the consultation

The use of funded reinsurance has been an area of regulatory interest to the PRA for some time. It carried out a thematic review of these arrangements in 2022-3 which resulted in a [Dear CRO letter](#), published in June 2023. In that letter the PRA commented that it saw "*significant potential risks to the PRA's objectives from the systematic use of FundedRe to meet the increase demand for bulk transfer of defined benefit pension liabilities*" and was considering whether it should develop specific policy proposals to address the topic.

In this consultation, the PRA comments that, in its view:

"UK insurers use funded reinsurance to support an acceleration of the existing demand for BPA, without materially changing the overall volume of possible BPA in a large but finite market largely in run-off".

The implication is that, without the increased reliance on cross-border funded reinsurance, which is supporting record volumes and deal sizes in the bulk purchase annuity market, the increased demand for BPA arrangements would remain but would be satisfied over a longer time horizon. A more gradual approach may be preferable to the PRA from a risk management perspective. By contrast, the PRA suggests that the current competitive nature of the BPA market, associated with the use of funded reinsurance, raises the risk of dilution of management standards and protection against counterparty exposure - for example through inappropriate collateral and/or excessively concentrated exposure to credit-focussed counterparties. Asset quality is a particular area of concern, including the use of alternative asset allocation/illiquid investments by some newer counterparties.

The consultation proposals are intended to clarify the PRA's expectations in respect of risk management and structuring of arrangements, to reduce the risk to the market which it perceives from these developments.

The proposals

The new supervisory statement is aimed at mitigating risks arising from funded reinsurance arrangements, in particular in circumstances where there is a recapture of transferred assets and liabilities. A number of new expectations are introduced in the supervisory statement to achieve this.

Risk management

Counterparty internal investment limits

The PRA expects firms to develop internal investment limits for funded reinsurance both in respect of any single counterparty and multiple highly correlated counterparties. This should be based on an "immediate recapture" metric, which measures the impact on the firm's SCR of an immediate recapture of all business ceded to the counterparty or counterparties. In calculating the metric firms should:

- consider the nature of the collateral they may inherit on a recapture, including the risk that they recapture a "worst-case" collateral portfolio
- assume a reduced MA spread where recapture within the MA portfolio is assumed, to take into account prudent rebalancing and trading costs (see further comments on recapture into the MA portfolio under "The SCR")
- consider broader factors beyond the current credit rating of counterparties, including operational capabilities and the firm's own diversified asset strategy.

Limits should be set so that a singular recapture from one counterparty does not threaten the firm's business model. The PRA comments that, where a firm's business model is reliant to a material extent on funded reinsurance with one counterparty, this could present "particular challenges" with regards to compliance with the prudent person principle.

Collateral policy

The PRA expects firms to have clear collateral policies in place which will enable firms to formulate an executable recapture plan under stressed conditions. Collateral policies will be expected to include detailed policies with regard to illiquid assets in collateral pools (including on approaches to credit assessments, valuation methodologies, MA eligibility monitoring, SCR modelling, and investment management on recapture) and robust testing of assets intended to meet MA eligibility criteria on recapture.

Recapture plans

Recapture plans should be approved by the Board and should include, among other things, provision for monitoring the financial position of the counterparty, a step-by-step process for achieving the recapture, and actions required to ensure MA compliance following a recapture. Firms should also have in place a clear

decision-making process for scenarios where optional contractual termination rights are triggered (e.g. a drop in solvency ratio).

The SCR

The proposed guidance includes the PRA's expectations for firms' assessments of the material and quantifiable risks associated with funded reinsurance arrangements, which will feed into the SCR calculation when taking the arrangements into account as a risk-mitigation technique. The detailed guidance applies to firms using internal or partial internal models but the PRA also reminds firms using the standard formula of the requirement to assess via their ORSA the appropriateness of the standard formula for the risks to which they are exposed. Where the standard formula is inappropriate firms may need to develop a partial internal model.

The guidance covers:

- assessment of the probability of default
- assessment of the loss given default
- calculation of the risk-mitigating impact of collateral
- recapture within the MA portfolio.

On the last point, the PRA comments that the starting point should be an assumption that assets and liabilities ceded under a funded reinsurance arrangement should be recaptured outside of the MA portfolio. This is because there are uncertainties around whether collateralised assets will meet MA requirements at the time of recapture. Firms can over-ride this assumption if suitable analysis is carried out to demonstrate that including the recaptured assets in the MA portfolio would not cause MA non-compliance. Where this is the case the SCR calculation should take into account any rebalancing necessary to achieve MA compliance.

Entering into and structuring of funded reinsurance arrangements

The PRA emphasizes that firms must consider all of the risks associated with a funded reinsurance arrangement, for the purposes of complying with the prudent person principle. It proposes a four step framework to identify and measure specific risks:

Step 1 - identify basis risk and collateral mismatch risk

Step 2 - stress the risk factors leading to basis risk and collateral mismatch risk

Step 3 - determine whether the arrangements fall within the firm's approved internal contractual risk appetite

Step 4 - if the arrangements fall outside the risk appetite, consider seeking improved contractual protections.

The PRA expects firms to have (i) an approved internal contractual risk appetite statement setting out the maximum acceptable loss at the individual funded reinsurance contract level; and (ii) internally approved minimum guidelines on contractual features for funded reinsurance transactions.

Comment

The PRA observes that much of the proposed new guidance reflects its existing regulatory expectations and/or risk management structures already being put in place by firms. The proposals do, nevertheless, introduce an additional layer of regulatory expectation for firms entering into funded reinsurance transactions. Firms will need to be able to demonstrate compliance with the additional expectations which will require the introduction of additional processes and documentation.

Careful consideration of risk management and prudent person principle requirements in respect of counterparty concentration risk and collateral arrangements will be particularly important. Firms may also need to make adjustments to the SCR benefit associated with their funded reinsurance arrangements as a result of the new guidance, particularly where they currently assume a recapture of assets into the MA portfolio.

For firms using the matching adjustment, the additional requirements around analysis of the MA compliance of recaptured assets will be in addition to the new requirements for an MA attestation discussed in our recent [briefing](#) on the PRA's consultation on the MA in the context of Solvency II reforms.

Next steps

Firms who wish to provide feedback on the consultation should note that the consultation period closes on Friday 16 February 2024. The PRA plans to implement the new supervisory statement during Q2 2024.

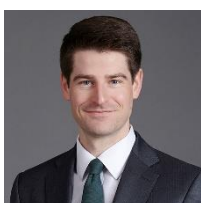
CONTACT



JONATHAN MARKS
PARTNER
T: 020 7090 3056
E: jonathan.marks@slaughterandmay.com



BETH DOBSON
PSL COUNSEL
T: 020 7090 3070
E: beth.dobson@slaughterandmay.com



THOMAS PEACOCK
SENIOR COUNSEL
T: 020 7090 4256
E: thomas.peacock@slaughterandmay.com



JAMES COSTI
SENIOR COUNSEL
T: 020 7090 5375
E: james.costi@slaughterandmay.com

London

T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels

T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong

T +852 2521 0551
F +852 2845 2125

Beijing

T +86 10 5965 0600
F +86 10 5965 0650

Published to provide general information and not as legal advice. © Slaughter and May, 2023.
For further information, please speak to your usual Slaughter and May contact.

www.slaughterandmay.com