Financial Services Regulatory Insights

PRA identifies shortcomings with funded reinsurance arrangements

AT A GLANCE

June 2023

What's new?

- The PRA issued a letter to the Chief Risk Officers of life insurers on 15 June 2023, sharing feedback on its review into funded reinsurance (FundedRe) arrangements. The PRA has previously urged insurers in the bulk purchase annuity (BPA) market to exercise caution, noting their increased reliance on FundedRe to support BPA business. The PRA therefore states it carried out its review to enhance its understanding of counterparty risks arising from FundedRe.
- FundedRe is the transfer of asset and longevity risk to a reinsurer. This means all the material risks of a BPA transaction are transferred to a reinsurer. The PRA's review focuses on the structuring of FundedRe transactions, corresponding risk management frameworks, and how the transactions are reflected in capital requirements. The PRA finds several shortcomings in these areas when assessed against its existing policies and expectations.

What does this mean?

- The PRA found that the key rationale for the use of FundedRe arrangements by life insurers include capital deployment restrictions, asset origination capabilities limits, and market presence growth.
- The PRA states it is concerned about UK life insurers underestimating counterparty risks in their use of FundedRe arrangements. This is with the backdrop of an increasingly competitive BPA market, where demand is expected to sharply increase due to improvements in funding ratios driven by the rise in interest rates. The PRA considers that counterparty risk needs to be considered in the context of changing business models and rapid structural shifts in the global life insurance market. For example, many insurers are discontinuing underwriting long term products such as annuity plans, and private equity firms are more involved in the market.
- The PRA identifies four key risks with FundedRe arrangements: **1)** probability of recapture (PR) given historical evidence of default risk might not efficiently address recapture risk, **2)** correlated PR increases the likelihood that credit cycle shocks affect multiple reinsurers simultaneously, **3)** loss given recapture as a credit cycle shock is likely to cause the deterioration of the reinsurer at the same time as the collateral portfolio, and **4)** certain management actions may be ineffective on recapture.
- The PRA finds that structural features of FundedRe transactions create the risk that firms recapture / retrieve sub-optimal portfolios with unmatched or inadequate assets, and with limited ability to be transformed effectively to firms' preferred portfolio.
- On capital requirements, the PRA looked at the impact on the sufficiency of some firms' financial resources upon recapture. The PRA finds that insurers had made

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improvements to their risk frameworks and internal models, however these need to be more closely connected to the terms of the FundedRe contracts. The PRA also finds that there is over-reliance on management actions under times of stress which may not be viable in all market conditions.

- The PRA also flags risks associated with asset-liability duration mismatch. The PRA finds that there were large permissible duration mismatches between the assets in the collateral pool and the liabilities ceded, and that a more sophisticated matching requirement was absent. On recapture, such absences can create risk that portfolios are insufficiently matched leading to complex rebalancing actions in stressed markets.
- When considering the risk management approaches that firms adopted, the PRA looked at how firms set counterparty risk limits. The PRA finds a range of different practices and states dynamic limits need to be considered to prevent any issues in times of market stress.

What do firms need to do?

- Firms should review the PRA's findings, and carry out a gap analysis against their own FundedRe arrangements.
- Following the gap analysis, firms may want to develop metrics to assist them in their monitoring and oversight of the completion of any remedial steps identified.

Firms should ensure their discussions and decisions follow appropriate governance processes and are effectively recorded, so that they are able to stand up to PRA scrutiny.

- Firms should ensure that they have robust processes and procedures in place when entering into FundedRe arrangements, for example, careful consideration should be given to whether the arrangements are within the insurer's established risk appetites. Thorough risk assessments should be completed of new and existing transactions, and any risks should be captured in firms' risk registers to ensure ongoing monitoring of the risks. Firms should include an assessment of the risks arising from their FundedRe arrangements in their ORSAs.
- Firms may want to pay particular focus to their collateral risk management and capital modelling approaches (especially where the reinsurer chosen for the FundedRe arrangement is domiciled outside the UK), given the PRA has identified these areas for targeted supervisory work.
- Firms should ensure they continue to comply with the PRA's supervisory statement (SS) SS1/20 – Solvency II: Prudent Person Principle and SS20/26 – Solvency II: reinsurance counterparty credit risk when executing FundedRe arrangements.
- The PRA requires insurers to inform their PRA supervisors promptly of any material FundedRe transactions entered into from 15 June 2023.

Next steps

The PRA is considering the need to develop and consult on further policy, beyond existing expectations. To inform its thinking on policy development the PRA states it will pay due regard to expert knowledge and views from the industry, and so firms may want to proactively engage with the PRA to help shape any future policy.

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