

PRA sets expectations for firms' funded reinsurance arrangements

HOT TOPIC

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Highlights

The PRA's new expectations on funded reinsurance arrangements come into effect immediately, and require impacted life insurers to perform a gap analysis against the new expectations to identify shortcomings and remedial actions, to report to the PRA by 31 October 2024.

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Summary

The PRA published its final policy on Funded Reinsurance (FundedRe) on 26 July 2024. FundedRe is a collateralised quota share reinsurance contract which transfers to a counterparty part or all of an insurer's asset and liability risks linked to a portfolio of annuities.

Policy Statement 13/24 ([PS13/24](#)) provides feedback on the PRA's earlier consultation [CP24/23](#) (see our [At a glance](#)); the final text of policy expectations is set out in Supervisory Statement 5/24 ([SS5/24](#)). Alongside PS13/24 and SS5/24, the PRA issued a [letter](#) to the CEOs of life insurers. The letter details the PRA's implementation approach for SS5/24, and the approach for the self-assessment against SS5/24 that it expects insurers to perform.

The PRA's expectations in SS5/24 come into effect immediately, from 26 July 2024, and apply to UK Solvency II life insurers and insurers that have a UK branch that are considering or already holding FundedRe arrangements as cedants. The PRA is concerned that the current growth in FundedRe transactions by UK life insurers, if not adequately controlled, could lead to a rapid increase of risks in the sector. The risks could emanate through underestimation of the counterparty risks on UK insurers' balance sheets, the capital requirements appropriate for these risks, or the risks from recapture of assets onto cedants' balance sheets when a FundedRe counterparty defaults.

Background

The PRA accepts that FundedRe arrangements can assist firms in achieving a diversified asset strategy. However, it considers FundedRe can present undue risks where its use becomes systemic and integral to a firm's business model. The PRA's expectations as set out in SS5/24 aim to mitigate against the risks arising from these arrangements.

SS5/24 follows the PRA's April 2023 [speech](#) where it urged insurers in the bulk purchase annuity (BPA) market to exercise caution, noting their increased reliance on FundedRe to support BPA business. Additionally, in June 2023 the PRA shared findings of its thematic review into FundedRe, which it carried out to enhance its understanding of the counterparty risks arising from FundedRe (see our [At a glance](#)). The PRA's review focused on the structuring of FundedRe transactions, corresponding risk management frameworks, and how the transactions are reflected in capital requirements. The PRA found several shortcomings in these areas, which led to the PRA consulting on new expectations in CP24/23.

SS5/24 builds on existing requirements in relation to firms' reinsurance arrangements, and therefore should be read in conjunction with other relevant PRA rules and Supervisory Statements, such as the [Solvency Capital Requirement \(SCR\) - General Provisions](#) part of the PRA Rulebook.

PRA expectations in SS5/24 are anchored on the Prudent Person Principle (PPP), and are set out in three parts.

- The first part concerns the PRA's expectations for the ongoing risk management of existing FundedRe contracts.
- The second part sets out the PRA's expectations on the calculation of the SCR for FundedRe arrangements.
- The third part considers the PRA's expectations on a firm's decision making process when entering into and structuring new FundedRe arrangements.

Responses to CP24/23

The PRA found that generally respondents welcomed the PRA's proposals in CP24/23. However some made requests for further clarifications, and in light of these responses the PRA made some adjustments to the draft policy in CP24/23, now final in SS5/24.

The most significant changes include:

- Clarification that firms can consider diversification between FundedRe counterparties and linked risks.
- Clarifications relating to how firms will be expected to set internal investment limits.
- Clarifications on how the underlying nature of collateral assets should be considered and how to document these policies.
- Adjustments to expectations on board involvement with recapture plans.
- Clarifications on how firms would be expected to manage uncertainty in internal model (IM) outputs for FundedRe arrangements.
- Clarifications on how the PRA considers the time horizon regarding collateral mismatch risk.
- Changes to expectations on how firms use collateral haircuts.

Ongoing risk management

The PRA expects firms' risk management processes to consider the whole tail risk to which they are exposed. This is because the loss distribution for FundedRe is typically characterised by losses that although are rare, are severe in nature.

A firm's analysis of risks from FundedRe arrangements should be sufficiently detailed so that the actuarial function can provide an informed opinion on the adequacy of the firm's reinsurance arrangements. The analysis should depict with a high level of confidence that the firm can withstand either a single recapture event or multiple recapture events with highly correlated counterparties.

A firm's investment risk management policy should include FundedRe internal investment limits. As a minimum, a firm should calculate an immediate recapture metric, which should measure the impact on a firm's SCR coverage ratio of an immediate recapture of all business ceded to a counterparty, without considering the likelihood of such an event or management actions.

Internal investment limits should be set in a way so that the firm's business model is not threatened when a singular idiosyncratic event of a recapture of business from one counterparty occurs. The PRA considers that the firm's risk appetite, risk management policies, risk tolerance limits and investment strategy together with its overall business strategy should dictate what amounts to a threat to the firm's business model. The PRA expects firms to consider broader factors when setting internal investment limits beyond the current external credit rating of the counterparties.

The PRA considers where an insurer's business model is materially reliant on FundedRe with one counterparty, this could present challenges with regards to compliance with the PPP. Firms should have additional limits which consider concentration risks, in particular based on the simultaneous recapture from multiple highly correlated counterparties.

The PRA expects firms to have collateral policies integrated into their risk management policies, and these should enable firms to execute a recapture plan under stressed conditions. In particular, the PRA expects a detailed collateral policy for illiquid assets held in collateral pools backing FundedRe. Collateral policies at a minimum must include: details on approaches to credit assessments; valuation methodologies by asset class; matching adjustment (MA) eligibility monitoring; SCR modelling; and investment management approaches on recapture under different circumstances, including consideration of how assets may be managed long term if they cannot be easily sold.

A recapture plan should at a minimum cover: the monitoring approach for the financial health of the counterparty, and activities performed if a deterioration occurs; a detailed process for the recapture of all the assets and liabilities from relevant counterparties; a detailed process for asset transfers by asset class; actions to ensure MA compliance where MA portfolio recapture is assumed; and uncertainty in the recapture process.

The PRA expects the high level principles underlying the recapture plan, including a statement on the uncertainties inherent to the recapture process, to be approved by the board. Furthermore, board involvement should be proportional to the level of risk being taken. The board should also approve potential management actions when there is a reinsurance recapture. Additionally, firms should analyse their FundedRe exposures at least annually, and where exposures are material, firms should carry out stress testing which should feed into their Own Risk and Solvency Assessment (ORSA). The stress tests should be informed by firms' recapture plans, and will be relevant to setting FundedRe internal investment limits.

SCR

The PRA expects firms calculating their SCR using an IM to perform robust modelling taking into account FundedRe risks, and to recognise the importance of the output of the IM to decide whether to enter into FundedRe as a risk mitigation technique.

Firms should document their confidence levels on the extent to which their IM for counterparty risk is working effectively to support relevant FundedRe management decisions. Where a firm does not have a high level of confidence, firms should reflect this uncertainty in tighter limits to FundedRe arrangements.

The PRA sets out its expectations for probability of default (PD) for firms' FundedRe arrangements. This includes: clear articulation of data choice; calculation of a PD under stress conditions; the firm's position where contractual triggers are breached (including consideration of any beneficial nature of these clauses); understanding changes to the solvency ratio of a firm's counterparties under market stresses; further clarity on validation processes to explain day one new business gain by entering into a FundedRe arrangement; consideration of forward looking risks in relation to the deterioration of the counterparty; and consideration of whether any private information obtained during the counterparty approval process would assist in informing the PD.

With respect to loss given default or downgrade, the PRA expects firms to stress the cash flows of the insurance obligations reinsured using the same approaches used in the relevant modules of the IM. Firms should also consider the impact of deterioration in the credit quality of counterparties. Additionally, firms should consider the impact on the risk margin of the recapture of risks, and only take management actions into account in a firm's IM where the requirements in PRA rules ([SCR - Internal Models 11.8\(3\)](#)) are satisfied.

The PRA further sets out its expectations for the calculation of the risk mitigating impact of collateral on the firms' SCR calculations. This includes stressing collateral portfolios on a look through basis, considering collateral mismatch risk and setting the prudent recovery rates to capture the risk that the collateral may not be replenished.

The PRA expects firms to assume that assets and liabilities associated with FundedRe contracts be recaptured outside of an MA portfolio, unless firms can clearly demonstrate that such an inclusion would not cause non-compliance with the MA, taking into account management actions that can reasonably be expected to be performed in the future. Where a firm demonstrates MA compliance on recapture in its MA portfolio, the SCR calculation should consider risks including the stressed fundamental spread applicable to the collateral

portfolio, and the cost of replacing MA ineligible assets with alternative MA eligible assets, amongst other things. The PRA expects firms to take into account prudent rebalancing and trading costs either through a reduced assumed MA or by allowing for these costs separately.

Entering into and structuring of FundedRe

The PRA expects insurers to continue to comply with the PPP when considering whether to enter and how to structure FundedRe arrangements. This means firms should only invest in assets where they can identify, measure, monitor, manage, control and report risks and take them into account in the ORSA.

The PRA expects firms to undertake a quantitative assessment to inform their internal investment limit framework as part of the investment risk strategy. The PRA suggests a four-step framework for this assessment, which involves an approved internal contractual risk appetite statement setting out the maximum acceptable loss at the individual FundedRe contract level.

Additionally, the PRA expects firm to maintain internally approved minimum guidelines on contractual features for FundedRe transactions, which should include: the approaches to termination clauses; substitution rights for collateral assets; valuation approaches; concentration limits; and choice of applicable law. The PRA also expects firms to use clear risk based collateral haircuts or over collateralisation linked to the risk being addressed. The PRA expects that asset specific risk based haircuts (rather than general over collateralisation) will be used where the risks relate to the specific assets in the collateral pool.

Implementation and firm self-assessment

Alongside PS13/24 and SS5/24, the PRA issued a letter to the CEOs of life insurers. The letter aims to draw attention to the PRA's final policy, to share details of the PRA's implementation approach, and outline the required self-assessment approach against SS5/24.

The PRA confirms it will closely monitor the volume of FundedRe transactions, including any change in the quality of the collateral and the nature of FundedRe counterparties in the market. Further, the PRA has already confirmed its [2025 life insurance stress test](#) will include a FundedRe recapture event. The results of this stress test will further develop the PRA's views on this market.

The PRA expects the boards of UK life insurers to consider alignment with SS5/24 as soon as practicable. In any event, firm boards should provide the results of their self assessment analysis to the PRA by 31 October 2024. By this date, firms should provide to their PRA supervisor:

- The self-assessment, which should consider the firm's existing risk management practices against expectations in SS5/24.
- A summary table of board approved FundedRe limits for individual counterparties, for correlated counterparties and the firm's aggregate limit.
- A summary of remediation activities, with a timeline showing activities carried out by the firm and those remaining to comply with SS5/24.
- An overview of the level of confidence in IM output, and how this shaped FundedRe investment limits.
- An overview of steps taken by the board to limit its risk appetite for the volume and complexity of FundedRe transactions, where gaps are identified against the expectations in SS5/24.

The PRA expects the boards' assessment of these issues to be informed by the independent opinion of the Risk function. The PRA makes clear that where firms do not meet its expectations in SS5/24, it will consider using its supervisory powers against those firms, such as a restriction on the amount and structure of FundedRe.

What do firms need to do?

Life insurers should review SS5/24 and carry out a gap analysis (the self-assessment analysis) against their own FundedRe arrangements. The gap analysis should consider collateral policies, recapture plans, overarching frameworks, IMs (and assumptions used), and exposure limit frameworks.

Discussions and decisions to address any gaps identified should follow appropriate governance processes and be effectively recorded. The PRA has asked firms to include in their responses to their PRA supervisors areas that are not fully aligned with SS5/24, but where a firm's implemented framework achieves the same outcome.

Robust processes should be in place when entering into FundedRe arrangements. Thorough risk assessments should be completed for new and existing transactions, and any risks should be captured in insurers' risk register to ensure ongoing monitoring of the risks. As part of their response to their PRA supervisor, firms need to explain how their boards applied limits to risk appetites for FundedRe over the next few months, where there are gaps against the expectations in SS5/24.

An assessment of the risks arising from FundedRe arrangements should be included in ORSAs.

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Next steps

SS5/24 is effective immediately, from 26 July 2024. The PRA expects firms to perform a self-assessment against the expectations of SS5/24, and to provide the results of this to their PRA supervisor by 31 October 2024. The PRA will use firm results to inform its supervisory engagement with individual firms, as well as its consideration of the case for further measures in this area.

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