

The Standard Formula

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What the UK PRA's Scrutiny of Funded Reinsurance for UK Bulk Purchase Annuity Market Could Mean for Deals

The bulk purchase annuity (BPA) market — whereby UK defined-benefit pension schemes offload liabilities and assets to specialised life insurance carriers — continues to expand. Industry estimates predict that the UK life insurance industry could onboard more than £500 billion of pension liabilities and associated assets over the coming decade.

As the latest instalment in a series of warnings to the BPA market, on 15 June 2023 the UK's Prudential Regulation Authority (PRA) released its preliminary findings from its review in this area. The review focused on the “funded reinsurance” (particularly to offshore reinsurers) that is driving much of the BPA activity in the UK.

Funded reinsurance (sometimes also referred to as asset-intensive or asset-backed reinsurance) essentially involves relevant pension scheme assets travelling up to the reinsurer as premium, and the reinsurance constitutes the sole recourse of the cedant in respect of the liabilities reinsured. In many cases, such reinsurance being in place is integral to the ability of the cedant carrier to enter into the BPA transaction in the first place.

The PRA's review is based on a representative sample of recent transaction structures and contracts. It focuses on the potential for disruption arising from the recapture by the cedant of suboptimal collateral portfolios (upon reinsurer default or otherwise) at a time of market stress. This focus is a recognition that reinsurer business models are increasingly credit-focused, which increases the likelihood that credit cycle shocks will affect multiple reinsurers at the same time.

In this article, we provide a checklist of the perceived shortcomings identified by the PRA that the PRA is most likely to focus on when evaluating a deal. We also share practical suggestions to mitigate the risk that the PRA will use its powers, as lead regulator in respect of the cedant, to block a transaction.

1. Collateral

Portfolio Assets

Issue: In its survey, the PRA identified collateral types which it believes significantly reduce the efficacy of collateral to mitigate risks. It also noted that, on recapture, some of these assets would need to be traded in a potentially stressed market, leading to further losses. Examples included:

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- Non-matching adjustment-eligible assets.
- Illiquid and private assets, including structured and securitised assets.
- Liquid assets outside the core expertise of the insurer.
- Assets denominated other than in pound sterling.

Mitigants: Participants may consider one or a combination of the following, in ascending order of prescription, and which might tighten if the financial strength of the reinsurer declines:

- Enhanced oversight by the cedant over the collateral portfolio through enhanced reporting and more prescriptive investment guidelines.
- Stricter portfolio composition and asset management principles (e.g., which impose complete or partial Solvency II/matching adjustment compliance on the investment profile, or which require a portfolio to be readily re-tradeable into Solvency II/matching adjustment compliance, even in a time of market stress).
- Retention by the reinsurer of regulatory arbitrage/tax benefits, but loss of investment freedom.
- Associated rights for the cedant to recapture/re-localise assets in the event of non-compliance.
- Net reinsurance, retention, funds withheld and/or collateral account charged in favour in agreed proportions.

Under-Collateralisation

In some instances, the PRA found that contracts were collateralised at less than 100% of initial premium. This was portrayed as adequate when then compared to the best estimate of liability (BEL) with an implicit matching adjustment spread and after the application of an asset valuation haircut. The PRA also noted that collateralisation levels can be very dynamic, leading to potential risk of under-collateralisation in certain market conditions.

Mitigants: These elements need to be clearly understood by participants (and in turn regulators) when structuring and managing such contracts. Participants should also employ more frequent (i.e., more often than quarterly) rebalancing to reduce the risk of collateral gaps driven by the volatility of the type of assets concerned. Participants should also consider the case for *ad hoc* rebalancing in between these fixed dates.

Asset Liability Mismatch

Issue: For firms relying on matching adjustment approval, the PRA identified examples of:

- Tolerance for a lengthy mismatch between the assets in the collateral pool and the liabilities ceded.
- Absence of more sophisticated matching requirement (key rate duration matching or cashflow matching).

Mitigants: Stricter asset liability management (ALM) principles embedded in these contracts would avoid large rebalancing actions in stressed markets upon recapture.

Haircuts

Issue: A haircut to collateral valuation is an effective method of addressing “wrong way risk” (i.e., the risk that investment/other issues affecting a reinsurer in times of stress also impact the collateral pot that is intended to support the reinsurer’s obligations) and wider ALM considerations (e.g., unhedged currency mismatch and rebalancing needs). In its survey, the PRA identified examples of:

- In some instances, a complete absence of collateral valuation haircuts.
- Where haircuts were present, an absence of a clear framework for setting them at a level that reflects risks in the collateral portfolio.

Mitigants: Participants should include an appropriate haircut to apportion risk more fairly between cedant and reinsurer.

Collateral Amount – Discounting

Issue: In funded reinsurance structures, the required collateral amount is often determined on a discounted cash flow basis with a prescribed discount curve.

Mitigants: Where the discount curve is driven by the market spreads of the collateral portfolio, participants should put in place firm safeguards to prevent the reinsurer changing the portfolio to higher spread assets. Where the discount curve is more market-index driven, participants should employ more frequent (i.e., more often than quarterly) margining to reduce the risk of collateral gaps. Participants should also consider the case for *ad hoc* margining in between these fixed dates.

2. Termination Triggers

Issue: From its survey, the PRA identified that some termination triggers linked to the reinsurer’s solvency ratio are set at levels that are insufficiently prudent, for example at the regulatory intervention level, which may not allow sufficient time/opportunity the reinsurer to rectify the issue.

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Mitigants: Early termination (including automatic) triggers, where necessary, should be set at the appropriate level and be informed by the business and risk profile of the cedent's reinsurers. These might include a failure to maintain the solvency coverage ratio within a sufficiently comfortable percentage of risk appetite.

3. Collateral Triggers

Issue: The PRA noted instances of contractual triggers allowing the cedant to require strengthening of the collateral package following the occurrence of certain events, in particular a reinsurer credit rating downgrade.

Mitigants: Triggers should be set at a level that is practicable for the reinsurer to meet them at, and which will facilitate the continued life of the contract. Setting these triggers too low could magnify an existing liquidity stress events at the reinsurer level and further prejudice the security package.

4. Governance and Risk Management

The PRA goes on to make a series of observations around carrier's risk-management arrangements in the context of funded reinsurance arrangements. These principally concern how stress testing and modelling of different scenarios impact on the firm's SCR ratios. Finally, the PRA makes a series of observations as to how funded reinsurances were (and should be) treated on a firm's balance sheet and internal model.

Practical Implications

As we discussed in our [9 May 2023 issue](#) of *The Standard Formula*, the practical implications of the PRA's stated concerns could be as follows:

- **The PRA will carefully scrutinise the development of BPA and funded reinsurance transactions.** We expect the PRA will use its powers to request draft documentation ahead of execution and suggest amendments where required. Ultimately, the PRA may use its authority to veto any arrangement that it feels poses undue risks to its statutory objectives.
- **Asset portfolios will undergo even further scrutiny, in the context of funded reinsurances and recapture.** We expect that non-UK funded reinsurances will require a high degree of matching adjustment compliance and localization of collateral in the UK, whether by funds withheld or otherwise.
- **The PRA will view sceptically capital release to shareholders as a result of offshore reinsurance,** firmly encouraging that released capital either remain with insurers or at least within their domestic UK groups, and that insurers invest it in a manner consistent with UK government objectives. At least some degree of well-signposted investment in line with those objectives may be helpful.

The PRA is planning further supervisory work in this area, including targeted supervisory work on collateral risk management and internal model approaches. The PRA is also requesting all firms to notify it promptly of each material funded reinsurance transactions entered into from 15 June 2023 (the date of its preliminary findings), with a gross premium of £200 million or more being material for these purposes.