Skadden | The Standard Formula

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The PRA's Expectations for Funded Reinsurance: How To Comply

The PRA has released an important statement on its approach to funded reinsurance. Our view is that the statement endorses the conceptual principle that funded reinsurance (particularly to offshore counterparties) should best be regarded as a synthetic participation in a UK life insurance balance sheet. Ideally, it should involve:

- No material diminution in total asset coverage.
- A funds-withheld structure for the premium (possibly, funds transferred and a secured account), supported by an additional secured collateral account.
- An asset portfolio which is either matching adjustment-compliant or close to compliance (or is capable of ready reinstatement to compliance on recapture or earlier decline in strength of the reinsurer).

Nonetheless, flexibility in structure and contractual terms will continue to be driven by the financial strength of both the cedant and the reinsurer. The PRA's statement could be viewed as implying that, on a recapture, the cedant should ideally remain within its risk appetite (albeit at the lower end), or at least capable of continuing to write new business without taking significant value-destroying management actions.

1. Introduction

On 26 July 2024, the UK Prudential Regulation Authority (PRA) published a supervisory statement (SS5/24) setting out the PRA's expectations with respect to UK insurers that are party to (or wish to be party to) funded reinsurance arrangements, together with a Dear CEO letter and a policy statement on the subject.

Funded reinsurance arrangements involve a form of quota share reinsurance contract that transfers part or all of the asset and liability risks associated with a portfolio of bulk and/or individual annuities to a reinsurance counterparty. The rapid growth of primary bulk purchase annuity business in the UK market has lead to greatly increased demand for funded reinsurance, as primary insurers seek to increase their underwriting capacity without having to go back to their shareholders or others to seek more capital.

This memorandum summarises how UK insurers and their reinsurance counterparties can help ensure compliance with the supervisory statement, which is effective immediately. Boards of UK insurers must consider whether their company's management of existing funded reinsurance transactions as well as any future transactions align with the supervisory statement.

It is apparent that the PRA is concerned that assets and liabilities are leaving the jurisdiction and finding their way into the hands of reinsurers over which the PRA has no direct regulatory control — particularly, privately-owned offshore firms — and which may have a degree of flexibility in their affairs that is beyond what UK regulators would accept. The PRA's remedy is to regulate those reinsurers indirectly via the UK cedant entities.

The PRA's Expectations for Funded Reinsurance: How To Comply

The PRA recognises funded reinsurance agreements as part of a diversified asset strategy. However, the PRA has highlighted a number of perceived issues with funded reinsurance. The PRA holds the view that the current growth of funded reinsurance transactions could lead to a rapid and systemic build-up of risks, namely the risks that:

- Counterparty risks are underestimated by UK insurers.
- Assets recaptured will not be sufficient or appropriate in the event of reinsurer default.
- Capital requirements with respect to these two risks are underestimated by cedants.

The PRA is concerned that, without material improvement in approaches to risk management, UK insurers could use funded reinsurance in such volumes and complexity that it is not consistent with prudent risk management, either individually or from a market-wide systemic perspective.

On the basis that a funded reinsurance agreement is an asset of the primary carrier, the foremost principle that informs the PRA's approach to supervising funded reinsurance transactions is the Prudent Person Principle (PPP), *i.e.*, that UK insurers may only invest in assets the risks of which they are able to:

- Identify, measure, monitor, manage, control and report.
- Take into account in assessing their own solvency needs in their Own Risk and Solvency Assessment (ORSA).

In particular, the PRA has highlighted that, where a UK insurer's business model is reliant to a material extent on funded reinsurance, particularly with a small number of counterparties, the PRA considers that this could present challenges in complying with the PPP.

2. Ongoing Risk Management

UK insurers must do the following with respect to the assessment of risks incurred through funded reinsurance transactions:

- Have risk management processes to identify, measure, monitor, manage, and report the risks arising as part of the UK insurer's general risk management processes.
- Have risk management processes focussed on the whole tail risk to which the UK insurer is exposed.
- Provide sufficient evidence to enable the their UK insurer's actuarial function to express an informed opinion on the adequacy of the firm's reinsurance arrangements (showing how the UK insurer may withstand a single or multiple recapture events involving highly correlated counterparties[1]).
- Ensure the size and structure of the funded reinsurance transaction is limited, so that the impact of recapture is capable of being reliably estimated.

[1] For example, those with an investment portfolio with a large quantum of private credit positions that are owned by an asset manager whose fortunes are driven by private credit markets.

a. Counterparty Internal Investment Limits

The supervisory statement provides important guidance on how UK insurers should determine internal limits on funded reinsurance, including, use as a risk diversification tool in and of itself and the degree of cession to reinsurers.

Immediate Recapture Metric

UK insurers must calculate an immediate capture metric (which applies only for the purpose of setting internal investment limits) which:

- Should measure the impact on the UK insurer's solvency capital requirement (SCR) coverage ratio of an immediate recapture of all business ceded to a funded reinsurance reinsurer, excluding the likelihood of such an event.
- Should be calculated before management actions are considered, in order to maximise the reliability of information provided to management.

Additional Requirements re Counterparty Investment Limits

In addition, UK insurers must:

1. Consider the nature of the collateral the UK insurer would receive on recapture, and whether this collateral would be sufficient and adequate to cover the technical provisions and risks recaptured.
2. Assume limited to no re-collateralisation by the reinsurer in stress.
3. If the UK insurer assumes recapture within the matching adjustment (MA) portfolio, take into account prudent rebalancing and trading costs.
4. If the reinsurer has collateral substitution rights, the UK insurer must consider a "worst-case" collateral portfolio on recapture (*e.g.*, at the lower end of permitted credit quality and poorly matched — yet permitted — assets).
5. Allow for the increased costs of managing the recaptured portfolio post recapture.
6. Consider a range of scenarios covering the whole distribution of the risks in the tail as part of the exposure measurement basis of the immediate recapture metric and, in doing so, measure the UK insurer's exposure to funded reinsurance in stressed conditions, including:
   a. Stresses to the liability cash flows.
   b. Stresses to the value and quality of collateral.
   c. Considering the risks beyond the 1 in 200 confidence level over one year (through a tail-value-at-risk (TVaR) approach or stress and scenario testing.

7. Set internal investment limits so that a singular idiosyncratic event of a recapture of business from one counterparty does not threaten the UK insurer's business model.
8. Avoid taking on single counterparty exposures which, upon recapture, could threaten their ability to continue to meet their solvency risk appetite or require significant value-destroying management actions to be taken (*e.g.*, the UK insurer enters run-off).
9. Avoid overexposures or excessive reliance on a particular funded reinsurance arrangement.
10. Set limits to avoid overexposure in any periods of high Solvency Capital Requirement (SCR) coverage above the UK insurer's long-term target SCR coverage ratios which could result in a breach of the exposure limit set by the UK insurer when SCR coverage returns to long-term target levels.
11. Consider broader factors when setting internal investment limits beyond the current external credit rating of the counterparties.
12. Design appropriate counterparty approval and ongoing monitoring processes and to use these instead of relying solely on changes to external credit ratings.
13. Have additional limits which consider other forms of concentration risk, including a limit based on the simultaneous recapture from multiple highly correlated counterparties (based on an assessment of similarities in the risk profile of the counterparties operating in the funded reinsurance market).
14. Set an aggregate limit focused on the UK insurer's own need for a diversified asset strategy as well as operational capabilities on recapture, independent of the counterparties.
15. Set the solvency-based limit by considering in particular the ability of the UK insurer to perform the required rebalancing of the asset portfolio, the required hedging activities, and the operational processes associated with the recapture.

b. Collateral Policy

The supervisory statement provides important guidance on how UK insurers should determine their collateral policy with respect to funded reinsurance. Clear collateral policies are a key part of a UK insurer's risk management framework.

General

The UK insurer must:

- Consider the collateral it is exposed to when factoring that into its limit-setting process.
- Have a collateral policy that allows the UK insurer to:
  - formulate an executable recapture plan under stressed conditions, and
  - have a reliable estimate of the impact of recapture given the value and quality of asset-liability matching of the recaptured collateral,

  so that the UK insurer can survive the impact of a recapture without it threatening its business model.
- Have a detailed collateral policy for illiquid assets backing funded reinsurance (level of detail proportionate to size of exposures), which should cover at a minimum:
  - Approaches to credit assessment.
  - Valuation methodology by asset class.
  - MA eligibility conditions monitoring.
  - SCR modelling of the assets.
  - Investment management approaches on recapture under different circumstances, including consideration of how assets may be managed long-term if they cannot be easily sold (implying that there should be consideration of the implications of an association between a reinsurer and an affiliated asset manager).

Specific Requirements if the UK Insurer Has MA Approval

If the UK insurer intends to assume they can recapture collateral assets into their MA portfolio on recapture, the UK insurer must ensure ongoing compliance of such assets with the MA eligibility conditions as part of the UK insurer's internal risk management policies.

Where the reinsurance documentation sets out broad contractual definitions of MA eligibility conditions that do not match the UK insurer's own MA approvals, the UK insurer must undertake robust testing (proportionate to the characteristics and materiality of the collateral assets) of samples of assets held in the collateral portfolio against UK insurer's MA approvals on a regular basis.

In addition the UK insurer must:

- Also only assess MA eligibility conditions in line with their own permissions, and should not assume that potential future applications for MA approval will be successful for the purpose of collateral management arrangements.
- Develop supporting analysis to demonstrate clearly that, in both prevailing and stressed economic conditions, the recapture from a counterparty would not result in a breach of the MA conditions (including the matching of cash flows).

c. Recapture Plan

The supervisory statement provides important guidance on how UK insurers must plan for recapture.

Requirements for Recapture Plan

A UK insurer with funded reinsurance arrangements must have a recapture plan that at a minimum includes detail on:

- Approaches to monitoring the financial condition of the reinsurer.
- Activities to be carried out if a deterioration in financial condition of the reinsurer is identified.
- A step-by-step process for achieving the recapture of all the assets and liabilities.
- A step-by-step process for asset transfers by asset class, including contract novation (*e.g.*, for derivatives).
- Actions to ensure MA compliance where recapture into the MA portfolio is assumed.
- Areas of uncertainty in the recapture process.

UK Insurer Board Engagement

A UK insurer must:

- Have the high-level principles underlying the recapture plan, including a statement on the uncertainties inherent to the recapture process, approved by the board of the UK insurer.
- Ensure the board reviews and approves the recapture plan as:
  - Being proportional to the level of risk being taken.
  - Reflecting how internal investment limits have been set.
  - Being clear on what potential impacts on the UK insurer's business model have been accepted.
- Ensure the board of the UK insurer approves the analysis of potential management actions in the event of a reinsurance recapture.

Decision-Making Process re Recapture

A UK insurer must ensure that:

- Its recapture plans articulate a clear and structured decision-making process for assessing whether ceded business should be recaptured when optional contractual termination event clauses are triggered.
- It analyses its funded reinsurance exposures at least annually to inform its recapture plan and its funded reinsurance internal investment limits.

Where exposures are material, the UK insurer should carry out stress testing specific to its funded reinsurances in its ORSA, which should be informed by the recapture plan and quantitative testing of the outcome of the recapture plan.

3. Solvency Capital Requirement

If the UK Insurer Calculates Its SCR Based on the Standard Formula

The UK insurer must include in its ORSA a clear assessment of the appropriateness of the standard formula, including a consideration of the nature, scale, and complexity of the risks transferred, the risks retained, and the risks to which it is exposed due to funded reinsurance arrangements.

If the UK Insurer Uses Full or Partial Internal Models To Calculate Its SCR

The Solvency II internal model use test requires the output of such models to play an important role in risk management, decision-making and capital allocation. See our July 2024 article, "The Standard Formula: A Guide to Solvency II – Chapter 9: Internal Models."

The UK insurer must:

- Engage in robust modelling that takes into account the risks associated with funded reinsurance.
- Recognise the importance of the internal model or partial internal model to the decision-making process when it comes to deciding whether to enter into a funded reinsurance arrangement as a risk mitigation technique.
- Document the design and operational details of its internal model and indicate any circumstances under which the internal model does not work effectively.
- Specifically document its level of confidence that the internal model for counterparty risk is working effectively to support the relevant management decisions regarding funded reinsurance.

a. Probability of Default (PD)

In assessing PD, UK insurers must factor in the following in relation to their funded reinsurance arrangements:

1. Adequate data for assessing PD.
2. **Stressed PD.** PD must be calculated both in prevailing conditions and under stress conditions to reflect all material risks, including the heightened risk of default in stressed credit conditions.
3. **Termination clauses and dispute.**
   a. The stressed PD must be calibrated so that it is informed by the UK insurer's internal policy on the actions it would take if certain contractual triggers are breached.
   b. It must be demonstrated that the presence of termination clauses in contracts reduces the scale and likelihood of large losses on recapture.

4. **Counterparty solvency ratio.** The solvency ratio of counterparties must be analysed for changes under various market stresses and how this could inform the UK insurer's stressed PD.
5. **Validation.** For purposes of complying with the requirement in the SCR — Internal Models rules, validation processes must be developed to explain specifically the sources of any day-1 new business gain generated by entering a funded reinsurance arrangement.
6. **Forward-looking.** Historical data should be evaluated to see if it captures all risks, including future risks of deterioration of the counterparty conditions.
7. **Non-public information.** Private information gathered as part of the internal counterparty approval processes should be considered.

b. Loss Given Default or Downgrade (LGD)

In assessing LGD, UK insurers must factor in the following in relation to their funded reinsurance arrangements:

- **Stressed liabilities.** The cash flows of the insurance obligations ceded under the reinsurance should be stressed using the same approaches used in the relevant modules of the internal model or partial internal model (including stressing longevity risks and market risks within the liabilities such as inflation and market sensitive policyholder options).
- **Possible credit deterioration of the counterparty.** The impact of deterioration in the credit quality of counterparties in the context of their reinsurance recoverables must be considered, taking into consideration the lifetime of the reinsurance contract.
- **Risk margin on recapture.** The impact on the risk margin of the recapture of risks must be considered.
- **Management actions.** Management actions may only be taken into account in an internal model where the relevant SCR requirements are complied with.

UK insurers must be able to demonstrate that their internal models or partial internal models capture wrong-way risk, especially in the context of credit risk.

c. Collateral

A UK insurer must address the following as part of its calculation of the risk-mitigating impact of collateral on its SCR calculation as it relates to funded reinsurance arrangements:

- **Look-through.** Collateral portfolios must be stressed on a look-through basis to reflect the risks to which the UK insurer would ultimately be exposed on recapture.
- **Collateral mismatch risk.** Potential mismatches between the stressed value of the underlying ceded insurance liabilities and the stressed collateral required under the terms of the funded reinsurance arrangement must be assessed.
- **Recollateralisation.** Where large gaps between the required collateral and the available collateral in the collateral portfolio emerge after immediate stresses, prudent assumptions must be applied in setting recovery rates to reflect the risk that the counterparty might not be able to replenish the collateral.

d. Recapture Within MA Portfolio

Unless the UK insurer is able to demonstrate clearly that recapture into the MA fund would not result in MA noncompliance in future stressed economic conditions or conditions at the current time (both taking into account future management actions that can reasonably be expected to be carried out), a UK insurer must assume that assets and liabilities for ceded business are recaptured outside the MA portfolio.

If a UK insurer can demonstrate MA compliance on recapture in its MA portfolio, the calculation of the SCR should be based on the spread of the collateral portfolio after the rebalancing necessary to achieve MA compliance, which should consider all material and quantifiable risks and may include but is not limited to:

- The stressed fundamental spread applicable to the collateral portfolio.
- The cost of replacing MA-ineligible assets with alternative MA-eligible assets of suitable quality.
- The cost of replacing assets where aggregate internal risk appetite limits for the management of the MA portfolio are breached.
- The cost of setting up a cross-currency hedge programme in stress for currency mismatches in the collateral portfolio.
- Trading activity to achieve internal appetite for the level and nature of cash flow matching on recapture of the collateral portfolio (this should clearly consider stressed trading costs relevant to the collateral asset portfolio).
- The cost of other hedging after the recapture (including but not limited to foreign exchange, inflation and interest rates derivatives which may not be recaptured).

4. Entering Into and Structuring of Funded Reinsurance Arrangements

a. Risk Assessment

As part of the assessment of risks when negotiating funded reinsurance arrangements, a UK insurer must undertake a quantitative assessment to identify and measure the specific risks it might incur, for the purpose of determining its internal limits and risk management processes.

The PRA considers the following four-step framework helpful for UK insurers in considering how the quantitative assessment can be carried out:

The PRA's Expectations for Funded Reinsurance: How To Comply

- **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 factors that would lead to the identified risks at the appropriate magnitude and over the appropriate time frame.
- **Step 3:** Based on the outcome of the quantitative risk assessment, determine whether the new arrangement falls within the UK insurer's approved internal contractual risk appetite.
- **Step 4:** Where the result is outside of the UK insurer's risk appetite, it should consider all potential options, including by seeking improved contractual protections in the reinsurance contract and collateral agreements.

UK insurers must have an approved internal contractual risk appetite statement setting out the maximum acceptable loss at the individual funded reinsurance contract level. Step 3 is to ensure that the proposed new contract is consistent with the risk appetite statement.

b. Basis Risks

For the purpose of Step 1 in the framework above, the UK insurer's identification of risks must include, at a minimum, an assessment of possible gaps between expected reinsurance cover and actual cover, for example, as a result of simplifications, modelling and exclusions.

c. Collateral Mismatch Risk

A UK insurer's assessment of collateral mismatch risks must include the impact of simplifications and underlying collateral behaviour.

d. Time Horizon

UK insurers must perform a quantitative assessment as set out in Steps 1 and 2 above under plausible stress scenarios, both for the full life of the contract and in the event the contract is terminated ahead of its completion.

UK insurers must consider the risk that large shortfalls emerge at recapture where the margining is undertaken only on an infrequent basis.

e. Contractual Mitigations

UK insurers must have internally approved minimum guidelines on contractual features for funded reinsurance transactions which they would apply when deciding whether to enter into a funded reinsurance arrangement. This would include, but is not limited to:

- The approach to termination clauses.
- Substitution rights for collateral assets.
- Valuation approaches.
- Concentration limits.
- Choice of applicable law.

This should also cover investment guidelines taking into consideration the PPP and the UK insurer's internal investment strategy. UK insurers must document the rationale for the choice of the minimum guidelines adopted in their policies.

UK insurers must:

- Use clear risk-based collateral haircuts or over-collateralisation linked to the risk being addressed.
- Ensure 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.
- Ensure that over-collateralization is appropriate for risks that are not asset-specific, such as liability risks and asset-liability mismatch risks.

The haircut and over-collateralisation policy should provide, at a minimum, that haircuts and over-collateralisation:

- Are calibrated to ensure that the risk of a shortfall in the realisable value of collateral in the event of default relative to the total amount due from the reinsurer is within the level of confidence required by UK insurer's risk appetite.
- Allow for the expected volatility of key risk factors that drive the movement in the value of the collateral assets under stressed conditions and the total amount due from the reinsurer.
- Capture other broader risk considerations that affect the value of collateral and the value of obligations from reinsurer to cedant in the event of default.
- Are based on the market risks of the assets defined as eligible under the collateral agreement.
- Are calibrated at a high confidence level, using a long historical time period that includes at least one stress period.
- Are calibrated to incentivise the correct behaviours on the counterparty.

5. Further Action

Of more immediate importance to life insurers is the content of the Dear CEO letter accompanying the supervisory statement. In particular, this requires that all recipients provide their PRA supervisor with the following:

- A Self-Assessment Analysis, looking at the firm's current risk management practices against the expectations set out by the PRA in the supervisory statement.
- A summary table of the firm's board-approved funded reinsurance limits for individual counterparties, for correlated counterparties and the firm's aggregate limit.

- A remediation summary of the activities a firm will carry (or has carried) out to meet the expectations set out in the supervisory statement.
- An overview of the perceived level of confidence achieved in respect of any internal model output (at a transaction level), and how this has been used to shape funded reinsurance investment limits.
- An overview of board actions taken to limit risk appetite for the amount and complexity of funded reinsurance transactions over the coming months, and where gaps exist against the expectations set out in the supervisory statement.
- Evidence that the board's assessment is informed by an independent opinion from the firm's risk function.

Life insurers will need to move quickly to meet these requirements given the deadline of end October. The PRA has indicated that it will be continuing to focus on this area, and has suggested that implementation of the supervisory statement will potentially be part of periodic discussions, and that the PRA will ultimately consider "Section 166" actions where it continues to have concerns and/or consider industry-wide rulemaking to regulate funded reinsurance further.