PRA Publishes Consultation Paper CP24/23 on Funded Reinsurance

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In recent years, the Prudential Regulation Authority ("PRA") has focused extensively on the life reinsurance industry. Consultation paper CP24/23 is the latest in a suite of papers and reviews undertaken by the PRA in this area. CP24/23 outlines the PRA's proposed expectations in respect of life insurance firms entering into funded reinsurance arrangements as cedants. Funded reinsurance is a type of collateralised quota share reinsurance which transfers all or part of the asset and liability risks of a life insurer's portfolio of annuities to a third-party reinsurer (commonly an offshore vehicle).

The PRA is of the view that there are significant risks arising from the increased use of funded reinsurance arrangements. In particular, it is concerned about excessive concentrated exposure to correlated, credit-focused counterparties. The PRA's paper is accompanied by a draft supervisory statement ("SS") outlining the PRA's expectations in respect of the ongoing risk management of funded reinsurance arrangements, the modelling of the solvency capital requirement (the "SCR") associated with funded reinsurance arrangements, and how firms should consider the structuring of funded reinsurance arrangements.

Background. Recent years have seen significant growth across all areas of the global life reinsurance market, including in reinsurance of annuities and other business with long-term guarantees, and to support the writing of bulk purchase annuity ("BPA") business. The PRA has already voiced concerns about the use of funded reinsurance arrangements to support the BPA market, undertaking a thematic review in 2022–2023, culminating in a letter to firms' chief risk officers on 15 June 2023 that highlighted the potential underestimation of counterparty risks by life insurers.

The PRA's work is best understood as part of a concerted effort by global regulators to mitigate the risks associated with changes to the life reinsurance market, exemplified by, for example, recent consultation papers from the Bermuda Monetary Authority (a popular jurisdiction for life reinsurers) and ongoing work by the National Association of Insurance Commissioners in the United States to improve oversight of the increasingly opaque investment structures seen in some life reinsurance deals.

The PRA is keenly aware of the global context; in CP24/23, it notes that it has, alongside the International Association of Insurance Supervisors and the International Monetary Fund, identified a structural shift in the life insurance sector to cross-border reinsurance arrangements, with counterparties that may be exposed to illiquid investments through the private asset origination capacities of the alternative asset managers affiliated with those counterparties. Such language is no doubt a reference to the increased interest of private equity and large asset management groups in the life insurance industry in the past decade. The PRA notes that exposures may become concentrated in a small number of counterparties with a highly correlated risk of default, and that competition in the BPA market may result in a deterioration of the quality of collateral agreed with counterparties. At the level of the SCR, the PRA is concerned that counterparty risk on cedants' balance sheets may be underestimated, leading to a rapid build-up of risk in the UK life insurance market.

Proposals. The PRA proposes to clarify expectations for firms considering entering into funded reinsurance arrangements, and it does not consider that its proposals should impact the ability of firms to invest in UK productive assets—a key focus of much of the PRA's recent reforms.

The "Immediate Recapture" Metric. The PRA proposes that firms should set limits on exposure to funded reinsurance counterparties. It is concerned that existing risk-management systems are ineffective, primarily because they underestimate the recapture risk and do not fully account for the potential increase in exposure should an arrangement be recaptured. Firms will be expected to have an "immediate recapture" metric, which measures the impact on a firm's SCR of a scenario where all ceded business with a counterparty is recaptured, regardless of the likelihood of such an event. The impact of mitigating action is also ignored. The aim is to provide firms with a gross view of the risks they face in the event of a full recapture.

The PRA proposes that firms set internal counterparty investment limits against this framework to ensure that their business model is not exposed to the failure of a single counterparty. Where this framework shows that a firm's business model is reliant to a "material" extent on one counterparty, it will be difficult to demonstrate compliance with the prudent person principle. Firms are also expected to have additional limits around concentration risk, including a consideration of simultaneous recapture from multiple highly correlated counterparties.

Collateral. Firms should have clear collateral policies in place, enabling them to formulate a recapture plan under stressed conditions, reliably estimate the impact of recapture, and ensure that their business model can survive a recapture event. The PRA expresses concern around firms' increased willingness to accept illiquid assets as collateral for funded reinsurance policies, which brings additional risks and uncertainty to the effectiveness of a recapture, particularly the valuation of privately sourced illiquid assets and their credit risk. Firms' collateral policies are expected to

include, as a minimum, details on approaches to: (i) credit assessments, (ii) valuation methodologies, (iii) matching adjustment (“MA”) eligibility monitoring, (iv) SCR modelling, and (v) investment management approaches on recapture. Additional expectations for firms that assume MA eligibility of recaptured assets are also proposed.

Adequate risk management of funded reinsurance arrangements requires documented recapture plans which demonstrate that a firm’s business model can survive any single recapture event and multiple recaptures from correlated counterparties. Plans will be expected to include “robust” forecasts of the cost of the plan under stressed conditions, and must be a key part of setting a firm’s funded reinsurance risk appetite.

SCR. For firms using the standard formula, the PRA reminds them of the obligation to include in their Own Solvency and Risk Assessment (“ORSA”) a clear assessment of the appropriateness of the standard formula, including with respect to the nature, scale and complexity of the risks inherent in funded reinsurance arrangements.

The PRA notes that many firms utilising funded reinsurance use internal models to calculate their counterparty risk SCR; however, these models may have been approved before funded reinsurers became material counterparties, meaning that they are not calibrated to accurately reflect any increases in risk relating to such new counterparties. The PRA will set expectations on certain elements to be incorporated into internal models to calculate a counterparty SCR for funded reinsurance.

Firms will need to clearly articulate the data they use to set probability of default (“PD”) assumptions, and PD must be calculated in both base and stressed conditions. The PRA’s concern that firms are underestimating PD for their counterparties arises from the entry into the market of reinsurance counterparties with newer business models and a lack of directly relevant historical data. Firms should also consider information gathered during counterparty due diligence to inform their assumptions. When setting loss given default (“LGD”) assumptions, firms should stress the underlying liability cash flows using the same approaches used in the internal model when calculating a stressed Best Estimate Liability value, and they should consider the impact of deterioration in counterparty credit quality.

Firms are expected to stress their underlying collateral portfolios on a look-through basis. This may negatively impact their SCR calculations, given the difficulties in valuing the illiquid assets that many funded reinsurers hold as collateral. They must also consider mismatches between collateral and underlying liabilities that may arise under stress; again, this will be an important consideration because of the illiquid assets often used as collateral in funded reinsurance arrangements. Finally, firms must be able to articulate how their models reflect scenarios where reinsurance arrangements no longer represent effective risk transfer in their internal models.

Recapture and the MA. The PRA proposes to set an expectation that firms assume that assets and liabilities associated with funded reinsurance contracts be recaptured outside a firm's MA portfolio, unless they can demonstrate that inclusion would not result in breaching MA conditions under base and stressed scenarios. This change is expected to be significant for insurers who have operated on the assumption that such assets and liabilities could be recaptured within their MA portfolios, and for firms whose MA permissions do not include the kind of privately sourced assets that are frequently used as collateral in funded reinsurance arrangements.

Where firms can demonstrate that inclusion would not result in breaching MA conditions under base and stressed scenarios, calculations must take into account any rebalancing and trading activities necessary to comply with a firm's MA conditions. The market feasibility of proposed management actions under stress must be demonstrated, as well as the firm's operational readiness and capabilities to effect them.

Quantitative Risk Assessment. Firms must have a quantitative risk assessment process for funded reinsurance arrangements, as part of their overall investment risk strategy. This assessment must reflect a range of risks, including all forms of basis and collateral mismatch risk, and should be used whilst negotiating funded reinsurance arrangements to seek further contractual protections where possible.

Contractual Mitigations. Finally, the PRA expects firms to have internally approved guidelines on contractual features for funded reinsurance transactions including, but not limited to, termination rights, substitution rights for collateral assets, valuation approaches, concentration limits and governing law clauses. The guidelines should also take into account the firm's internal investment strategy. The PRA also expects firms to document the rationale for the choice of minimum guidelines in their contractual policy for funded reinsurance transactions.

Next Steps. The PRA's consultation closes on 16 February 2024. The proposed date for these changes to come into effect is Q2 2024.

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Please do not hesitate to contact us with any questions.

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