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CLIENT ALERT

PRA Publishes Final Supervisory Statement on Funded Reinsurance

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Overview

On 26 July 2024, the Prudential Regulation Authority (the "**PRA**") published its Policy Statement on the use of funded reinsurance by life insurers. The Policy Statement appended its final Supervisory Statement, and a "Dear CEO" letter setting out further expectations and next steps for firms.

These pronouncements are the latest step in the PRA's direct engagement with the regulation of funded reinsurance over the last two years. That engagement began with a speech by Charlotte Gerken, the Bank of England's former Executive Director for Insurance Supervision, on 20 September 2022. A thematic review of the use of funded reinsurance by longevity insurers followed and gave rise to a "Dear CRO" letter in June 2023 in which the PRA set out its initial observations and requested that firms take appropriate remedial actions and notify all "material" transactions to the PRA. A Consultation Paper and draft Supervisory Statement followed on 16 November 2023.

The UK insurance and reinsurance market has been awaiting the final Supervisory Statement, hoping that it would clarify the PRA's expectations and the regulatory framework applicable to funded reinsurance. With the final Supervisory Statement and accompanying Policy Statement and Dear CEO letter, the PRA has provided further clarity. But it has done so while maintaining a high bar of regulatory expectations for insurers that make use of funded reinsurance, despite the apprehensions voiced by the market as to the feasibility of those expectations.

<u>Developments in PRA Position</u>: The final Policy Statement and Supervisory Statement reiterate certain key concerns and themes that the PRA has consistently raised over the past two years, and the accompanying Dear CEO letter stresses that UK insurers must materially improve their efforts to comply with the PRA's policies and meet its expectations regarding funded reinsurance.

Those expectations, and their respective underlying themes, are set out below along with a comparison of the PRA's position prior to the 26 July Policy Statement, Supervisory Statement and Dear CEO letter (the "**Prior PRA Position**"), the market's response to those positions, where applicable (the "**Market Response**"), and the PRA's positions in the 26 July Policy Statement, Supervisory Statement and Dear CEO Letter (the "**Current PRA Position**").

1. <u>Counterparty Credit Risk</u>

Theme: Threat to business model

- **Prior PRA Position**: Insurers should limit exposure to funded reinsurance counterparties to levels that do not threaten their ongoing business model in the event of recapture.

- **Market Response**: Further clarity is needed on how to interpret the expectation that a recapture of business from one counterparty "*does not threaten the firm's business model*".

- **Current PRA Position**: While the PRA has left it open to firms to determine what would constitute a threat to its business model, it clarified that firms should avoid single counterparty exposures which, upon recapture, "*could threaten their ability to continue to meet their solvency risk appetite … or which would require significant value destroying management actions to be taken such as closure to new business*".

Theme: Management actions and immediate recapture metric

- **Prior PRA Position**: Firms should consider an "*immediate recapture*" metric based on the impact on the firm's SCR coverage ratio of an immediate recapture of all business ceded to a counterparty, irrespective of the likelihood of such event and ignoring any possible management actions.

- **Market Response**: The absence of any allowance for management actions is overly prudent.

- **Current PRA Position**: The PRA reiterated that it expects firms to consider possible worst-case scenarios resulting from their exposures.

Theme: Correlated counterparties and simultaneous recapture

- **Prior PRA Position**: Insurers should have additional counterparty limits "*based on simultaneous recapture from multiple highly correlated counterparties*" and an *"aggregate limit focused on the firm's own need for a diversified asset strategy as well as operational capabilities on recapture*".

- **Market Response**: The multiple default of correlated counterparties is an extremely remote risk and assuming this risk when setting counterparty limits might be disproportionate, and, if firms are to assess this risk systematically, the PRA should clarify how firms should assess the extent to which counterparties are correlated.

- **Current PRA Position**: The final Supervisory Statement clarified that firms should consider similarities in the risk profile of funded reinsurance counterparties. The PRA uses the express example of correlated credit risk: "*…where a firm is exposed to multiple counterparties where credit risk makes up a majority of their post diversification capital requirements ie where the firm has an indirect concentrated exposure to credit risks the PRA expects firms to have an internal exposure limit that considers this concentration risk*." However, the PRA disagreed that the risk of default is remote and expressed its concern that firms are underestimating counterparty risk and therefore must assess their exposure to the risk of simultaneous recapture.

2. <u>Recapture Plans</u>

Theme: Board approval

- **Prior PRA Position**: Insurers must document recapture plans for their funded reinsurance arrangements to demonstrate that their business model can survive any single or multiple recaptures from correlated counterparties. The draft Supervisory Statement required the insurer's board to approve these recapture plans.

- **Market Response**: Requiring board approval for all recapture plans would be inflexible and management would be better suited to approving recapture plans.

- **Current PRA Position**: The PRA revised its expectations according to the Market Response, with the Supervisory Statement now requiring boards to approve the high level principles underlying the recapture plan (and not the plan itself), review the recapture plan, and approve potential management actions in a recapture event.

3. SCR Modelling

Theme: Proportionality and materiality

- **Prior PRA Position**: Insurers' solvency capital requirement calculations should apply the PRA's detailed counterparty risk module standards. The PRA's expectations focus on ensuring that insurers' models adequately account for all material and quantifiable risks relating to funded reinsurance arrangements as a risk-mitigation technique.

- **Market Response**: The PRA's expectations introduce significant computational complexity and expert judgment to the modelling process, which would likely have an immaterial impact on the ultimate SCR and divert resources away from other important risk management functions, such as recapture planning.

- **Current PRA Position**: The PRA clarified that firms should model counterparty credit risk in accordance with the PRA's expectations and address any related uncertainties in the firm's risk management practices, including by limiting exposure to factors that cause uncertainty, implementing tighter funded reinsurance investment limits, or reducing risk-taking in contractual terms or collateral structures.

Theme: Insufficient data

- **Prior PRA Position**: Firms should take into account the deterioration of counterparties' credit quality under stress when determining the probability of default.

- **Market Response**: Respondents objected to this expectation because it would require information from insurers' counterparties that may be both more granular and more commercially sensitive than information counterparties would readily disclose.

- **Current PRA Position**: The PRA decided to maintain its position, noting that firms do not need "*to build an internal model module for their counterparties*" and suggested that firms "*should be able to use public disclosure of solvency ratio sensitivities*".

Theme: Validations

- **Prior PRA Position**: As part of determining the probability of counterparty default, firms should develop validation processes to "*explain the sources of any day one new business gain generated by entering a funded reinsurance arrangement*" (with unexplained elements indicating risks that may not be captured by the firm's internal model).

- **Market Response**: Validation would be challenging given the lack of publicly available reinsurer pricing bases and investment and capital strategies.

- **Current PRA Position**: The Supervisory Statement provides that the validation can be carried out by comparing the premium charged by the reinsurer with the premium that would have been charged by the insurer in the absence of a funded reinsurance arrangement and reconciling the difference.

4. Collateral

Theme: Haircut and overcollateralisation policy

- **Prior PRA Position**: Firms should make use of risk-based collateral haircuts and overcollateralisation to mitigate the risk that the collateral does not match the exposure it secures.

- **Market Response**: The PRA's expectations are too prescriptive: haircuts are determined at the outset of the transaction and therefore cannot move in line with risk drivers, haircuts should not be required where firms intend to retain the collateral assets on recapture and haircuts and overcollateralisation should not both be required (one or the other should suffice).

- **Current PRA Position**: The PRA revised the Supervisory Statement to clarify that (i) haircuts are appropriate to address asset-specific risks, (ii) overcollateralisation is appropriate to address non-asset specific risks and (iii) both haircuts and overcollateralisation should be set at the commencement of the transaction and consider the expected volatility of key risk factors.

Theme: Collateral policies

- **Prior PRA Position**: Firms should have clear and detailed collateral policies in place as part of their risk management policies, addressing their approaches to credit assessments, valuation methodologies per asset class, margining frequency, matching adjustment (MA) eligibility monitoring, SCR modelling of the assets, and investment management approaches on recapture under different circumstances (including consideration of how assets may be managed if they cannot be easily sold). Firms should also consider the risks of collateral mismatches where the rebalancing of collateral is undertaken infrequently.

- **Market Response**: The PRA's detailed expectations for collateral policies are disproportionate where collateral is liquid, where large haircuts have been applied or where holdings are immaterial. Further clarity is needed on what it means for collateral rebalancing to be considered "infrequent".

- **Current PRA Position**: The Supervisory Statement clarified that the level of detail in the collateral policy should reflect the materiality of the firm's exposures to illiquid asset holdings. Similarly, the PRA revised its expectations for monitoring MA eligibility, stating in the Supervisory Statement that although it does expect firms to undertake regular sample testing to confirm MA eligibility, such monitoring should reflect the characteristics and materiality of the collateral assets. The PRA has placed the responsibility on firms to determine and justify their own frequency for collateral rebalancing, taking into account the risk of a shortfall emerging at recapture. The draft Supervisory Statement identified "quarterly" as infrequent, however the final Supervisory Statement omits that reference.

5. Diversification

Theme: Benefits of diversification

- **Prior PRA Position**: The policies in the Supervisory Statement apply to all funded reinsurance arrangements, regardless of the nature of the counterparty.

- **Market Response**: The PRA's expectations should distinguish between funded reinsurance arrangements with risky monoline counterparties and arrangements with well-established reinsurers that benefit from a diverse risk profile and asset exposure.

- **Current PRA Position**: In response, paragraph 1.5 of the final Supervisory Statement clarifies that firms may consider benefits resulting from well-diversified funded reinsurance portfolios or diversification between the cedant's and the counterparty's risk profiles or asset holdings in their risk management and modelling. However, the PRA considers that most of the risks arising from funded reinsurance arrangements would arise regardless of the nature of the counterparty and has therefore resisted any further adjustments to the text of the Supervisory Statement to reflect the differing nature of potential counterparties.

Next Steps

- Application of the Supervisory Statement: The Dear CEO letter states that firms' boards should consider their alignment with the Supervisory Statement requirements as soon as practicable and be particularly mindful of the PRA's expectations before entering into any new funded reinsurance arrangements in the meantime. The PRA's urgency is underscored by the fact that the Supervisory Statement was made immediately effective for existing and future funded reinsurance transactions, despite objections from respondents to the Consultation Paper that the implementation of the Supervisory Statement should be delayed until the end of the year. The PRA, however, did clarify that it does not expect firms to renegotiate the terms of existing agreements.

- Stress Test: The PRA has separately announced its approach to the 2025 Life Insurance Stress Test, which will, in addition to the "core scenario", include a new "exploratory scenario" modelling the impact of recapture under stress of all funded reinsurance arrangements with the relevant insurer's most material counterparty. The results of the above self-assessment, together with the funded reinsurance stress test in 2025, will inform the PRA's view on whether further measures are needed.

- Self-Assessment: The PRA also requires boards of life insurers to carry out a self-assessment of their current funded reinsurance risk management practices against each of the expectations in SS5/24 and, where an insurer's practices fall short, to specify remediation plans. Each firm must provide this assessment to its respective PRA supervisor by 31 October 2024, together with a summary table of the firm's counterparty limits (per counterparty, across correlated counterparties and in the aggregate), an assessment of its board's confidence in its SCR modelling output for funded reinsurance and an overview of steps taken by the board to limit the firm's risk appetite for funded reinsurance where gaps exist against the SS5/24 expectations.

Closing Remarks

The PRA has indicated in the Dear CEO letter that, if it continues to have concerns, it may take further measures, including "*explicit regulatory restrictions on the amount and structure of FundedRe, or measures to address any underestimation of risk, or regulatory arbitrage, inherent in these transactions*". It has also indicated that it may commission s166 Skilled Persons reviews if it has concerns with respect to specific insurers. This threat of further measures may be intended to encourage insurers to align their practices promptly with the PRA's expectations laid out in the Supervisory Statement. It is apparent that the PRA is seeking prompt adjustments in light of the pace with which funded reinsurance has become a prominent feature of the bulk annuity market.

The PRA's publications come against the backdrop of increased global scrutiny of asset-intensive reinsurance arrangements. The National Association of Insurance Commissioners (NAIC) in the US is due to introduce draft rules in its August meeting to regulate such arrangements more tightly (including by requiring firms to review the reserve adequacy of a reinsurance counterparty). Moreover, the International Association of Insurance Supervisors (IAIS) confirmed earlier this year that they will continue to gather data on the use of asset-intensive reinsurance as part of their 2024 Global Monitoring Exercise, pursuant to which the IAIS aims to obtain more information on potential systemic risk developments in the insurance sector and identify key themes for deeper discussion amongst insurance supervisors worldwide.

We will continue to monitor developments in the PRA's approach to funded reinsurance as insurers respond to its publications.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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