FEEDBACK ON THE PRA'S THEMATIC REVIEW WORK ON FUNDED REINSURANCE ARRANGEMENTS

On 15 June 2023, the PRA published a letter from Charlotte Gerken on 'Feedback on the PRA's preliminary thematic review work on funded reinsurance (FundedRe) arrangements' (linked here). The letter, addressed to the Chief Risk Officer at life insurance firms, provides insights from the PRA's thematic review of FundedRe in the UK life insurance market, given its growing use in supporting bulk purchase annuity (BPA) transactions, which the PRA has previously expressed concern.

Overall, firms should expect PRA challenges in structuring deals that do not comply with regulatory expectations for concentration, investment and other risks.

APPROACH

The PRA looked at firms' practices in three key areas: (i) structuring of FundedRe transactions, (ii) risk frameworks and (iii) capital requirements. Significantly, the PRA identifies clear links between these three areas: counterparty exposure management and limits, security package expectations and 'deal economics'. Each needs to work in unison, as weaknesses in one area, or insufficient integration, may lead to poorly informed business decisions.

KEY RISKS

Against the background of an increasingly competitive BPA market, the PRA has expressed concern regarding direct BPA carriers' reliance on third-party reinsurers to support new BPA business (and the resulting counterparty risk). As a result of its engagement with market participants and its review of examples of contractual arrangements that they are entering, the PRA highlights the following areas where it believes potential risks may exist:

- Probability of recapture (PR): given new reinsurers and existing reinsurers whose business models are increasingly concentrated, historical evidence of default risk might not effectively capture recapture risk.
- Correlated PR: new business models are increasingly credit-focused which increases the likelihood that credit cycle shocks affect multiple reinsurers at the same time.
- Loss given recapture (LGR): 'wrong way' risk in the transactions: a credit cycle shock is likely to cause the deterioration of the reinsurer at the same time as the collateral portfolio.
- Management actions: certain management actions might not be effective on recapture.

MAIN FINDINGS

The PRA believes that firms' practices showed some material shortcomings in the following areas (detailed further in Annex 1 to the letter), when assessed against the PRA's current policies and expectations.

Sub-optimal collateral portfolios

The PRA found that a key risk arising from FundedRe is that firms may recapture sub-optimal portfolios (unmatched or with inadequate assets) with depressed values and with limited ability to be transformed effectively to the firms' preferred portfolio.

Some structural features of contracts that generate this risk are identified as follows:

- under-collateralisation - for example, in some instances, the contracts were collateralised at less than 100% of the premium;
- asset-liability mismatch - for example, in some transactions, the PRA identified large permissible duration mismatches between the assets in the collateral pool and the liabilities ceded, and absence of more sophisticated matching requirement;
- absence of collateral valuation haircuts, which can be beneficial in addressing wrong way risk and wider ALM considerations;
- termination triggers linked to the reinsurer's solvency ratios set at levels that were insufficiently prudent;
- infrequent collateral rebalancing requirements; and
- contractual triggers for strengthening the collateral package in certain events. Setting these triggers at adequate levels can be difficult as, if set too low, could magnify a liquidity stress events at the reinsurers and further lead to deterioration in the security package.

These are already areas of concern to cedants and are heavily negotiated, but we can expect to see firms pushing harder to ensure that these risks are mitigated by the contractual terms meeting the PRA's expectations.

Resource sufficiency

Resource sufficiency on recapture was the second source of risk identified by the PRA. The PRA set out risk management approaches adopted by firms and how FundedRe arrangements were treated on the Solvency II balance sheet within internal models.

While some improvements were observed, the PRA highlights the high reliance on management actions both within internal models and in risk management frameworks and its concern that under stress, these actions may not be feasible.

Some other key takeaways include:

- The "immediate recapture" measure is the most reliable metric for measuring counterparty exposure since it is the least subjective and does not depend on speculative future market situations.
- Looking at how firms approach risk management and limit setting, the PRA found that dynamic exposure limits must be considered to avoid creating problems during market stress, and firms must be aware of how the limits could change during stress.
- Any management actions assumed within the calculation of the impact of a FundedRe arrangement being replaced or recaptured should also be carefully considered and realistic.

Next steps

The PRA has requested that firms:

- consider the findings of the letter and take appropriate remedial action (including continued compliance with their existing obligations, such those outlined in Supervisory Statement SS1/20 - Solvency II: Prudent Person Principle and SS20/16 - Solvency II: reinsurance - counterparty credit risk (linked here)); and
- notify their supervisor promptly of individual 'material' FundedRe transactions entered from the date of its letter. The letter notes that materiality should be considered in the context of impact on Solvency Capital Requirement (SCR), amount of gross premium and/or complexity of the arrangement and specifies that gross premium more than £200mn would be considered material.

In the letter, the PRA has made it clear that it will continue to raise issues where it sees weaknesses within firms or inadequate justification for the assumed effectiveness of management actions.

Therefore, firms planning to participate in FundedRe transactions should assess their own risk management against the PRA's expectations. This includes assessing the robustness of credit and counterparty risk capabilities, the validity of internal models, and the resilience of liquidity sources, as well as managing collateral risk.

To the extent that any gaps are identified, firms should develop appropriate processes and procedures, and ensure that in relation to both new and existing Funded Re transactions, there is a record of the appropriate governance processes, and any risk identified are effectively monitored going forward.

C L I F F O R D

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