

NAVIGATING FUNDED REINSURANCE IN THE UK: INSIGHTS FROM THE PRA'S CP24/23 CONSULTATION PAPER

On 16 November 2023, the PRA published a consultation paper (CP24/23) on funded reinsurance (Funded Re), outlining proposed expectations for life insurers entering into or holding Funded Re arrangements as cedants, particularly in the context of bulk purchase annuity (BPA) business. The consultation paper is relevant to UK Solvency II firms and UK branches and therefore their reinsurers as well. A link to the CP is [here](#).

The PRA's proposals will result in a new draft supervisory statement (SS) covering ongoing risk management, solvency capital requirement (SCR) modelling, and the structuring of Funded Re arrangements.

The proposals set additional expectations on firms with a number of additional limits being incorporated into the existing risk management framework specifically for Funded Re – such as counterparty limits, special investment limits and recapture metrics. This will also require firms to document specific collateral policies and recapture plans.

From a Matching Adjustment (MA) perspective, firms will be required to assume that assets and liabilities received on recapture under Funded Re arrangements will not be MA eligible, unless it can be clearly demonstrated that the inclusion will not result in non-compliance with the MA conditions. We note that this will also need to be considered in the context of the MA attestation requirements under the Solvency UK proposals.

Whilst the proposals build on the themes raised in recent PRA speeches and Dear CEO/CRO letters and echo concerns raised by EIOPA and other regulators, the scope of expectations go beyond previous statements.

The proposals broadly cover:

- **Counterparty internal investment limits:**

- Cedants are expected to set limits to their exposures to Funded Re counterparties, going beyond the risk tolerance limits set out in [SS1/20](#) on compliance with the Prudent Person Principle.
- This includes the application of an 'immediate recapture metric', intended to measure the impact on SCR where all ceded business with a counterparty is recaptured, ignoring the likelihood of such an event and without taking into account the impact of mitigating management actions. This could require firms to treat all counterparties in Funded Re transactions in the same manner, regardless of financial strength/standing.
- Firms would also be required to set internal investment limits focused on the idiosyncratic risk of the counterparty, independent of the risk of default of counterparties generally in the market. This is aimed at ensuring firms are not exposed to a single counterparty where failure of that counterparty would threaten their business model.
- Further additional limits relating to concentration risk are also proposed, to include a limit based on simultaneous recapture from multiple highly correlated counterparties. This adds an additional restriction limiting Funded Re exposure to any one reinsurer or group of reinsurers.

- **Collateral policies:**

- Cedants will be required to have clear collateral policies in place to ensure that collateral is sufficient to cover potential exposures and ensure firms have a reliable estimate of the impact of recapture of stressed collateral.

- As firms are increasingly accepting illiquid assets to back collateral, collateral policies would be expected to include, at a minimum, details on approaches to credit assessments, valuation methodologies, MA eligibility monitoring, SCR modelling and investment management approaches on recapture.
- **Recapture plans:** The PRA proposes that firms document a recapture plan for Funded Re arrangements in order for firms to demonstrate that they can survive any single recapture event and multiple recaptures from correlated counterparties, as well as make robust forecasts of the costs of recapture actions under stressed conditions.
- **Recapture within Matching Adjustment Portfolios:** There is an expectation that firms assume that assets and liabilities within Funded Re contracts be recaptured **outside** the MA Portfolio, unless the firm can clearly demonstrate that such an inclusion would not result in non-compliance with the MA conditions under both base and stressed scenarios. If demonstrated, firms will also need to take into account rebalancing and trading activities necessary to achieve MA compliance in their calculations.
- **SCR calculation:** The PRA proposes certain elements that should be reflected in internal models to accurately calculate a counterparty SCR for Funded Re:
 - Probability of default (PD): Firms will need to clearly articulate their data choice for setting PD assumptions for Funded Re transactions and be able to calculate PD in both base and stressed conditions.
 - Loss given default (LGD) and downgrade: Firms will be expected to stress underlying liability cashflows using the same approaches used in the main modules of the internal model when calculating a stressed BEL value.
 - Collateral: Additional expectations are proposed on the recognition of the loss-mitigating effect of collateral, including a requirement on firms to stress underlying collateral portfolios on a look-through basis taking into account key market risks.
- **Quantitative Risk Assessment:** Finally, there is a proposal that firms have a quantitative risk assessment process for funded reinsurance arrangements to inform the firm's internal investment limit framework as part of its investment risk strategy. This would include an approved internal contractual risk appetite statement setting out the maximum acceptable loss at the level of each individual Funded Re contract.

It is clear that the PRA's proposed expectations are comprehensive and cedants will need to demonstrate compliance to convince the PRA that they are adequately equipped to manage the unique risks of Funded Re arrangements.

Implementation and Feedback

The PRA proposes implementing these expectations in Q2 2024. The consultation period is open until February 16, 2024. The PRA has indicated that in the meantime it intends to monitor market practices and we expect that the indication in the Dear CRO letter for firms to notify the PRA promptly of individual material Funded Re transactions still stands and may consider additional measures if needed to address any sector-wide vulnerabilities identified.

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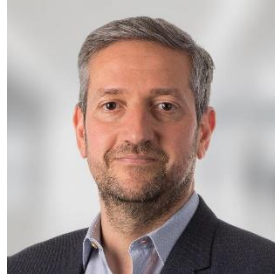
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