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FUNDED RE – PRA SUPERVISORY STATEMENT

Background

On 26 July 2024, the Prudential Regulation Authority ("**PRA**") published its final supervisory statement (SS 5/24) (the "**Supervisory Statement**") on funded reinsurance ("**Funded Re**"). The Supervisory Statement was accompanied by a Dear CEO letter outlining the implementation approach for the Supervisory Statement (the "**Letter**").

The Supervisory Statement followed a consultation on Funded Re arrangements (see PS13/24, the "**Policy Statement**") and consultation paper CP 24/23 ("**Consultation Paper**").

In this briefing note, we focus on the actions that the PRA expects firms engaging in Funded Re to take in order to ensure compliance with the Supervisory Statement and the Letter.

Immediate actions

The PRA has asked UK life insurers using or considering Funded Re to assess their current practices against the expectations set out in the Supervisory Statement.

By 31 October 2024, firms will need to provide their PRA supervisor with:

(a) A self-assessment analysing the firm's current risk management practices against the expectations in the Supervisory Statement, including justification for areas that are not fully aligned.

(b) A summary of the firm's board-approved Funded Re limits for individual counterparties, correlated counterparties, and the aggregate limit. Please refer to the section on "internal investment limits" below for further details.

(c) A summary, with a timeline, of the activities the firm has carried out and plans to carry out to meet the Supervisory Statement expectations.

(d) An overview of the perceived level of confidence in the firm's internal model output at the transaction level, and how this has shaped its Funded Re investment limits.

(e) An overview of the steps the board has taken to limit the firm's risk appetite for the amount and complexity of Funded Re transactions where gaps exist against the PRA's expectations.

Given that less than three months remain until the 31 October deadline, if not already done, firms (and their boards) will be expected to move quickly to identify, any gaps against the SS5/24 expectations, and to approve the various Funded Re limits described below.

On-going risk management and solvency capital requirements

Internal investment limits

Firms must set and maintain three categories of internal investment limits:

(a) limits on Funded Re exposure to an individual reinsurer,

(b) limits on aggregate Funded Re exposure to correlated reinsurers (correlation determined based on similarities of risk profile), and

(c) an aggregate limit on all Funded Re transactions by the firm (i.e. a solvency-based limit).

In calculating these limits, the PRA expects firms to apply an 'immediate recapture' metric i.e., the impact that an immediate recapture of all business ceded to a reinsurers, correlated reinsurers or all Funded Re counterparties, as applicable, is expected to have on firm's solvency capital requirement ("**SCR**") coverage ratio, ignoring the likelihood of such an event. In other words, firms may be required to treat all reinsurers in the same manner, regardless of their financial strength/standing.

The PRA also expects firms to make certain key assumptions when setting the investment limits, as set out in the box below:

Investment Limits – Assumptions

(a) no management actions will be implemented prior to the recapture;

(b) there will be limited to no re-collateralisation of the portfolio by the Funded Re counterparty(ies);

(c) if assumptions in relation to invested limits substitution rights are granted to the Funded Re counterparty(ies), the firms will recapture the 'worst case collateral portfolio';

(d) there will be costs (including for prudent rebalancing and trading) associated with recapture and portfolio management thereafter;

(e) the firm's SCR coverage ratio will be at or around its long-term target levels; and

(f) factors other than external credit ratings impact assessment of the counterparty (i.e. firms should design appropriate counterparty approval and ongoing monitoring processes and not rely solely on changes to external credit ratings for its assessment).

The key guiding PRA principle is that the Funded Re exposure of a firm (either to a single reinsurer or to multiple reinsurers, correlated or otherwise) should not exceed a level such that a recapture of business threatens their business model. Firms must also consider the nature of the collateral they expect to receive on recapture, and whether that would adequately cover the technical provisions and risks recaptured.

When setting the solvency-based limit, firms are also expected to consider their need for a diversified asset strategy as well as operational capabilities on recapture, in particular, the ability to perform the required rebalancing of the asset portfolio, the required hedging activities, and the operational processes associated with the recapture.

Collateral Policy

Firms must have a clear collateral policy which, amongst other things, allows them to formulate an executable recapture plan under stressed conditions, and have a reliable estimate of the impact of recapture. The level of detail in collateral policies should reflect the materiality of exposures, meaning that firms with significant exposures should have more detailed policies. Particular attention is paid to illiquid assets.

Policy for illiquid collateral assets

If Funded Re transactions also involve illiquid assets in the collateral pool, the collateral policy is expected to cover at least the following:

(a) approaches to credit assessment;

(b) valuation methodology by asset class;

(c) matching adjustment ("**MA**") eligibility conditions monitoring;

(d) SCR modelling of the assets; and

(e) investment management approaches on recapture under different circumstances, including consideration of how assets may be managed long term if they cannot be easily sold (i.e. affiliation between the reinsurer and the asset manager needs to be considered).

If a firm intends to assume that it can recapture collateral assets into its MA portfolio, the frequency and details of monitoring should be aligned with the characteristics and materiality of the collateral assets. Firms must develop supporting analysis to demonstrate clearly that, in both prevailing and stressed economic conditions, recapture from a reinsurer would not result in a breach of the MA conditions (including the matching of cash flows).

Recapture plan

All firms entering into Funded Re arrangements must prepare and maintain a recapture plan. Please see the box below for the minimum requirements.

Recapture plans should at a minimum should cover the following:

(a) approaches to monitoring the financial condition of the Funded Re counterparty, and activities to be carried out if a deterioration is identified;

(b) a step-by-step process for achieving the recapture of all the assets and liabilities from relevant counterparties, taking into account all applicable laws;

(c) a step-by-step process for asset transfers by asset class, including contract novation (e.g. derivatives);

(d) actions to ensure MA compliance where recapture into the MA portfolio is assumed;

(e) a step-by-step process for assessing whether ceded business should be recaptured when optional contractual termination event clauses are triggered; and

(f) areas of uncertainty in the recapture process.

The Board is expected to be involved in setting high-level principles guiding the recapture plan and reviewing inherent uncertainties in recapture plan. The level of board involvement should be proportional to the level of risk being taken, meaning that higher-risk scenarios would necessitate more detailed board oversight. Boards are expected to approve:

(a) the recapture plan, as a whole, being proportional to the level of risk being taken, reflecting how internal investment limits have been set and reflecting what potential impacts on a firm's business model have been accepted;

(b) the high-level principles underlying the recapture plan, including a statement on the uncertainties inherent to the recapture process; and

(c) the analysis of potential management actions in the event of a reinsurance recapture.

Firms must analyse their Funded Re exposures at least annually to inform their recapture plans and internal investment limits. Where the exposures are material, a firm should carry out stress testing (specific to its Funded Re) in its own risk and solvency assessment (ORSA) report, which should be informed by the recapture plan and quantitative testing of the outcome of the recapture plan.

Probability of Default ("PD") and Loss Given Default or Downgrade ("LGD")

To accurately calculate a firm's SCR for Funded Re and measure the counterparty credit risk capital charge, the PRA expects certain elements to be reflected in internal models or partial internal models of the firm, such as the PD and LGD in relation to the Funded Re counterparties.

In assessing PD, the PRA expects firms to factor in the following:

(a) Availability of adequate data for assessing the PD.

(b) PD must be calculated both in prevailing conditions and under stress conditions.

(c) The stressed PD must be calibrated so that it is informed by a firm's internal policy on actions it would take if certain contractual triggers are breached. Default, insolvency, occurrence of credit event etc. shall be included as a termination clause in the contracts to demonstrate the reduction in scale and likelihood of large losses on recapture.

(d) The change in solvency ratio of their counterparties under various market stresses, and how this informs their stressed PD.

(e) Any historical data, to see if it captures all risks, including future risks of deterioration of the counterparty conditions.

(f) Private information gathered as part of the internal counterparty approval processes.

(g) Sources of any new business gain on day one, generated by entering a funded reinsurance arrangement.

Similarly, for the purpose of assessing the LGD, the PRA expects the firms to:

(a) Stress the cash flows of the insurance obligations ceded under the Funded Re using the same approaches used in the relevant modules of the internal model or partial internal model.

(b) Consider the impact of deterioration in the credit quality of counterparties as part of the stressed counterparty default adjustment in the context of their reinsurance recoverable, taking into consideration the lifetime of the reinsurance contract.

(c) Consider the impact on the risk margin of the recapture of risks.

(d) Take into account the management actions only when the internal model complies with the relevant SCR requirements.

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

Impact of collateral on SCR calculation

A firm must address the following in calculating the risk-mitigating impact of collateral on its SCR calculation as it relates to Funded Re arrangements:

(a) Collateral portfolios must be stressed on a look-through basis to reflect the risks to which the firms would ultimately be exposed on recapture.

(b) Potential mismatches between the stressed value of the underlying ceded insurance liabilities and the stressed collateral required under the terms of the Funded Re arrangement must be assessed.

(c) 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 reinsurer might not be able to replenish the collateral.

Recapture within MA portfolio

For the purpose of internal models or partial internal models, firms with MA approvals should assume that recaptured assets and liabilities under a Funded Re arrangement will sit outside their MA portfolio unless they can demonstrate that its inclusion would not result in MA non-compliance. MA non-compliance must be assessed in both prevailing as well as stressed economic conditions (taking into account future management actions that can reasonably be expected to be carried out).

If a firm can demonstrate MA compliance on recapture in its MA portfolio, it must still consider rebalancing and trading activities (including associated costs) necessary to achieve MA compliance in its calculations of the SCR.

A firm should assess MA eligibility conditions in line with its own permissions, and not based on the assumption that potential future applications for MA approval will be successful. We assume that the PRA would also expect that MA eligibility is re-assessed based on approved changes to its MA approval itself. Further, where the reinsurance contract sets out broad contractual definitions of MA eligibility conditions that do not match the firm's own MA approvals, a firm is expected to 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.

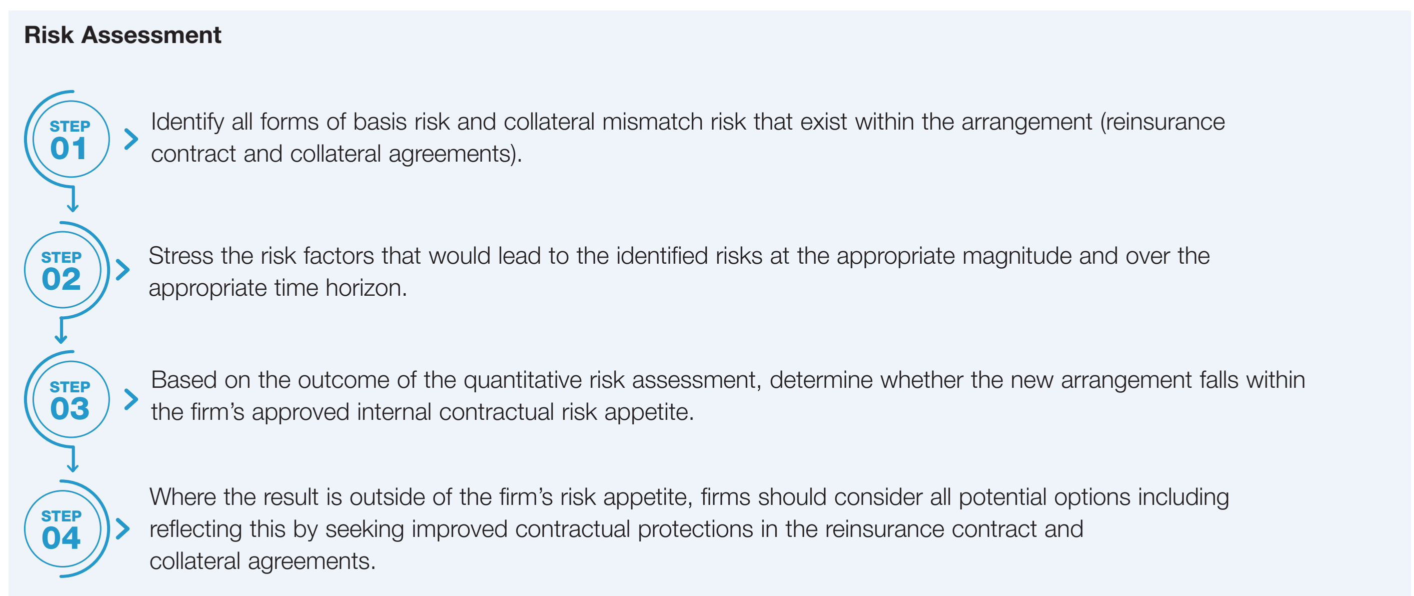
If there is a mismatch between a firm's actual MA approvals and the contractual definition, the firm must (a) clearly reflect in its internal models (through an allowance for mistake) a scenario where non MA eligible assets are included within the collateral portfolio by mistake; and (b) treat all assets in the collateral portfolio for which the insurer does not currently have MA approval as non-MA eligible in their internal models or partial internal models.

Entering into Funded Re arrangements

Risk assessment (including basis risk and collateral mismatch risk)

Firms must have an approved internal contractual risk appetite statement setting out the maximum acceptable loss at the individual funded reinsurance contract level.

As part of the assessment of risks when negotiating funded reinsurance arrangements, a firm 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. For such a quantitative assessment the PRA proposes a four step framework, as set out in the box below:



For the purpose of Step 1 in the framework above, the firm's identification of basis 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. Similarly, a firm's assessment of collateral mismatch risks must include, at the minimum, the impact of simplifications and underlying collateral behaviour.

Time Horizon

Firms must perform a quantitative assessment (as set out in Steps 1 and 2 of "Risk Assessment" section above) under plausible stress scenarios, both for the full life of the contract and on early termination. Large shortfalls can be expected to emerge at recapture where firms undertake margining only on an infrequent basis, and the firms must consider this risk at the time of agreeing terms with the reinsurer.

Contractual Mitigants

Firms must have internally approved minimum guidelines on contractual features for Funded Re transactions, which they should apply when deciding whether to enter into a Funded Re arrangement. This would include, but is not limited to, the approaches to the items shown in the box below:

Contractual Terms

- termination clauses,
- substitution rights for collateral assets,
- valuation approaches,
- concentration limits,
- choice of applicable law, and
- investment guidelines.

The rationale behind the minimum guidelines should also be documented in the firm's policy.

The PRA also expects firms to use clear risk based collateral haircuts or over collateralisation linked to the risk being addressed (please see box below for requirements). However, where the risks relate to the specific assets in the collateral pool, the asset specific risk-based haircuts (rather than general over collateralisation) is expected to be used. Over collateralisation may be appropriate for risks that are not asset specific such as liability risks and asset liability mismatch risks.

Haircuts and over-collateralisation:

(a) should be 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 the firms approved internal risk appetite;

(b) 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;

(c) 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;

(d) are calibrated at a high confidence level, using a long historical time period that includes at least one stress period;

(e) are calibrated to incentivise the correct behaviours on the counterparty; and

(f) (only in respect of haircuts) should be based on the market risks of the assets defined as eligible under the collateral agreement.

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