SLAUGHTER AND MAY/

INSURANCE BRIEFING

July 2024

FUNDED REINSURANCE - PRA FINAL POLICY

On 26 July the PRA published PS13/24, setting out feedback to CP24/23 - Funded reinsurance, together with a final supervisory statement (SS5/24) and accompanying Dear CEO letter.

The new policy expectations set out in SS5/24 came into effect immediately. The Dear CEO letter requires firms using FundedRe to provide a number of pieces of information to the PRA by **31 October**, including an assessment of the firm's risk management practices against the expectations in the supervisory statement.

Dear CEO letter

The Dear CEO letter sets out some important points regarding the PRA's attitude towards funded reinsurance ("FundedRe") arrangements and its expectations of firms in implementing the requirements of SS5/24. Key messages include:

- the PRA remains concerned that the current growth in FundedRe transactions by UK life insurers could, if not controlled properly, lead to a rapid build-up of risks in the sector, for example through underestimation of counterparty risks in insurer balance sheets or recapture risks on counterparty default
- the PRA considers that insurers need to make further improvements in their risk management practices for FundedRe transactions to meet the PRA's expectations
- the PRA will monitor closely the volume of FundedRe transactions, any change in the quality of collateral and counterparties, and firms' progress to implement its expectations - and the PRA's next life insurance stress test (due to launch in January 2025) will incorporate a FundedRe recapture event
- if the PRA considers that firms are not meeting the expectations set out in the supervisory statement it will consider taking further action, which could include: (i) exercising its supervisory powers under section 55M of FSMA to impose requirements on firms; and (ii) introducing explicit regulatory restrictions on the amount and structure of FundedRe, or measures to address any underestimation of risk inherent in the transactions. The latter could, presumably, include some kind of SCR adjustment for firms engaging in FundedRe.

The PRA expects boards of firms using (or considering using) FundedRe to consider the implications of SS5/24 and provide the following to their PRA supervisor by 31 October 2024:

- <u>**A "self assessment analysis"**</u>: an assessment of the firm's current risk management practices against all the expectations set out in SS5/24. This should include a justification if there are areas where the firm has not aligned fully with the expectations of the supervisory statement but where the firm's implemented framework is considered to achieve the same outcome

- **Limits**: a summary table of the firm's board-approved FundedRe limits for individual and correlated counterparties and the firm's aggregate limit
- **Remediation activities**: a summary of the activities the firm has carried out and intends to carry out to meet the expectations set out in SS5/24
- **Level of confidence in the modelling**: an overview of the perceived level of confidence achieved in the firm's internal model output, at a transaction level, and how this has been used to shape the firm's FundedRe investment limits (see further discussion below)
- **Risk appetite**: an overview of what steps the board has taken to limit its risk appetite for the amount and complexity of FundedRe transactions over the coming months, where gaps exist against the expectations set out in SS5/24.

The assessment should be informed by an independent opinion from the firm's risk function.

The PRA observes that feedback to CP24/23 suggested a high level of uncertainty in the probability and potential size of losses to which insurers are exposed when entering into FundedRe transactions. The PRA proposes that the size and structure of transactions therefore need to be limited so that the impact of recapture is capable of being reliably estimated, particularly in stress conditions. This is reflected in the requirement for firms to confirm to their supervisor the level of confidence in the modelling of relevant transactions and in adjustments made to the final version of SS5/24, as discussed below.

PS13/24 and SS5/24

We discussed the PRA's original proposals in our **November briefing**. It published those proposals (in **CP24/23**) after having identified what it considered to be significant potential risks with the systematic use of FundedRe by UK insurers to meet increased demand in the bulk annuity market

Key points included: limits on exposures to single or highly correlated counterparties; requirements for collateral policies and recapture plans; and restrictions on the extent to which firms can assume that assets will be recaptured within the MA portfolio when calculating the SCR.

The PRA has made a number of changes in response to feedback but the core policy remains the same. Most notably, the PRA has made amendments to the draft supervisory statement to emphasize that (in the context of modelling counterparty risk) if firms identify areas of uncertainty in their modelling then they would be expected to consider this in their risk management system - for example, by limiting exposure to factors which increase the level of uncertainty. It states that this reflects consultation responses which focus on the uncertainties in the modelling of risks associated with funded reinsurance. This point is also highlighted in the Dear CEO letter, as mentioned above.

Other key points from the policy statement include:

Risk management

- A number of respondents queried the proposal that investment limits should be considered on a pre-management actions basis, and suggested that the limits should reflect actions that could reasonably be achieved under stresses. The PRA has rejected this proposal on the basis that the limit should capture the maximum possible loss
- The PRA has included a clarification in the final supervisory statement acknowledging that there may exist diversification benefits between different counterparties and different risk exposures, but noting that firms should be prudent in recognising these benefits

- In response to feedback, the PRA has amended the supervisory statement to provide that board involvement is expected in setting the high level principles underlying recapture plans, rather than every individual element
- A number of amendments have been made by the PRA to the collateral policy expectations. These include:
    - clarification that the level of detail in the collateral policy should reflect the materiality of exposures and that ongoing monitoring of collateral should reflect the characteristics and materiality of the collateral assets
    - additional detail on factors which could lead to an asset being considered illiquid
    - clarification that the collateral policy may refer to existing methodologies or other documentation

The Solvency Capital Requirement

- Several respondents challenged the introduction of a requirement for firms to analyse counterparty solvency ratios under stress as part of the SCR calculation but the PRA has chosen not to make any change to this expectation

Entering into and structuring of FundedRe arrangements

- In light of consultation responses, the PRA has added further detail in respect of its expectations for collateral haircuts. The PRA expects that asset-specific risk-based haircuts (rather than general over collateralisation) will be used where the risks relate to the specific assets in the collateral pool. Over collateralisation may be appropriate for risks that are not asset-specific, such as liability risks and asset liability mismatch risks
- Some further detail is also included on minimum expectations for the haircut and over collateralisation policy, including in respect of:
    - calibration to ensure that the risk of a shortfall in the realisable value of collateral is within the firm's risk appetite
    - allowance for expected volatility of key risk factors
    - capturing of broader risk considerations that affect the value of collateral and of the reinsurer's obligations in the event of default (including the impact of wrong way risks and cash flow mismatches)
    - the time period over which haircuts and over collateralisation should be calibrated

General

- The PRA has made a number of adjustments to the supervisory statement to highlight appropriate application of proportionality and materiality considerations.

Next steps

The new policy expectations set out in SS5/24 came into effect immediately and the PRA commented in the Dear CEO letter that "we expect your board to have considered your alignment with the supervisory statement as soon as practicable". Firms will need to submit the information required by the Dear CEO letter to the PRA by 31 October.

It is worth noting that, as clarified in the policy statement, the supervisory statement applies to existing as well as future arrangements. The PRA does not expect firms to renegotiate the terms of contracts already entered into as a matter of course but they should assess the risks of existing arrangements against the expectations in Chapter 4 of SS5/24 (Entering into and structuring of funded reinsurance arrangements) if such an analysis has not already been carried out, to ensure that they are appropriately aware of any resulting risks for risk management and internal model purposes.

CONTACT

JONATHAN MARKS
PARTNER
T: 020 7090 3056
E:jonathan.marks@slaughterandmay.com

THOMAS PEACOCK
PARTNER
T: 020 7090 4256
E: thomas.peacock@slaughterandmay.com

CAROLINE PHILLIPS
PARTNER
T: 020 7090 3884
E: caroline.phillips@slaughterandmay.com

BETH DOBSON
PSL COUNSEL
T:020 7090 3070
E: beth.dobson@slaughterandmay.com

NICK BONSALL
PARTNER
T:020 7090 4276
E: nick.bonsall@slaughterandmay.com

JAMES COSTI
SENIOR COUNSEL
T:020 7090 5375
E: james.costi@slaughterandmay.com

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650

www.slaughterandmay.com