In late July 2024, the UK Prudential Regulation Authority (PRA) published a Dear CEO letter alongside policy statement PS13/24 and supervisory statement SS5/24. In combination, these documents set out the PRA's expectations on the implementation approach for ceding insurers using Funded Reinsurance (or FundedRe) as a means of risk management.

The recently formed IFoA Working Party on UK Funded Reinsurance has been assessing key elements of the PRA's pronouncements. This short note does not intend to be exhaustive in nature, but sets out an overview of these aspects.

1. What is FundedRe?

Funded reinsurance is a well-established form of reassurance deployed by holders of asset-intensive risk. In the context of the UK bulk annuities market, a typical FundedRe arrangement involves the insurer ceding the longevity and investment risk (usually a combination of credit and market risk) for a block of business to a reinsurer. Although the FundedRe moniker has most recently stuck, this type of arrangement is also known as quota share reinsurance or asset intensive reinsurance.

In recent years in the UK, there has been a growing use of FundedRe by insurers active in the growing bulk annuities (or pension risk transfer) market. With an eye on providing pension schemes looking to de-risk with a greater level of capacity, FundedRe is a means of insurers managing their capital position and asset sourcing requirements. It is a form of risk management that transfers the majority of the risk associated with the insured business and replaces it with counterparty risk exposure to the reinsurer. Reinsurers see FundedRe as an attractive method of deploying capital and investment capabilities to access new business opportunities in the UK bulk annuities market.

2. Why is the PRA concerned?

The PRA has increased their focus on FundedRe following the significant increase in its use by UK insurers in the past few years. In this note, we focus on the following three broad areas of concern:

(i) **Counterparty Limits**: The robustness of insurance firms' controls on the extent of the use of FundedRe.

(ii) **Collateral policy and counterparty SCR calculations**: The quality and quantity of the collateral provided by the reinsurer to the insurer as security against the liabilities reinsured, alongside the quantum of the capital held by ceding firms against the risk of the reinsurer defaulting.

(iii) **Recapture Plan**: The robustness and governance around ceding firms' recapture plans, which set out the proposed actions if one or more of their reinsurance counterparties were to default.

3. What are the key elements of the PRA's expectations of UK insurers using FundedRe?

Overall, the PRA has maintained a prudent approach to FundedRe and has clarified expectations in a number of areas. Firms are being asked to review their risk management approach, transaction volume, and choice of reinsurance counterparties for FundedRe transactions.

(a) Counterparty Limits

- *Quantifying exposure to reinsurers*
    - The PRA expects firms to consider the impact of an immediate recapture of the ceded liabilities (and associated collateral) on technical provisions. This approach expressly excludes the ability of firms to recognise any management actions (such as arranging replacement reinsurance or closure to new business) in their assessment of exposure to reinsurers.
    - In addition, firms are expected to measure the exposure in stressed conditions (i.e. where both the collateral asset and the liabilities are stressed) to consider risks in the tail, beyond the 1-in-200 confidence level over one year.
    - Firms will be expected to review their exposures at least annually.
- *Counterparty limit framework*
    - The PRA expects a three-tier approach in setting counterparty limits. The focus is on counterparty limits for default of a single counterparty based on an immediate recapture impact (as set out above). Additional limits are expected for a simultaneous recapture of multiple correlated counterparties, and a solvency-based overall aggregate limit for FundedRe exposure. Insurers will need to consider different limits, or limits sets to a different confidence level, when considering correlated counterparties, and the aggregate FundedRe position.
    - The PRA says firms should avoid taking large exposures where upon recapture it may need to take management actions which would be a threat to the firm's business model (and expressly identifies cessation of new business as such a management action).
    - The PRA expects firms to set limits considering the long-term SCR coverage ratio target to prevent scenarios where a short-term heightened SCR position leads to higher limits allocated to counterparties in the near term.
- *Assessing counterparties*
    - The PRA places stronger emphasis on avoiding overexposure and excessive reliance on a single counterparty or arrangement. This could be seen as the PRA encouraging a wider panel of diversified reinsurers, and avoiding overuse of monoline reinsurers i.e. those entities whose balance sheets have limited levels of risk diversification.
    - The PRA expects insurers to focus on the underlying risk profile of counterparties, measured by diversified capital requirements, rather than solely considering the credit rating of the counterparties.
    - Firms can consider the potential benefits of diversification in three areas: (i) Cedant vs Counterparty risk profile (ii) Collateral vs Counterparty Assets and (iii) Collateral vs Cedant Assets.

(b) Collateral policy & counterparty SCR calculations

- *Collateral Policy*

- The PRA expects firms to have clear collateral policies in place as part of their risk management framework, which should allow firms to formulate an executable recapture plan under stressed conditions. The policies are expected to cover, for example, clear risk-based asset specific haircuts and/or over-collateralisation linked to the risk being addressed (such as liability risks).

- The PRA accepts that firms can continue to accept illiquid assets in collateral but expects firms to have a detailed collateral policy for these assets with the level of detail proportionate to the materiality of the exposures. The policy should cover at a minimum: valuation methodology by asset class, credit assessment, matching adjustment ("MA") eligibility conditions monitoring, SCR modelling and investment management approach on recapture under different circumstances.

- *Specific requirements for firms with MA approval*

  - Firms with MA approval must ensure ongoing MA compliance of collateral assets to assume MA eligibility upon recapture and maintain MA compliance under current and stressed scenarios.

  - The PRA expects firms to prudently weigh up the benefits of including non-MA eligible assets (for example) in collateral against the potential increased risks on recapture (such as, transforming the assets into MA eligible assets).

- *SCR calculation and the risk mitigating impact of collateral*

  - In determining the counterparty SCR, the PRA expects a number of elements to be considered for firms using an internal model or partial internal model. In the context of calculating a probability of default of a reinsurance counterparty, these requirements include considering the quality of their data sources and analysing the solvency ratio of counterparties under various market stresses. Where data driven probability of default is insufficient, the PRA expects firms to consider a notching down of the rating of the relevant counterparty.

  - When assessing the risk mitigating impact of collateral under SCR, the PRA expects firms to stress assets on a look-through basis, adopt prudent re-collateralisation assumptions, and consider mismatch and basis risk. The PRA also specifies that the assessment of the collateral mismatch should consider the discount curve applied to the ceded liability cashflows used to determine the required collateral amount.

  - Regarding management actions, PRA makes it clear that firms can take credit for these only where certain specific requirements are satisfied, including where they can reasonably be expected to be carried out.

(c) Recapture plan

- *Governance & Board involvement*

  - The PRA's expectation for Board involvement in FundedRe recapture plans has been further clarified. Board approval is now expected for high-level principles, statements of uncertainty, management actions, and associated analysis in the event of recapture.

- The PRA acknowledges that firms can be proportionate in relation to setting a framework regarding which changes and updates to the recapture plan need to be approved by the Board.

- *Content of recapture plan*

    - Insurers will need to consider whether their current recapture plans (where they exist) reflect the PRA's expectations for recapture plans. This may involve reviewing existing FundedRe arrangements and historic risk assessments when deals were executed, including assessing the financial and non-financial resources available in a stressed recapture event.

    - The PRA expects firms' analysis of risks arising from funded reinsurance to demonstrate with a high level of confidence that the firm can withstand in a viable form either a single recapture event or multiple recapture events involving highly correlated counterparties. The PRA expects firms to set out detailed steps in their recapture plan, including the treatment of assets and liabilities and annual stress testing in respect of FundedRe to the overall ORSA calculation.

    - Reinsurers may need to further consider structures and protections that meet the PRA expectations on recapture planning which may not be the most optimal structure from a reinsurer's perspective.

4. What is the likely impact on market participants?

Insurers' current approach to managing the risks arising from their use of FundedRe will vary, with each adopting a different framework based on their internal risk management policies and appetite. As a general matter, industry professionals suggest that the PRA's expectations will not significantly alter either the approach of insurers or reinsurers in relation to FundedRe activities to support the growth of the UK bulk annuities market. Indeed, we expect the industry to welcome the relative consistency that the PRA's expectations would set.

Firms are required to provide the PRA with a self-assessment of the firm's current risk management practices against all of the expectations set out in SS5/24 by 31 October. UK insurers are therefore analysing their current collateral policies, identifying any gaps in alignment with the expectations of the SS, and putting in place any remedial activities that may be required.

We identify five elements which we believe may have a tangible effect on market participants:

(i) *Exposure quantification in stress*: Stress testing 'beyond the 1-in-200' is likely to create some uncertainty and potential inconsistency in how individual firms assess their exposures. The PRA mentions that a range of scenarios need to be considered covering the whole distribution of the risk in the tail. This is likely to be computationally difficult to undertake for each individual FundedRe arrangement.

(ii) *Aggregate counterparty limit*: It is possible that the introduction of an aggregate limit on FundedRe will curb the overall level of reinsurance capacity that is available to each insurer and, by extension, the market. A lower level of implied capital and asset sourcing provided to the bulk annuities market may impact the attractiveness of pricing for pension schemes and/or the ability to support the demand from pension schemes to de-risk.

(iii) *Assessment of counterparties*: In order to enable insurers to assess the relative correlation of reinsurers, it is likely that reinsurers will need to provide further information to their insurer counterparties (some of which would potentially be non-public). This may be more difficult for listed reinsurers where such information may be considered market sensitive.

(iv) *Counterparty SCR calculation*: The modelling approach suggested by the PRA in relation to the probability of default assigned to a reinsurance counterparty, particular in relation to how the reinsurer's solvency ratio moves in different market environments, is likely to be an onerous undertaking. The PRA have, however, clarified that they expect the approach adopted by firms to be proportionate.

(v) *MA eligibility of collateral assets:* The PRA's expectations around firms' risk management policies in relation to the MA eligibility of collateral assets adds complexity for firms that allow non-MA eligible assets in collateral or assets outside their current MA permissions, especially for FundedRe transactions material in size when compared to the firm's overall MA portfolio. In addition, modelling collateral assets within the MA poses additional challenges, as firms must demonstrate MA compliance under prevailing and stressed conditions, account for prudent asset rebalancing, and consider associated costs (such as trading and hedging costs) in calculating the MA when allowing such assets.