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The PRA Tightens Expectations for Funded Reinsurance for the UK Bulk Purchase Annuity Market

Background

On 16 November 2023, the UK Prudential Regulatory Authority (PRA) released draft measures to address perceived risks in the market for funded reinsurance, which is widely used as part of transactions that shift pension scheme liabilities to insurers.

The bulk purchase annuity (BPA) market, in which UK defined-benefit pension schemes offload liabilities and assets to specialised life insurance carriers, continues to expand. Industry estimates predict that the UK life insurance industry could take on more than £600 billion of pension liabilities and associated assets over the coming decade.

To support this expansion, life insurers are making increased use of funded reinsurance, which reduces the capital strain on insurers compared to a traditional reinsurance strategy of reinsuring longevity risk and retaining asset risk. Insurers are also constrained by asset origination capabilities and the level of price competition in the market.

In funded reinsurance (sometimes referred to as asset-intensive or asset-backed reinsurance), relevant pension scheme assets travel up to the reinsurer as premium, and the reinsurance constitutes the sole recourse of the cedant with respect of the liabilities reinsured. In many cases, the reinsurance arrangement is essential to the ability of the cedant carrier to enter into the BPA transaction in the first place. Funded reinsurance is akin to a quota share reinsurance treaty in a property and casualty context, whereby the reinsurer takes on risk holistically.

Importantly for the reinsurer, funded reinsurance involves a much larger premium than a conventional longevity reinsurance, giving the reinsurer a significant pool of assets to invest. That is particularly attractive for reinsurers associated with large alternative asset managers. Reinsurers active in this market are often based offshore in Bermuda, although a significant number are in the US.

The PRA has observed that insurers are making increased use of cross-border funded reinsurance arrangements. They have particularly noted the emergence of new reinsurers:

- associated with alternative asset managers, whose business models are more heavily driven by investment in private credit assets (and real estate/infrastructure) and who have a lower appetite for insurance risks, or
- existing reinsurers whose business models may leave them increasingly exposed to a small number of reinsurance counterparties (or related collateral pots).

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These trends have also been noted by international institutions such as the International Association of Insurance Supervisors (IAIS) and International Monetary Fund (the IMF).

Earlier this year, the PRA concluded a thematic review of the use of funded reinsurance that is driving this BPA activity. See our 9 May 2023 alert "The UK PRA Warns the Bulk Purchase Annuity Market" and our 30 January 2023 alert "The UK PRA's Priorities for Insurance Supervision in 2023".

The 16 November 2023 proposals follow on the thematic review. They can be viewed as a "turning of the screw" on these transactions, requiring firms to self-assess thoroughly whether each reinsurance arrangement is likely to meet the PRA's concerns, in particular around counterparty and concentration risks.

We summarise these as follows.

1. Counterparty internal investment limits

The PRA proposes that insurers set limits on their exposure to funded reinsurance counterparties. These should apply not just to an individual counterparty (independently of other counterparties in the market), but also to multiple highly correlated counterparties, together with an aggregate limit focused on the insurer's own need for a diversified asset strategy.

These limits are designed to ensure that an insurer's exposure to funded reinsurance counterparties is limited to a level that does not threaten the insurer's ongoing business model viability in the event the reinsurance is terminated (otherwise referred to as recapture), both on an individual idiosyncratic basis and across multiple highly correlated counterparties (in a multiple reinsurer failure scenario).

The concern around concentration relates to reinsurers whose business models may be correlated to each other and to broader credit conditions, especially in times of stress (*e.g.*, they are investing heavily in private credit or other alternative assets and have an ownership whose fortunes are linked to the private credit or other alternative markets).

2. Collateral policy

In a funded reinsurance transaction, the collateral should represent the discounted value of the liability cash flows payable to the insurer. The size of this collateral in a funded reinsurance transaction is large. It is present from inception and will be posted to the cedant insurer.

The PRA proposes that insurers should have clear collateral policies in place as part of their risk management policies closely linked to their risk appetite. These would, at a minimum, detail approaches to credit assessments, valuation methodologies, matching adjustment (MA) eligibility monitoring, solvency capital requirement (SCR) modelling, and investment management approaches on recapture.

Particular concerns are expressed about the increasing use of illiquid assets as collateral, especially where insurers are assuming that illiquid collateral assets would be recaptured into MA portfolios. The PRA says there is increased uncertainty about the valuation of privately sourced illiquid assets and their associated credit risk, particularly in a stress scenario. There will be additional expectations for insurers assuming the MA eligibility of recaptured assets, to ensure that such a recapture would not result in a breach of MA conditions under base or stressed scenarios.

The PRA expects that insurers will take into account any rebalancing and trading activities necessary to achieve compliance with the MA conditions on recapture. Where MA eligibility is dependent on assumed management actions, the PRA expects insurers to demonstrate the market feasibility of these management actions under stress, and that they have the operational readiness and capabilities required to perform the management actions in stress.

There is a concern that keen price competition in the BPA market raises the risk of reduced standards for funded reinsurance as insurers compete for contracts. This may encourage a reduction in the quality of the reinsurance collateral agreed with counterparties. The PRA is worried that this competitive pressure leads insurers to enter funded reinsurance deals that expose them to assets that are inappropriate to back their liabilities, or where associated risks are not properly considered. In addition, the regulators say these risks may compound across the sector, creating a systemic issue.

3. Recapture plans

The PRA is concerned that the possibility of a funded reinsurance arrangement being recaptured is often assumed by insurers to be remote and/or far in the future, and so the risks associated with the recapture may not be fully priced into transactions or appropriately managed.

Consequentially, the PRA proposes that insurers formulate and document a step-by-step recapture plan for their funded reinsurance arrangements, clearly defining the collateral to be recaptured, taking into account all applicable governing laws. This would include an "immediate recapture" metric to measure the impact on the firm's SCR coverage ratio in a scenario where all ceded business with a counterparty is recaptured, ignoring the likelihood of such an event. The potential impact of mitigating management actions should be omitted to provide management the gross view of the risks they are facing, and to allow for the time it may take to implement mitigating actions, under stress.

Where the MA is used, insurers should assume that assets and liabilities associated with funded reinsurance contracts are recaptured outside of an MA portfolio, unless they are able to clearly demonstrate that such an inclusion would not result in non-compliance with the MA conditions under both base and stressed scenarios.

4. Internal model/SCR

The PRA proposes that the following components be reflected in an insurer's internal model (where applicable) to address the known uncertainties inherent to funded reinsurance arrangements.

Probability of default (PD). Insurers should clearly articulate their data choice for setting PD assumptions for funded reinsurance arrangements, to include:

- whether the data adequately reflects the counterparty's business model;
- contractual events of default in the relevant instruments; and
- wider considerations, such as the likelihood of regulatory intervention, ahead of insolvency.

This concern arises in part from the nature of reinsurance counterparties with newer business models and, in most instances, an absence of directly relevant historical data. The use of proxies from the corporate bond market or other listed markets may not reflect all the specificities of funded reinsurance counterparties.

Loss given default (LGD) and downgrade. Insurers should stress, when calculating a stressed best estimate liability (BEL) value, the underlying liability cashflows using the same approaches used in the main modules of the internal model. The PRA also expects firms to be able to demonstrate that their internal models or partial internal models capture "wrong-way" risk.

Collateral. Insurers should:

- stress their underlying collateral portfolios on a look-through basis, taking into account key market risks;
- consider where mismatches between collateral and underlying liabilities may arise under stress; and
- make prudent assumptions around the ability of counterparties to re-collateralise in stressed conditions.

Insurers should also maintain a risk-based collateral haircut policy providing, at a minimum, that haircuts:

- capture and move in line with key risk drivers that are relevant in the transactions. This includes price volatility (if assets are not intended to be, or cannot be, retained) and currency volatility (if the risk is not hedged).
- capture other broader risk considerations, where relevant. This includes but is not limited to wrong-way risks and cash flow mismatches.
- are based on the market risks of the assets defined as eligible under the collateral agreement.
- are calibrated at a high confidence level, using a long historical time period that includes at least one stress period.
- are calibrated to incentivise correct behaviour on the part of the counterparty.

The PRA notes that changes to an insurer's internal model may have to be approved by the PRA before it enters into a material contract with a reinsurer on a funded reinsurance basis.

5. Entry into and structuring of funded reinsurance arrangements.

Insurers should avoid a "pass-or-fail" approach to their reinsurance structuring as part of their internal risk appetite framework. Instead, insurers should maintain a quantitative risk assessment for a given trade:

- setting out the maximum acceptable loss at the individual funded reinsurance contract level.
- as a minimum, reflecting all forms of basis and collateral mismatch risk and include stressing risk factors that would lead to significant basis and collateral mismatch risk over an appropriate time horizon.

Firms should also maintain internally approved minimum guidelines on contractual features for funded reinsurance transactions including, as a minimum, approaches to:

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

Conclusion

In summary, firms can expect a significantly enhanced degree of regulatory oversight of funded reinsurance arrangements. The combined effect of this plethora of regulatory expectations is that, in practice, a deal will not go through unless and until the PRA is satisfied in the round. Thus, regulatory engagement and the possibility of challenge will clearly need to be built into the transaction timetable.

Insurers will also need to invest in compliance policies and personnel ahead of time. Clearly, it will make sense to develop and agree on these policies with the PRA in advance in order to pave the way towards their implementation in an actual deal.