

Life Insurance firms
For the attention of CEOs

Gareth Truran
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Dear [CEO]

Supervisory statement (SS) 5/24 – Funded reinsurance: Implementation approach

The Prudential Regulation Authority (PRA) is publishing today policy statement (PS)13/24 – Funded reinsurance,¹ containing feedback on consultation paper (CP)24/23² and the final text of our new policy expectations in SS5/24 – Funded Reinsurance ('FundedRe'). These expectations come into effect today, 26 July 2024. I am writing to draw your attention to the final policy, share some insights gained from the consultation process and explain how we expect firms who use Funded Re to assess their practices against the expectations set out in the Supervisory Statement.

As we have set out previously,³ the PRA is concerned that the current growth in FundedRe transactions by UK life insurers could, if not properly controlled, lead to a rapid build-up of risks in the sector. This could arise through underestimation of the counterparty risks on UK insurers' balance sheets, the capital requirements appropriate

¹ www.bankofengland.co.uk/prudential-regulation/publication/2024/july/funded-reinsurance-policy-statement.

² www.bankofengland.co.uk/prudential-regulation/publication/2023/november/funded-reinsurance-consultation-paper.

³ Letter from Charlotte Gerken 'Feedback on the PRA's preliminary thematic review work on funded reinsurance arrangements'. Available at: www.bankofengland.co.uk/prudential-regulation/letter/2023/june/thematic-review-work-on-funded-reinsurance-arrangements.



for these risks, or the risks of recapture of assets onto cedants' balance sheets if a FundedRe counterparty were to default.

Since our thematic work last year and the publication of CP24/23, we have seen some evidence through our supervisory work of firms developing and improving their risk management practices for these transactions, including their exposure limit frameworks, recapture plans, and internal models. However, we consider that further improvements are still needed by UK insurers to meet our policies and expectations, including those set out in SS5/24. Without material improvements, the PRA is concerned that UK insurers may use FundedRe, in volume and complexity, in a way that is not consistent with prudent risk management.

The PRA will continue to monitor market practice and assess the risks to its objectives from this market over the coming months, taking into account growth of FundedRe in individual firms and the market as a whole. In particular, we will monitor closely the volume of FundedRe transacted by firms, any change in the quality of the collateral and the nature of FundedRe counterparties active in the market, and the progress firms make in implementing risk management and control arrangements in line with SS5/24. The PRA's next life insurance stress test (LIST 2025)⁴ will also incorporate a FundedRe recapture event, and information gathered through this exercise will also help inform our views on the development in the market.

If, in future, we consider that firms are not achieving our expectations on the risk management practices needed to mitigate the risks FundedRe poses to our objectives, we will consider whether it is appropriate to take further action such as exercising any of our powers under the Financial Services and Markets Act (FSMA) 2000 to address those risks, including supervisory powers under section 55M and rule-making powers. This could include, for example, consideration of explicit regulatory restrictions on the amount and structure of FundedRe, or measures to address any underestimation of risk, or regulatory arbitrage, inherent in these transactions.

Feedback from the consultation

Our final policy expectations for FundedRe emphasise the importance of firms having in place appropriate risk management arrangements such as individual and aggregate limits, collateral policies, and plans to recapture assets from FundedRe counterparties in the event of stress. They also set expectations on firms' solvency capital requirements for such transactions, and for firms' decision-making processes when structuring and entering into new FundedRe transactions.

⁴ www.bankofengland.co.uk/prudential-regulation/publication/2024/july/list-2025.

Responses to CP24/23, particularly in the Solvency Capital Requirement (SCR) chapter of the SS, demonstrated the particularly high level of uncertainty in the probability and potential size of losses to which insurers are exposed when entering into FundedRe transactions. This uncertainty is driven by the complexity and opacity of the arrangements and the tail nature of the risks, together with the absence of adequate public, historic or forward-looking data on FundedRe counterparty credit risk, particularly in stress conditions.

It is essential that firms who have entered into FundedRe transactions are able to demonstrate, with a high degree of confidence, that they can withstand, in a viable form, either a single recapture event or multiple recapture events involving highly correlated reinsurance counterparties. For this to be possible, the size and structure of transactions needs to be limited in such a way that the financial and non-financial impact of recapture is capable of being reliably estimated, particularly in stress. This can then be compared to the financial resources likely to be available to the firm in such stressed conditions.

If such an outcome cannot reliably be estimated by firms, other safeguards in the form of tighter limits in the size and structure of transactions, need to be in place. The fact that respondents have noted the challenges in achieving a high level of confidence in their estimation of potential losses from FundedRe arrangements underlines our concerns about these transactions. SS5/24 therefore sets out how the PRA expects firms to adopt a prudent risk appetite for FundedRe, alongside a particularly strong risk management framework, which takes into consideration the increased uncertainty outlined in this letter. We consider that a strong investment limit framework, with limited subjectivity, is an essential guardrail.

Implementation

The Prudent Person Principle (PPP), on which a majority of the expectations in SS5/24 are anchored, applies to the management of existing FundedRe arrangements as well as to future FundedRe exposures that firms are considering entering into.⁵

The SS is effective immediately. If your firm makes use of FundedRe transactions, or is considering doing so, we expect your board to have considered your alignment with the SS as soon as practicable. In the interim firms and their boards should be particularly mindful of its expectations before entering into new FundedRe arrangements.

To allow us to assess firms' current position against our expectations, we expect the boards of UK life insurers using, or considering using, FundedRe to consider the

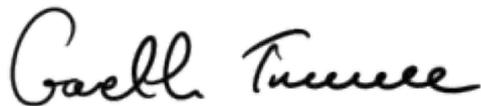
⁵ www.prarulebook.co.uk/prarules/investments.

implications of SS5/24 and to provide their PRA supervisor, by 31 October 2024, with the following:

1. **Self Assessment analysis:** An assessment of your 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 your firm has not aligned fully with the expectations of the SS but where its implemented framework is considered to achieve the same outcome.
2. **Limits:** A summary table of your firm's board approved FundedRe limits for individual counterparties, for correlated counterparties and your firm's aggregate limit.
3. **Remediation activities:** A summary, including a timeline consistent with the implementation approach detailed in the previous section, of the activities that your firm has carried out and intends to carry out to meet the expectations set out in SS5/24.
4. **Level of confidence in the modelling:** An overview of the perceived level of confidence achieved in your internal model output, at a transaction level, and how this has been used to shape your FundedRe investment limits.
5. **Risk appetite:** An overview of what steps your 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.

We will expect the board's assessment of these issues to be informed by an independent opinion from your Risk function. Your responses will be used to inform both our supervisory engagement with you on these issues over the coming months, and the PRA's assessment of the case for further measures in this area.

Yours faithfully



Gareth Truran
Executive Director, Insurance Supervision