

Supervisory Statement | SS20/16

Solvency II: reinsurance – counterparty credit risk

May 2024

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BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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1. Introduction

1.1 This supervisory statement (SS) is addressed to all UK firms that fall within the scope of the Solvency II Directive ('the Directive')¹, third-country insurance branch undertakings and to Lloyd's. It sets out the Prudential Regulation Authority's (PRA) expectations of firms with respect to general issues regarding reinsurance and the management of reinsurance counterparty credit risk.

1.2 This statement should be read in conjunction with the PRA's rules in the Solvency II Sector of the PRA Rulebook, and the PRA's insurance approach document.²

1.3 This SS expands on the PRA's general approach as set out in its insurance approach document. By clearly and consistently explaining its expectations of firms in relation to the particular areas addressed, the PRA seeks to advance its statutory objectives of ensuring the safety and soundness of the firms it regulates and contributing to securing an appropriate degree of protection for policyholders.

2. General considerations

2.1 The PRA recognises that reinsurance can be an important part of risk management. As firms decide on appropriate reinsurance to place, the PRA expects boards to:

- understand the risk transfer taking place;
- ensure that the economic impact is adequately reflected in business planning, capital setting and reserving; and
- appreciate the wider associated risks to which reinsurance placements can give rise.

2.2 The PRA is aware that complex reinsurance arrangements exist in the market. For these, as for all reinsurance contracts, the PRA expects appropriate treatment, both in terms of: (a) whether there is an effective transfer of risk; and (b) the appropriate solvency capital requirement (SCR) treatment, recognising the scope of the risk transfer and the counterparty credit risk. Boards should satisfy themselves that the methodology chosen to calculate the SCR, whether that be the standard formula or an internal model, continues to remain appropriate for the firm's risk profile.

2.3 Additionally, the PRA expects firms' risk management systems to be sufficiently robust to ensure that the level of risk transfer arising is reflected appropriately within their SCR

¹ Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast).

² Available at www.bankofengland.co.uk/publications/Pages/other/prasupervisoryapproach.aspx.

requirements, and that the total uncertainty and risk over the time horizon of the run-off of the obligations of both life and non-life firms has been considered within the own risk and solvency assessment (ORSA).³

3. Counterparty credit risk

3.1 The Solvency II framework promotes wider interests for the insurance sector such as competition, the freedom of movement of capital and the removal of restrictive practices. It also requires management of risk in a prudent fashion. The PRA appreciates that, to some extent, these aspects can potentially be in conflict, for example when firms have significant concentrations of reinsurance counterparty default risk.

3.2 Many UK-regulated insurance firms make extensive use of risk transfer through reinsurance (often intragroup reinsurance). Where a firm reinsures to a single or only a few counterparties (or connected counterparties), that firm can be exposed to a significant concentration of counterparty default risk. Although various factors play an important role in assessing counterparty credit risk, the PRA nonetheless expects firms to manage prudently concentration aspects of reinsurance counterparty default risk under Solvency II. Conditions Governing Business 3.1(2)(c)(iv) requires firms to have a risk management system covering concentration risk management. This includes all risk exposures with a loss potential which is large enough to threaten the firm's solvency or financial position. Conditions Governing Business 3.1(2) makes clear that the risk management system must cover risks which are covered by the SCR as well as those which are not, or not fully, included in the calculation of the SCR.

3.3 Where a significant level of risk is transferred to a few counterparties, the PRA expects firms to consider the impact of such concentrations (particularly in stressed scenarios) as part of their risk management systems. In light of their analysis, firms should review the need for additional measures that may be required to manage appropriately risks over and above the SCR components covering counterparty default risk and risk concentrations.

3.4 While recognising that Solvency II promotes the removal of restrictive practices, for example by prohibiting requirements concerning the localisation and pledging of assets in relation to certain reinsurance cessions (Articles 134 and 173 of the Directive), the PRA will continue to expect firms to mitigate reinsurance counterparty default risk concentrations by demonstrating prudent risk management and compliance with other relevant requirements within the PRA Rulebook. When assessment indicates additional measures are appropriate, mitigation may take various forms (examples include, but are not limited to, funds withheld and collateral agreements), and will often be uniquely tailored to a firm's specific business.

3.5 The PRA expects firms' assessment of reinsurance counterparty default risk to include their appetite for this risk, and their identification, reporting and mitigation of major instances

³ See Supervisory Statement 26/15 'Solvency II: ORSA and the ultimate time horizon – non-life firms', June 2015; www.bankofengland.co.uk/pr/Pages/publications/ss/2015/ss2615.aspx

of this risk. Firms are expected, among other actions, to continue monitoring the level of annual cessions as a proportion of their gross premiums and the quantity of reinsurance recoverables compared to their available capital resources, and take appropriate actions to manage risks arising. Additionally, firms should consider aspects relating to the prudent person principle (set out in the Investments Part) as well as to what extent reinsurance concentrations may impede effective resolution (as required by Fundamental Rule 8).

3.6 The PRA's expectations of risk management increase in proportion to the size of the concentration and the risk it poses to a firm. Conversely, the PRA also recognises that, for smaller firms, the consideration of the trade-off of different component aspects contributing to the credit risk might be materially different to those for larger firms. In situations where satisfactory mitigation is absent and viewed necessary, the PRA will make clear to firms that better management of counterparty default risk is required and, where necessary, take a proportionate approach to enforcing this.

Annex – SS20/16 updates

This annex details the changes that have been made to this SS following its initial publication in 2016:

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Following publication of PS8/24 'The PRA's approach to the authorisation and supervision of insurance branches, this SS was updated to:

- include third-country insurance branch undertakings in the introduction to align the language of the scope with the language used in the PRA Rulebook. This is detailed in paragraph 1.1;
- correct a typographical error in paragraph 1.1 to improve readability.

This policy is effective from Thursday 23 May 2024.