RAB response to the PRA's consultation on funded reinsurance

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General comments

The Insurance Europe Reinsurance Advisory Board (RAB) welcomes the opportunity to respond to the Prudential Regulation Authority (PRA) consultation (CP24/23) on funded reinsurance, including the proposed draft Supervisory Statement (the "**Supervisory Statement**").

As shown by the consultation paper, reinsurance is an important risk mitigation tool that contributes to the functioning of a strong insurance market.

The RAB agrees that (re)insurers should consider broader factors (rather than just credit ratings) in counterparty assessment. In line with Article 101(3) of the Solvency II Directive, the solvency capital requirement (SCR) is intended to capture all material quantifiable risks to which the (re)insurer is exposed. The RAB welcomes clarity provided by the Prudential Regulation Authority (PRA) on its expectations on how risks relating to funded reinsurance should be considered in risk management, risk assessment and the SCR calculation, in relation to correlations and concentrations of similar counterparties and risks, to which the (re)insurer is exposed. ORSA is well suited to include analysis of non-quantifiable but material risks.

However, the RAB underlines that correlations between counterparties and their risk exposures are not necessarily always risks to which (re)insurers entering into funded reinsurance transactions may be exposed. For example, (re)insurers may transact with uncorrelated or even negatively correlated counterparties, and therefore are not exposed to such risks, leading to increased diversification within the insurers overall risk profile. In these situations, it would be appropriate for the SCR to give due credit for the risk mitigation provided by the funded reinsurance (as, indeed, it should for all material aspects of an (re)insurer's risk profile), without materially overstating or understating relevant risks.

The RAB therefore considers that the Supervisory Statement should clearly state that (re)insurers' risk management, risk assessment and capital processes should be based on robust assessment of the risks to which they are exposed, and to clarify that (re)insurers are not required to provide capital for, nor are precluded from entering into funded reinsurance transactions on the basis of risks to which they are not exposed.

This would not preclude an expectation on (re)insurers to consider extreme recapture risks as part of robust risk management and stress testing processes. Nonetheless, there is a risk to harm sound risk management

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practices if (re)insurers are assumed to be exposed to risks that are not a necessary feature of the market. On the contrary, it may disincentivise new and more diversified funded reinsurance capacity that might lead to increased competition and a reduction in contagion risk within the industry.

Furthermore, the RAB considers that it would be beneficial for the Supervisory Statement to include references to a broader range of specific factors that may be taken into account in the SCR, probability of default (PD) and loss given default (LGD) calculations. It should nonetheless be clear that this would not be an exhaustive list and that insurers should be able to rely on publicly available information.

Some simple illustrative examples are given below, focused on diversification between the reinsurer and the ceding insurer or the collateral portfolio:

- Diversification between the reinsurer and insurer's business model and risk profile.
  - A global reinsurer who is exposed to both property & casualty (P&C) and life risks, with a low exposure to corporate credit and other non-government credit-risky asset classes represents a very different risk profile to most bulk purchase annuities (BPA) writers as well as a pure credit- focused reinsurer.
- Diversification of the collateral portfolio with the reinsurer's business model and risk profile (ie, the opposite of wrong-way risk)
  - Collateral provides more protection to the insurer if the collateral portfolio is uncorrelated or less correlated with the reinsurer's business model and risk profile. For example, if corporate credit and other credit risk assets only make up a small portion of a reinsurer's balance sheet then:
    - A reinsurance default is unlikely to have been caused by a credit stress event, and therefore the collateral portfolio is less likely to be in stress; or
    - In a credit stress event that has caused a reduction in the collateral value, the reinsurer is less likely to be in a stress event and is more likely to be able to re-collateralise the transaction quickly to a fully funded level.
    - From a risk perspective, it can therefore be inferred that a BPA writer transacting funded reinsurance with a diversified reinsurer, with such reinsurance being collateralised with assets which are diversified compared to the reinsurer's risk profile results in a reinsurance transaction that is more secure than that which is implied purely by assessing the reinsurer's credit rating.

The above demonstrates that UK BPA writers transacting with very diversified reinsurers can benefit from additional diversification protection, compared to insurers transacting with reinsurers with a concentrated (particularly "credit-focused") business model and significant wrong-way risk.

Detailed feedback

- **SCR**

"Broader factors", including diversification between business models, risk profiles and collateral pools should be explicitly mentioned in sections 3.1 – 3.4 of the Supervisory Statement, in addition to more detail in the sub sections on PD and LGD in the Supervisory Statement.

- **Probability of default**

The Supervisory Statement should explicitly mention diversification (or lack thereof) between the reinsurer and the insurer's risk profile, which would particularly impact stressed PD. For example, if an insurer is in stress and the reinsurer has a concentrated business model with the insurer, the PD should also be stressed upwards, for example under a credit stress. Where the insurer and reinsurer are diversified or negatively correlated (e.g. a reinsurer that is light on credit exposure), then it could be argued that the PD should not be stressed in that scenario. This principle should be mentioned in the "Stressed PD", "Solvency Ratio" and "Forward looking" sub bullets in paragraph 3.5.

- **Loss given default and collateral**

LGD and Collateral for Funded Reinsurance arrangements are inherently linked, and broader factors including the impact and diversification of the risk relating to the credit quality of the counterparty, and credit quality of the collateral should explicitly be stated in section 3.8.

While wrong way risk is explicitly mentioned in section 3.9, the opposite of wrong way risk should be mentioned in the same paragraph – for example if the counterparty is diversified when compared to the risks within the asset collateral pool, credit could be taken for this (perhaps via implying a higher effective counterparty credit rating as part of the calculation).