

Bank of England PRA

Prudential considerations for insurance and reinsurance undertakings when transferring risk to Special Purpose Vehicles

November 2024

Draft for consultation



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Contents

| | |
|---|-----------|
| Contents | 1 |
| 1: Introduction | 2 |
| 2: Risk transfer arrangements to SPVs: risks | 4 |
| The use of limited recourse clauses | 4 |
| The use of grace periods | 4 |
| Transferring long-tail risks | 5 |
| Transferring annuity (or similar) risks | 6 |
| SPVs in third countries | 6 |
| Multiple cedants to an SPV | 7 |
| Reinsurance recoverable | 7 |
| 3: Risk transfer exposures to SPVs: implications for portfolio risk management | 8 |
| Concentration risks | 8 |
| Tail risks | 9 |
| 4. Solvency capital requirement | 10 |

1: Introduction

1.1 This supervisory statement (SS) sets out the Prudential Regulation Authority's (PRA's) expectations in respect of the transfer of risk by firms to Special Purpose Vehicles (SPVs).¹

1.2 This SS is relevant to insurers and reinsurers transferring such risks to SPVs. It is also relevant to parties who wish to apply for or have obtained authorisation as a UK Insurance Special Purpose Vehicle (ISPV).

1.3 SPV structures offer insurance and reinsurance firms a means of transferring risks to the capital markets. In an SPV arrangement, a (re)insurer enters into a risk transfer agreement with an SPV, where the SPV assumes the risk from the (re)insurer and fully funds its exposure to those risks through issuing equity or debt instruments to investors. The (re)insurer's claims are then settled by the SPV, and the payment obligations to investors are subordinated to the obligation to pay these claims. The SPV must ensure that the risk transfer is effective and incontrovertible.

1.4 Such arrangements have similar implications for a cedant as conventional reinsurance arrangements. There are notable differences between transferring risk to an SPV and to a conventional reinsurer.

1.5 In this SS the PRA builds on existing requirements and expectations that apply in respect of cedants' reinsurance arrangements by setting out additional specific expectations in relation to the use of SPVs for that purpose. For the avoidance of doubt, the expectations in this SS supplement relevant requirements and other existing PRA expectations that apply to firms in relation to their outwards reinsurance arrangements, but do not modify or replace any relevant requirement or other existing PRA expectation.

1.6 The PRA will monitor the use of SPVs to transfer risk on an ongoing basis, including whether its expectations are being met. The PRA may seek assurance on firms' practices and will do so in a proportionate way.

1.7 This SS should be read in conjunction with:

- Chapter 3 of the Conditions Governing Business part of the PRA Rulebook;
- Chapters 6 and 7 of the Technical Provisions part of the PRA Rulebook;

¹ In the context of this SS, the expectations are in regard to the transfer of insurance underwriting risk from a cedant to an SPV.

- the Solvency Capital Requirement – General Provisions, Solvency Capital Requirement – Standard Formula, and the Solvency Capital Requirement – Internal Models parts of the PRA Rulebook;
- the Investments part of the PRA Rulebook;
- SS20/16 - Solvency II: reinsurance - counterparty credit risk²; and
- SS1/20 - Solvency II: Prudent Person Principle³.

1.8 This SS should also be read with the PRA's general approach to the authorisation and supervision of UK ISPVs as set out in the Statement of Policy (SoP). This SS applies to all UK cedants irrespective of the jurisdiction of the SPV that the cedant is ceding risks to. By clearly and consistently explaining its expectations on cedants in relation to the use of SPVs, 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.

1.9 Chapter 2 of this SS sets out risks that cedants should consider in relation to exposures to SPVs. Chapter 3 sets out PRA expectations of firms' risk management of their overall reinsurance programmes when SPVs are being used. Chapter 4 sets out PRA expectations with respect of the calculation of the solvency capital requirements (SCR) for such arrangements.

² <https://www.prarulebook.co.uk/guidance/supervisory-statements/ss20-16---solvency-ii-reinsurance---counterparty-credit-risk>

³ <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2020/ss120.pdf>

2: Risk transfer arrangements to SPVs: risks

2.1 This section sets out the PRA's expectations of firms in relation to their assessment of the risks arising from their risk transfers to SPVs.

2.2 For the purposes of assessing the extent and effectiveness of risk transfer to SPVs, the PRA expects cedants to consider, without limitation, the underlying funding positions of the SPVs on an ongoing basis. The PRA would expect cedants to ensure they have access to sufficient information from the SPVs to achieve this.

2.3 The PRA also expects cedants to consider any material basis risk that may arise. Eg this could be the case in situations involving risk transfers with non-indemnity triggers.

The use of limited recourse clauses

2.4 Although SPVs are, by definition, required to be fully funded to the maximum limit of coverage/liability under the risk transfer contract, cedants are at risk of receiving less cover than they may expect in certain scenarios.

2.5 Many SPV arrangements make use of limited recourse clauses. These have the effect of limiting the SPV's liabilities to the value of its assets, thus preventing the insolvency of the SPV. Therefore, should the value of the assets within the SPV reduce to a level below the maximum limit of coverage/liability expected, the level of effective cover provided to the cedant may also reduce.

2.6 The use of a limited recourse by an SPV can result in risk for the cedant as there is potential for the risks that were previously transferred to the SPV to revert back to the cedant if the limited recourse clause is triggered. The PRA expects firms to fully assess the implications of the limited recourse clause and consider the possibility that the SPV may not meet its full obligations initially agreed under the risk transfer agreement, potentially resulting in risks being transferred back to the cedant. Firms are expected to analyse the extent of risk transfer through stress scenario analyses, considering both economic impact and the legal robustness of the SPV structure. Furthermore, firms must assess the potential for risk to revert to the firm under foreseeable adverse scenarios and evaluate any unprovided liabilities that may arise with respect to the transferred risks.

The use of grace periods

2.7 In some cases the requirement for SPVs to be fully funded may be subject to a limited grace period. For example, this is allowed under the UK ISPV regime where the requirements in rule 2.1B of the Insurance Special Purpose Vehicles Part of the PRA Rulebook are

satisfied. The PRA expects firms ceding risks to an SPV wherever it is located to ensure that their arrangements with the SPV only allow for grace periods in the circumstances contemplated in rules 2.1A and 2.1B of the Insurance Special Purpose Vehicles Part of the PRA Rulebook.

2.8 In all cases where a firm transfers risk to an SPV, it should understand all the risks to which it is exposed in relation to the transfer of risk and its own responsibilities in ensuring the grace period is applied prudently. For some or all of the grace period an SPV may not have sufficient assets to meet a claim in full in respect of the risks it assumes from a cedant. The PRA expects the cedant to understand the implications of the grace period on the SPV's ability to meet its payment obligations. The PRA also expects cedants to have effective risk management arrangements in place to manage the risk of the SPV not having adequate and sufficient financial resources to pay any amounts that it may become liable to pay during the grace period.

2.9 The PRA expects cedants to mitigate the risk of the SPV not having adequate and sufficient financial resources to pay any amounts that it may become liable to pay during the grace period eg by monitoring and setting appropriate limits on its exposure to risk transfers to SPVs that have grace periods. The PRA expects cedants to consider the implications of the grace period and take necessary actions as is prudent eg by deferring taking capital credit until the grace period has completed or by allowing for the additional risk in capital calculations, that the SPV may not have sufficient funds to meet its payment obligations during the grace period. The firm is also expected to ensure that its risk limit framework could absorb any reduction in cover during the grace period, were risk events to crystallise in that period.

2.10 Where the perils being reinsured are seasonal perils the PRA expects that cedants would seek to reduce the possibility of a trigger event happening during the grace period by ensuring that the period during which a grace period can be applied does not fall within that season.

Transferring long-tail risks

2.11 When using SPVs for long-tail risks, or for the provision of multi-year cover, firms may face additional complications. Firms are reminded of the need to assess how contractual agreements with SPVs in respect of realised investment income affect payment cashflows given that the impact may be greater for long-tail risks. Firms will need to determine within the risk transfer contract whether the level of cover will remain fixed in nominal terms for the contract's duration or if it will increase in some way. If the cover is expected to increase as a result of an increase in the value of assets, firms will need to manage the resulting risks, which could include market, credit and interest rate risks. Should the SPV use a fixed rate investment strategy it could also introduce the risk of insufficient compensation on early repayment. Conversely, should the SPV use a variable rate investment strategy, the actual

investment returns realised may differ to expected investment returns. The longer the agreed coverage lasts the more material these risks become and at some point mitigants such as overcollateralization may be insufficient to compensate for the resulting uncertainty. Firms should take this into consideration when assessing any such transaction.

Transferring annuity (or similar) risks

2.12 Annuities or liabilities of similar nature (eg Periodic Payment Orders (PPOs)) can be of very long duration. To offer an acceptable or competitive price to a cedant for the risk transfer of this type of business an SPV would likely need to invest in assets with significant credit and market risk.

2.13 An investment strategy that involves material market and credit risks presents a higher risk of deterioration in asset values in the SPV and increases the likely cost of covering the cost of the liabilities transferred to the SPV over a longer term. Unless the SPV holds sufficient assets to cover those credit and market risks this could result in an increase in recapture risk for the cedant.

2.14 In addition, unlike more traditional reinsurers, an SPV does not benefit from diversification with a wider range of risks and other portfolios of liabilities, and is likely to have a more limited range of management actions to respond to a deterioration in operating conditions. The PRA would therefore not expect the use of an SPV to transfer risks from annuity business to result in a reduction in the overall level of capital a cedant hold for these risks, including allowance for any reduction in diversification, compared with that which would be held had the risks been retained on the cedant's balanced sheet.

2.15 Given the prudential risks, the PRA does not expect firms to use SPVs to transform the risks associated with annuities or similar insurance business.

SPVs in third countries

2.16 The PRA is aware that firms enter into risk transfer agreements with SPVs in a range of jurisdictions globally. This freedom is valuable in that it broadens the pool of capital available to support UK (re)insurers which, other things being equal, should enhance the coverage available to UK policyholders.

2.17 In such cases the PRA would expect cedants to be able to demonstrate how an SPV, to which it has transferred risks, satisfies the conditions of fully funding, effective risk transfer and subordination are being met on an ongoing basis. This applies both to firms using standard formula and those using internal or partial internal models to calculate their SCR. As part of ongoing supervision the PRA would expect that firms would consider the requirements that apply to the SPV in its jurisdiction; and to be able to explain those requirements to the PRA. A cedant should, at all times, be able to verify that the SPV risk transfer qualifies as a

risk mitigation technique. The PRA may request for details as appropriate, as part of its engagement with the firm.

Multiple cedants to an SPV

2.18 The PRA expects that where a (re)insurer cedes risk to an SPV with multiple cedants that, where necessary, there is a contract that clearly defines the allocation of losses in advance. The absence of clear contractual provisions can lead to disputes and delays in payment.

2.19 Cedants should be aware that in an SPV with multiple cedants there is a risk that the SPV could have insufficient assets to meet all claims, particularly if multiple claims are made concurrently. This can lead to each cedant receiving a reduced or even no payout.

2.20 The PRA expects cedants to fully understand the implications of limited recourse and subordination clauses in an SPV with multiple cedants as these clauses may significantly affect a cedant's ability to recover losses, particularly where a loss from another cedant has already been paid out by the SPV. Cedants are expected to ensure that appropriate arrangements are in place to mitigate these risks.

Reinsurance recoverable

2.21 The PRA expects that firms transferring risks to SPVs will not take credit as a reinsurance recoverable for expenses that fall within the scope of paragraphs (1) and (2) of the definition of aggregate maximum risk exposure (AMRE), as defined in the Glossary Part of the PRA Rulebook.

3: Risk transfer exposures to SPVs: implications for portfolio risk management

3.1 This section sets out PRA expectations for cedants' risk management of their outwards risk transfer arrangements collectively where SPVs form part or all of the risk transfer.

3.2 Given risk transfers to SPVs differ to other forms of risk transfer, cedants should ensure they have appropriate systems of governance to identify, measure, monitor, manage and report the risks related to SPV exposures, as set out by rule 3.1 of the Conditions Governing Business Part and rule 2.1 of the Investments Part of the PRA Rulebook. These not only include the risks inherent within any individual transaction, but also the consequences for firms' portfolio of outwards reinsurance arrangements.

3.3 As part of their systems of governance the PRA would particularly expect cedants to consider the implications of using SPVs for risk transfer on potential concentration risks and tail risks.

Concentration risks

3.4 Firms using SPVs as part of their outwards reinsurance arrangements must consider a range of portfolio concentration risks, in line with the requirements set out in the PRA Rulebook, including the Investment Part and other relevant supervisory statements such as SS1/20 – Solvency II: Prudent Person Principle. The PRA expects cedants to have a risk management system capable of covering such risks including those which are not fully captured in the calculation of the SCR. These concentration risks include, but are not limited to:

- Large, single SPVs: should a firm transfer risk to a single SPV, or place material reliance on a single SPV, that firm can be exposed to a significant counterparty risk linked to the areas set out in Chapter 2.
- Reliance on SPV wording in contractual documents: firms should understand the extent to which their assumptions and models are dependent on certain contractual wordings being upheld in the case of a claim dispute. This risk becomes more material where wordings have not previously been tested and where the same wordings are used across SPV arrangements.
- SPV investor concentration: although the fully funded nature of SPVs reduce the credit risk firms are exposed to from the ultimate holders of the risk (the investors), Chapter 2 makes clear this is not entirely eliminated given the nature of grace periods. In

addition where the same investors support material levels of firms' outwards risk transfer programmes, firms should consider any business model dependency on these investors and the extent to which replacement cover would be available if it were needed.

- Asset concentration: firms should consider the investments of the SPV in the context of their own investment strategies and investment risk appetites. Rule 5.2 of the Investment Part of the PRA Rulebook requires firms to ensure that their investments are diversified to avoid excessive reliance on any particular asset, group of assets, or geographic area, and to prevent excessive accumulation of risk in the overall portfolio. This should include exposures through the use of Letters of Credit by the SPV, where firms may already be placing reliance on Letters of Credit from the same counterparties.

Tail risks

3.5 SPVs must be fully funded up front and are therefore suitable to cover losses up to the value of the collateral. SPVs are not capable of covering losses beyond the level of the collateral provided. For firms transferring risk to UK ISPVs, firms should consider the UK ISPV's AMRE in assessing the ISPVs capability to cover losses.

3.6 Firms ceding to SPVs should not expect SPV arrangements to cover the entirety of an indeterminate tail. The finite nature of the SPV's coverage means that firms will retain some degree of tail risk. The extent of the tail risk will depend on the size of the SPV arrangements, their positioning within firms' wider reinsurance programmes and the shape of the tail.

4. Solvency capital requirement

4.1 This section sets out the PRA's expectations for firms' assessments of risks associated with entering into risk transfer arrangements with SPVs with the aim of capturing all material and quantifiable risks in the SCR when taking into account the effects of utilising SPVs as a risk mitigation technique.

4.2 Where firms use an internal model they must capture all material and quantifiable risks in their internal model. Where appropriate firms should consider the areas raised in Chapters 2 and 3 of this SS as part of their risk assessment. Firms should recognise that changes in the funding position of an SPV could materially impact the assessment of counterparty credit risk and should have processes in place to identify such changes.

4.3 Rules 3G1-3G9 of the Solvency Capital Requirement – Standard Formula Part of the PRA Rulebook set out the requirements that firms using the standard formula must follow when calculating the risk mitigation to be reflected in their SCR. The PRA would expect that UK ISPVs would in most circumstances meet these conditions. Firms are also required to consider rule 3G5(6) of the Solvency Capital Requirement – Standard Formula Part of the PRA Rulebook for SPVs which are not UK ISPVs.

4.4 In addition, rule 3G5 of the Solvency Capital Requirement – Standard Formula Part of the PRA Rulebook also requires firms using the standard formula to consider other risks that the SPV contracts might pose. Firms should explore, eg via scenario analysis, whether the terms of the contractual agreements, including grace periods, pose additional risks that should be captured by firms and reflect these appropriately in the SCR.

4.5 Should the funding of an SPV reduce unexpectedly during the period of a transaction the firm should consider the extent to which the SPV continues to be fully funded. In scenarios where a limited recourse clause is used the firm may be able to demonstrate the SPV is fully funded to a new, lower level of coverage. Alternatively, the firm may conclude the SPV is no longer fully funded. In such a case firms should refer to rule 3G5(5) of the Solvency Capital Requirement – Standard Formula Part of the PRA Rulebook for the required actions to restore compliance with the fully funded requirement and adjust the level of recognised coverage.

4.6 In addition, the PRA reminds firms using the standard formula of the PRA's expectations in SS19/16 – Solvency II: ORSA⁴ for firms to include in their Own Risk Solvency Assessment a clear assessment of the appropriateness of the standard formula for the risks in their business. In respect of a firm's risk transfer arrangement with SPVs this should include a

⁴ <https://www.prarulebook.co.uk/guidance/supervisory-statements/ss19-16---solvency-ii-orsa>

consideration of the nature, scale, and complexity of the risks transferred, the risks retained, and the risks to which they are exposed in respect of SPV arrangements.

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