SLAUGHTER AND MAY/

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PRA DEAR CRO LETTER BPA TERMINATION RIGHTS

As we reported in our May briefing note, the PRA has identified as an area for concern the use in buy-in policies of termination rights linked to breach of solvency thresholds. On 4 July, the PRA wrote to Chief Risk Officers of life insurance firms writing bulk purchase annuities (BPAs) to share its view of the potential risks arising from the use of solvency-triggered termination rights clauses ("STTRs"), and its assessment of how firms are mitigating the risks involved.

The PRA plans to engage with relevant firms on a case-by-case basis to understand how they intend to respond to the points raised in the letter. **In addition, firms are requested to notify their supervisors if they enter into BPA transactions containing STTR clauses after the date of the letter.**

A follow-up review is planned for 2026 to assess how market practices for STTR clauses have evolved and how risk management approaches have developed.

The annex to the letter sets out the PRA's views on potential risks to insurers from the use of STTRs and approaches to management of the risks, including in relation to matching adjustment portfolios.

Potential risks from use of STTRs

Liquidity impact	Liquidity risks may arise if any termination payment arising on an STTR termination is disproportionately comprised of liquid assets or particular asset classes, or where there are impediments to the transfer of illiquid assets on a termination
Asset concentration	Asset concentrations may increase if termination payments are disproportionately composed of a particular asset class. This could impact a firm's asset exposure limits or its ability to meet the prudent person principle. The position could be exacerbated if there are issues with recapturing collateral under an associated funded reinsurance arrangement
Contractual uncertainty	Contractual ambiguity could lead to disputes regarding asset valuation or the composition of assets in the termination payment
Operational challenges in stress	Where an STTR has been triggered, the firm will by definition be facing a degree of unexpected financial stress, which could lead to management and resource challenges. The need to transfer assets to comply with termination rights under an STTR could complicate an insurer's ability to execute any planned recovery options

Risk management considerations

The PRA identifies a number of areas where insurers have taken or should take steps to develop frameworks to mitigate risks associated with the use of STTRs. Key points include:

- firms could seek to limit the potential adverse impact of STTRs on liquidity and asset concentrations by including contractual flexibility over the asset composition of termination payments

- where there are contractual restrictions on the asset composition of termination payments, this should be aligned with the composition of the firm's underlying asset portfolio
- if possible, cure periods for breach of STTRs should take into account the time needed to execute management actions
- STTR exposure limits and triggers should be set by reference to effective scenario analysis which assumes concurrent termination across a firm's portfolio of STTR BPA deals, and makes prudent assumptions in relation to the ability to transfer illiquid assets
- where firms have entered into associated funded reinsurance arrangements, they should allow for receipt of "worst case" funded reinsurance collateral in the context of STTR exposure limits
- firms should consider the potential impact of STTRs on their resolution planning
- firms should gain as much assurance as possible in advance that contractual terms can be relied upon to operate as intended
- it is good practice for firms to maintain STTR termination plans covering preparatory actions and implementation in the event of a termination
- firms should consider the potential impact of STTRs on the MA portfolios, including their ability to meet the MA eligibility conditions.

Next steps

The PRA engaged with a number of market participants prior to issuing the Dear CRO letter, so major players in this sector will be familiar with the areas of concern identified by the PRA. To the extent firms have not already put in place risk management practices and procedures consistent with those identified by the PRA they should take steps to do so. Firms should also note the requirement to notify their supervisor of any future transactions they enter into which contain STTRs.

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