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Dive into pensions de-risking

The insurance regulator sets out its expectations for funded reinsurance

On 26th July, the PRA issued its long-awaited supervisory statement setting out its expectations for insurers entering and holding funded reinsurance contracts alongside a 'Dear CEO' letter to life insurers on its implementation approach.

This summary explores what funded reinsurance is and why it has become prevalent in the bulk annuity market; along with details of the supervisory statement and how it will impact pension schemes looking to enter into a buy-in or buy-out.

What is funded reinsurance?

When entering into a funded reinsurance contract, an insurer takes a portion of the buy-in/buy-out premium received from the pension scheme and passes it on to a reinsurer, often but not necessarily overseas. The reinsurer then provides monthly benefit payments to the insurer, and the insurer passes these payments on to the pension scheme or (following buy-out) the pensioners directly.

As part of a funded reinsurance transaction, insurers use a suite of contractual protections and collateral arrangements to protect against a reinsurer's financial strength deteriorating, particularly if that leads to default, as well as planned management actions should this occur. The idea in simple terms is that at (or ideally before) the point of a reinsurer failing, the insurer can step in and take control of a portfolio of assets that they can then use to back the liabilities themselves (a "recapture").

Why do insurers use funded reinsurance?

There are a range of reasons for using funded reinsurance and the primary rationale varies by insurer:

Scale: The insurer can write larger buy-ins/buy-outs both from a capital and an investment perspective. Less capital is used for writing the business if the risk is shared. Insurers may even end up with an improved capital position by writing the business, an unusual position for bulk annuities, which usually requires insurers to put up capital. Further, it allows insurers to invest quickly at scale, eg for a £1bn buy-in an insurer could use funded reinsurance for 50% and only need to source £500m of assets rather than £1bn.

Economics: The pricing offered by the reinsurer may be sufficiently attractive that it is more profitable for the insurer to pass on the risks than retain them. Whilst the capital savings of undertaking funded reinsurance could also be used to improve an insurer's return on capital.

What are the PRA's expectations?

The PRA's letter to insurance company CEOs restates the PRA's concerns that growth in funded reinsurance could pose a risk if it is not properly controlled. They note that while they have seen some improvements in risk management of funded reinsurance, they expect insurers to go further. Firms are required to provide further information regarding whether their funded reinsurance arrangements and associated risk management meets the PRA's new expectations by the end of October this year.

The PRA has also highlighted that if, in their view, the expectations outlined in the supervisory statement are not met, then they may seek to take further action and/or use their powers which could result in forcing an insurer to hold additional capital or restrict the use of funded reinsurance by a firm.

The PRA will incorporate funded reinsurance into one of the areas of their published industry-wide stress test, which will next be undertaken during 2025.

Details of the Supervisory Statement

The recapture terms are central to a funded reinsurance contract. If a reinsurer defaults or there is a termination event before that point, the expectation is that the ringfenced collateral assets in respect of the reinsurance will be returned to the insurer. Pre-emptive risk management of this recapture risk and its implications are at the heart of the PRA's expectations.

Counterparty limits

Counterparty limits need to be considered both at an individual reinsurer level as well as at an aggregate level in respect of the insurer's overall use of funded reinsurance. This should be set by reference to a new 'immediate recapture metric'. This metric measures the impact on the insurer's capital position in the event of a recapture, irrespective of the likelihood of this occurring and ignoring any mitigating actions that the insurer might take and while also being during stressed conditions (for example, the collateral assets being recaptured have fallen in value at the same time as the reinsurer default).

The counterparty limits should also have regard to the impact on the insurer's portfolio of assets when the collateral assets are recaptured to ensure they are compliant with broader regulatory requirements including those for the use of the Matching Adjustment.[1]

Contractual terms

The PRA expects insurers to have internally approved minimum guidelines on contractual features particularly around the form and type of assets held. There should be appropriate valuation haircuts or over-collateralisation in place that gives adequate consideration to the potential fall in asset values in stressed scenarios.

The types of assets being used as collateral are also a key focus for the PRA. The key questions are:

- if recaptured, will they meet Matching Adjustment criteria.
- are they well matched to the liabilities being reinsured or is there a potential future mismatch risk.
- if illiquid assets are used as collateral, what is the process for recapturing these assets and how will they be managed and valued once on the balance sheet.

The PRA also expects firms to formulate and document a recapture plan for their funded reinsurance arrangements, which may require Board approval. These recapture plans should include a structured decision-making process for where an option to terminate is triggered ahead of a potential reinsurer default

Capital levels

The solvency capital requirement (SCR) is the capital an insurer needs to hold to withstand a 1 in 200 event over a 1-year time horizon. When addressing funded reinsurance in this calculation, the PRA is clear that insurers need to consider:

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[1] The Matching Adjustment allows insurers to discount their liabilities using a risk-adjusted expected yield on their assets so long as assets match the insurer's liabilities.

- how to model the probability that the reinsurer defaults, especially in stressed scenarios.
- the contractual terms they have in place, particularly around termination and default scenarios and how assets get returned to the insurer.
- the amount and types of assets that an insurer might recapture in the event of a termination or default.
- what management actions they might look to undertake to mitigate the impact of reinsurance failure.

What does this mean for pension schemes?

It's clear that whilst the PRA has seen improvements in the risk management approaches taken to funded reinsurance, it is of the view that there is further work to be done. The PRA appears to remain concerned about the potential for funded reinsurance to be used at scale in order to meet pension scheme demand.

Any strengthening of the collateral parameters and contractual terms may increase the cost of funded reinsurance, which has the potential to dampen its use, particularly where an insurer's primary rationale for use was based on pricing impact.

For pension schemes with existing buy-ins or those who are considering their use, we believe trustees and sponsors should take comfort from the PRA's approach, ensuring effective risk management of funded reinsurance. We suggest pension schemes consider the extent to which an insurer utilises funded reinsurance and their risk management approach when assessing the insurer's financial strength.

Get in touch

If you have any questions about anything covered, please don't hesitate to get in touch.

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