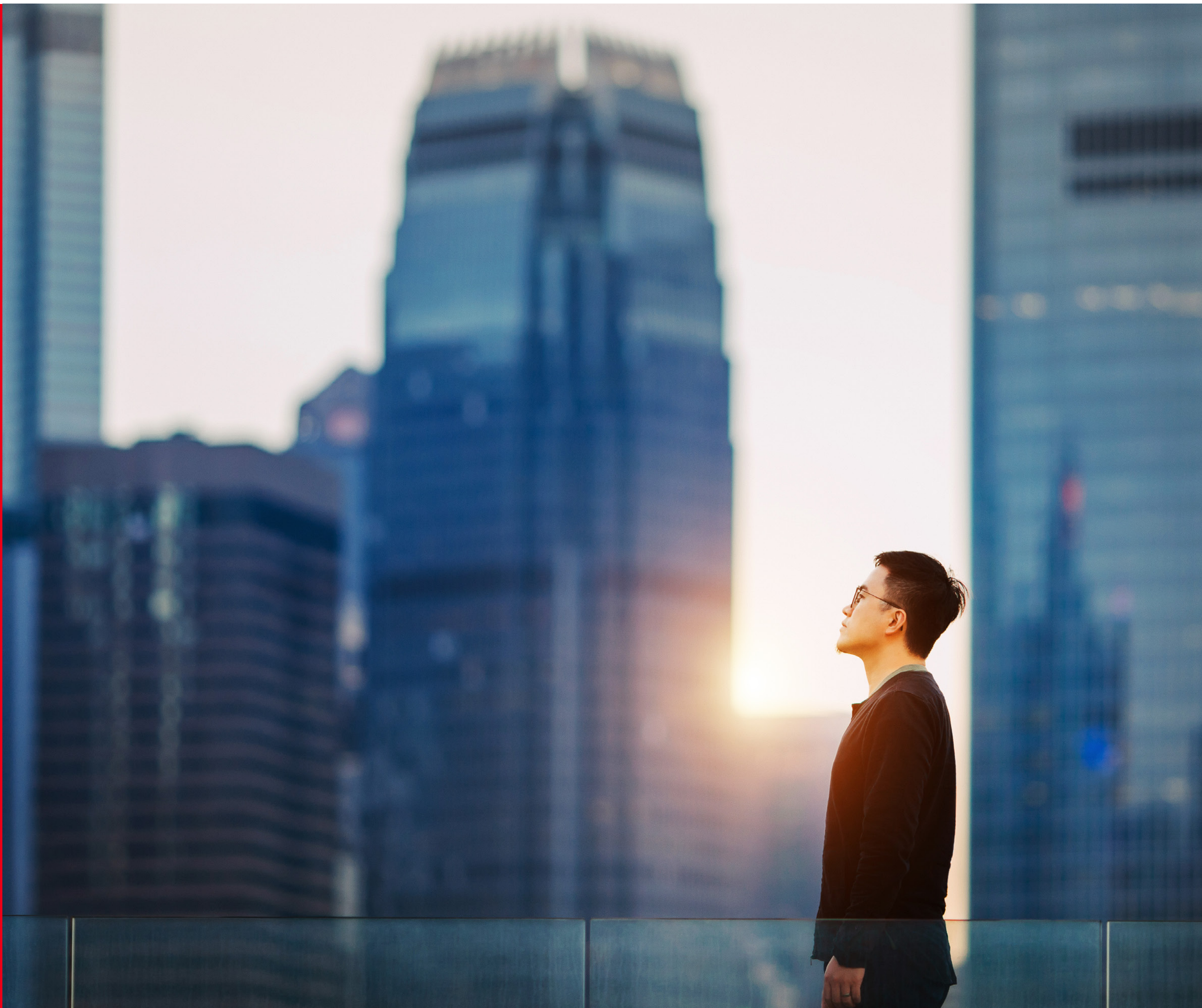
Funded Reinsurance

Impact in the UK Bulk Annuity Market



Impact in the UK Bulk Annuity Market

Increases in the use of funded reinsurance have raised questions about UK bulk annuity funds managing the risks with counterparty exposure and potential future asset recapture.

This has been an increasing area of focus for the Prudential Regulatory Authority (PRA) over the past 12 months, with new guidance to be introduced in Q2 2024 to ensure appropriate risk management and disclosure to the PRA.

What is Funded Reinsurance?

Reinsurance is a method of risk transfer, frequently used by UK bulk annuity providers. Traditionally, this was primarily used to transfer longevity risk to the global reinsurance market but is also now increasingly being used to transfer asset risk. The reinsurance of asset risk (or both longevity and asset risk on a combined basis) is known as 'funded reinsurance'.

Funded reinsurance is normally arranged by the payment of an upfront premium to the reinsurer in respect of part of the liabilities under an annuity. The reinsurer then pays income back to the annuity provider over time in respect of the pension benefits due. Without further action to protect the annuity provider, this could involve a substantial counterparty risk exposure to the reinsurer, which is typically based outside the UK (e.g. Bermuda).

Funded reinsurance, used in moderation with appropriate risk controls, is a useful part of an insurer's toolbox for capital management. We also welcome the proactive approach taken by the PRA to seek additional protections and require insurers to have robust risk mitigation frameworks in place.

Why is it Becoming More Popular?

There are a number of factors that can make funded reinsurance attractive, including:

- Price optimisation / regulatory arbitrage – Most reinsurers operate in territories with different regulatory regimes to the UK. This can mean that the reserving cost is lower for some tranches of business (e.g. longer-dated liabilities). Accessing this through funded reinsurance can allow the UK insurer to optimise the overall bulk annuity price.
- Increased capital capacity – With rising demand for bulk annuities, UK insurers are looking for ways to increase their capacity for writing transactions, particularly the largest transactions. Through funded reinsurance, the insurer can reduce the amount of its own required capital to meet the reserving requirements for a new bulk annuity policy.
- Support for asset sourcing – The use of funded reinsurance allows insurers to access a greater pool of investment opportunities via the reinsurer. When writing a bulk annuity transaction, the insurer needs to find appropriate assets to back the new liabilities they will take on. The assets need to match the liabilities being taken on, but also to deliver a yield that supports a competitive annuity price. With greater demand for bulk annuities, asset sourcing has become a key challenge.

Regulatory Arbitrage

Regulatory arbitrage describes a practice where insurers look to benefit from different regulatory regimes across the globe with different reserving requirements (e.g. through reinsurance). Significant regulatory differences in different countries could be a concern if not effectively managed.

Risk Mitigation

International solvency regimes

A key aspect is ensuring the continued creditworthiness of a reinsurance partner which is based outside the UK and EU, and is therefore not subject to Solvency II reserving requirements. If the reinsurer was to fail, the liabilities would fall back to the UK insurer to meet in full. However, there are several safeguards to this.

The reinsurers that have been involved in funded reinsurance transactions to date are predominantly large US-based but multinational insurance groups, with the reinsurance substantially placed in the group's Bermuda insurance company.

The US and Bermuda both have their own well-established insurance solvency regimes, which require reserves against known liabilities and contingencies. Bermuda's regime has been granted equivalent status to Solvency II by the European Insurance and Occupation Pensions Authority (EIOPA).

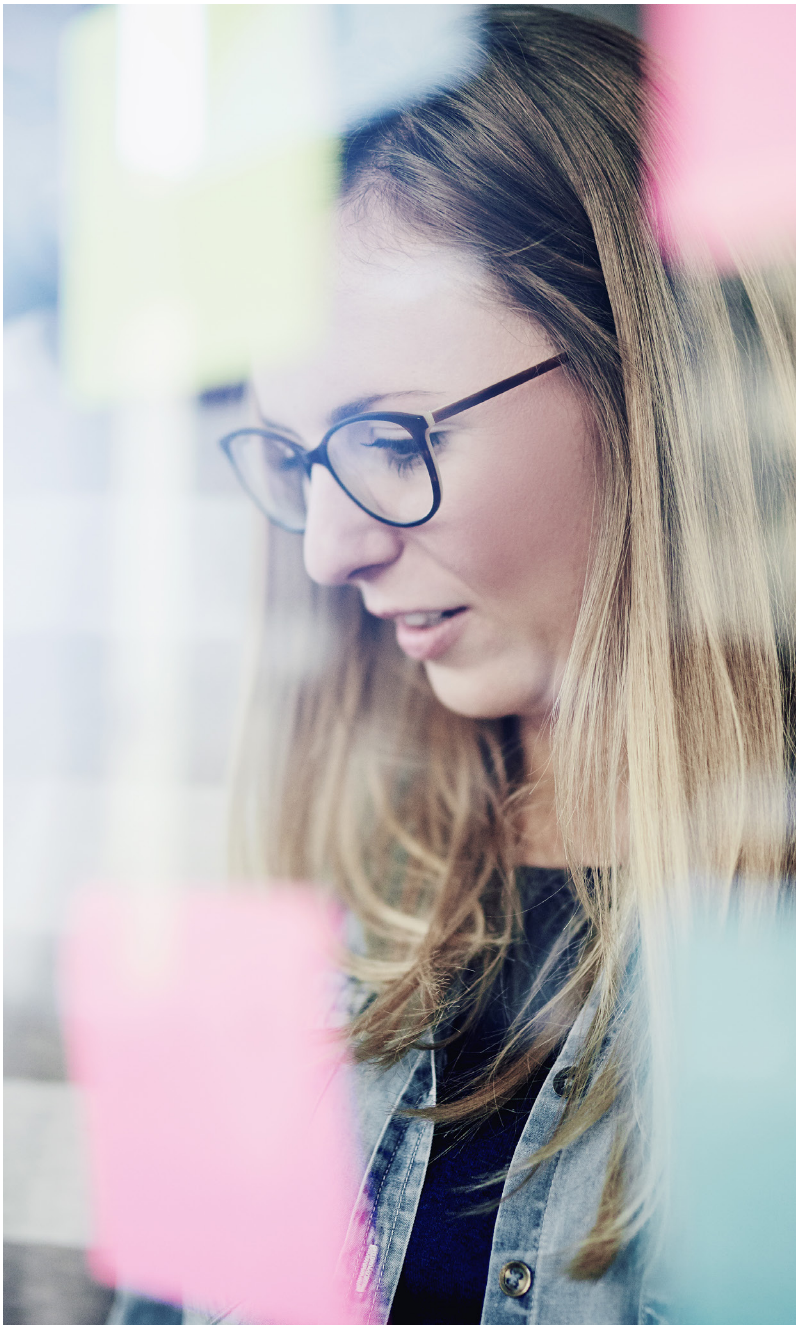
Collateral

The reinsurer counterparty risk will be mitigated via collateral pools backing the funded reinsurance deal. The reinsurer will hold ring-fenced collateral which would be passed to the annuity provider in the event of reinsurer failure. The reinsurance treaty will include detailed requirements for the quality and magnitude of asset holdings within the collateral pool.

Insurers pay particular attention to:

- The amount of total collateral posted (in some cases 'over-collateralisation' can be used to provide additional security)
- The ability of the insurer to enforce the collateral (including the triggers that qualify as reinsurer failure events)
- The nature of the assets posted as collateral (including credit quality and whether the assets could be used in the annuity fund if recaptured by the insurer upon a reinsurer failure event – this will depend partly on the scope of the insurer's internal model approved with the PRA)

In addition, UK insurers are required to make explicit allowance for counterparty risk in their reserves.



Collateral Requirements

Under the Solvency II insurance regime, the collateral should be high-quality, stable, and not materially influenced by the creditworthiness of the reinsurer. The UK insurer should also be able to access them quickly in the event of the reinsurer's default. The PRA concerns centre around accessing assets in periods of market stress.

UK Bulk Annuity Provider Activity

Most reinsurance transactions are confidential, so details of what has been transferred to date is only partially available publicly. This is an area of weakness in the disclosure requirements of Solvency II, and so far, has not been addressed in the UK solvency regime post-Brexit. However, the PRA is likely to receive extensive information on reinsurer exposures.

We understand that many of the annuity providers (Legal & General, Pension Insurance Corporation, Aviva, Standard Life and Just Group) have used external funded reinsurance in recent years. Some of these companies also have overseas life insurance companies in their wider group ownership to which liabilities may be transferred internally as well.

Just Group has been relatively public on its use of funded reinsurance, with it restricted to a small number of their larger transactions.

Conversely, Rothesay has disclosed it does not use funded reinsurance and currently has no plans to do so in the future. We are aware that some of the other insurers – who are writing lower volumes - are still considering this option for potential future development.

We would expect the level of external funded reinsurance to remain in the range of 0-10 percent of the annuity business written so far for insurers.

There has been significant recent interest from the reinsurance market in supporting funded reinsurance, with Resolution Re, Prudential Retirement, AIG and RGA among the reinsurers offering cover to UK insurers.

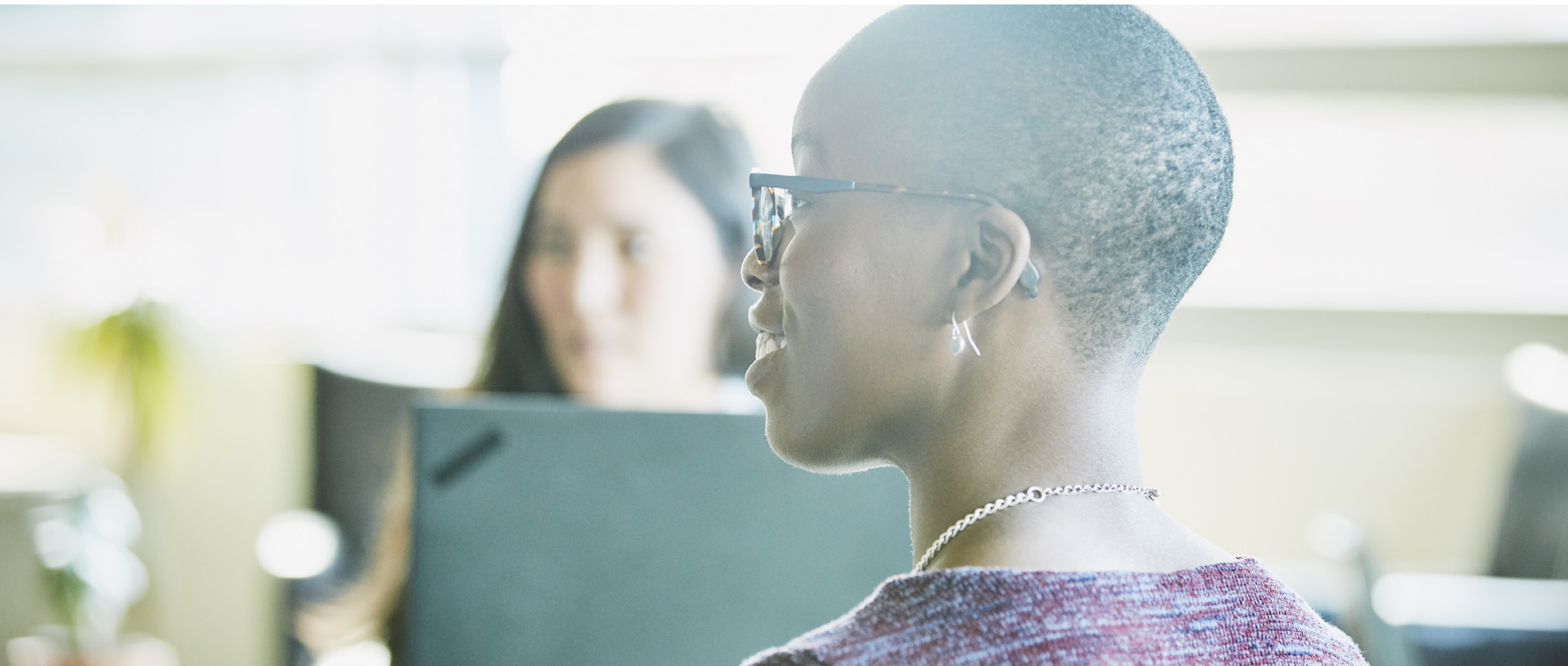
Regulatory Supervision in the UK

The PRA has been keeping a close watch on the use of funded reinsurance and has expressed the need to investigate the robustness of the current regulatory requirements amid the growing demand for bulk annuities in the UK, especially since the PRA has less oversight and direct control of risks that have been transferred outside of the UK.

The PRA published a consultation paper in November 2023 that proposed a number of new requirements on UK insurers. These proposed changes include:

- Limits on exposures to single or a number of highly correlated reinsurance counterparties, addressing the potential concentration of counterparty default risk.
- Explicit requirements for collateral assets, including that insurers should make prudent allowance for the costs of rebalancing their asset strategy if these assets were returned to them on reinsurer default.
- Significant additional reporting, planning, and risk assessments by UK insurers.

The consultation closed in February 2024 with new guidance expected to be implemented in Q2 2024.



Regulatory Changes Across the Globe

There is ongoing global liaison between regulators, including the International Association of Insurance Supervisors - which seeks consistent supervision across territories.

Some changes are expected in Bermuda and the US which are likely to reduce the economic benefits of funded reinsurance, by reducing the scope for regulatory arbitrage.

The Bermudan Monetary Authority carried out a series of consultations in 2023 with proposals to strengthen the Bermuda regime and align more closely with the EU/UK regimes. The proposals are expected to increase the level of reserving in Bermuda in particular, by new requirements for deriving the discount rate that, for instance, may lead to lower rates for some illiquid assets.

In the US, the American Academy of Actuaries (AAA) has proposed amendments to reserving requirements in 2024. This would tighten reserves for onward funded reinsurance to other territories, with Bermuda the typical territory used.

A greater aligning of regulation across key territories is likely to reduce the scope for price savings from funded reinsurance, although the additional capital capacity will potentially still be attractive to some UK insurers. We expect some funded reinsurance to continue given the other advantages, but the greater focus across regimes should be reassuring for UK pension schemes.

Conclusion

The concept of funded reinsurance is not new. There has long been a practice of UK bulk annuity providers seeking reinsurance (at least for longevity risk) from numerous different counterparties, as well as putting in place risk mitigations for the counterparty exposure created. This has supported annuity pricing in the UK for several years and led to more efficient capital management by insurers.

A number of larger UK bulk annuity providers have been using funded reinsurance internally for some time– reinsuring risks to subsidiaries in other territories within their own group.

Used in moderation with appropriate risk mitigations in place, we believe funded reinsurance can help support bulk annuity pricing in the UK during a period of significant demand from pension schemes.

We expect insurers to have appropriate reinsurance treaties and risk management controls to avoid unnecessary risk from this activity, including high quality collateral pools. The increased supervision from the PRA is a positive step to formalise risk mitigations and seek to protect policyholders from undue risks arising over time.

However, we have been concerned about the lack of public disclosure from insurers over reinsurance, making surveillance of the insurance market more difficult. We hope the greater focus on this area leads to greater disclosure.

While regulatory arbitrage is an ever-present concern in any financial market, increased focus across regulatory jurisdictions is a positive step and UK pension schemes should be reassured by the proactivity of regulators to manage risks as they arise.

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