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Dive into pensions de-risking

The insurance regulator takes a look at funded reinsurance

On 15 June 2023 the Prudential Regulatory Authority (PRA) published a letter to bulk annuity insurers regarding their use of funded reinsurance. In this note we seek to help pension schemes understand what funded reinsurance is, its relevance to them, and what the PRA has concluded.

Background

Overview of funded reinsurance

Funded reinsurance is akin to a bulk annuity insurer doing its own buy-in behind the scenes. The 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 is then on the hook for providing monthly benefit payments to the insurer, and the insurer passes these payments on to the pension scheme or (following buy-out) the pensioners directly.

Reasons for use of funded reinsurance

Insurers typically use funded reinsurance for one or a combination of the following reasons:

- *Investing quickly at scale*. E.g. for a £1bn buy-in an insurer could use funded reinsurance for 50% and only need to source £500m of assets rather than £1bn.
- *Capital efficiency / scale*. The insurer can use less capital for writing the business if the risk is shared – either helping the insurer to write a larger buy-in/buy-out, or improve its return on capital. Insurers may even end up with an improved capital position by writing the business, an unusual position for bulk annuities.
- *Pricing*. 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.

Risk

If an insurer uses reinsurance on a particular buy-in or buy-out, this does not directly expose the pension scheme (or its members) to the reinsurer. If the reinsurance fails in any way, the insurer remains on the hook. But pension schemes should still consider the overall risk profile of a selected insurer, including the exposure that insurer has to reinsurers and how associated risks are managed. The use of reinsurance, be it funded or pure longevity, can vary significantly between insurers. Funded reinsurance has more inherent risk than longevity reinsurance, as the asset risk is passed across to the reinsurer at outset, so if the reinsurer fails, there is a potentially sizeable loss for the insurer.

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How do insurers manage these risks?

Insurers use a suite of contractual protections and collateral arrangements to protect against a reinsurer's financial strength deteriorating, 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.

PRA letter

The PRA letter shares their insights from a review of funded reinsurance across the sector. It goes into more detail about the risks inherent in funded reinsurance and how insurers are currently mitigating these. The PRA's key conclusions thus far are:

- There is a positive trend of improvement in insurers' risk frameworks and models relating to funded reinsurance.
- However, insurer practices still showed some material shortcomings, in particular some structural risks with regard to collateral portfolios and the assumptions made about the impact of possible reinsurer failure.
- There are limited risks to policyholder security from the use of funded reinsurance within a diversified asset strategy, but there could be significant risks if funded reinsurance were to be used systemically as a way of meeting increased demand for buy-in and buy-out.

The PRA set out a number of next steps, the main ones being:

- Insurers will need to consider whether the letter requires any remedial actions on their part.
- The PRA plans further supervisory work around insurer use of funded reinsurance, and will consider whether any further policy is required
- Insurers need to notify the PRA regarding any material funded reinsurance transactions they enter into.

In summary

Given the expected rapid growth in insurer balance sheets as more and more DB pension schemes seek to pass them their liabilities, we are encouraged that the PRA is scrutinising the use of funded reinsurance – especially given that assets and liabilities are commonly passed to reinsurers who are based overseas and therefore outside of the PRA's remit. The PRA appears to be accepting of the moderate use of funded reinsurance, but remains concerned about a scenario where its systemic use leads to the majority of UK DB assets and liabilities end up moving outside of the Pensions Regulator or PRA remit. We support this overall direction of travel, as well as a continued PRA focus on ensuring that where insurers do use funded reinsurance, they have appropriate risk mitigations in place.

For pension schemes with existing buy-ins or who are considering their use, we believe trustees and sponsors should take comfort from the PRA's approach. We suggest pension schemes consider the use of funded reinsurance when assessing the financial strength of a given insurer.

Get in touch

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

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