



PACIFIC LIFE RE

Funded Reinsurance

A reinsurer's
perspective



Introduction

The PRA recently published a statement¹ articulating the risks that it believes funded reinsurance may pose to the UK life insurance sector.

In this paper we cover Pacific Life Re's perspectives on this statement and follow up materials, highlighting why we believe the PRA's unbundling proposal is not appropriate and proposing alternative options to address the PRA's concerns.

Reinsurance provides significant benefits to the UK insurance industry and has supported policyholders' access to affordable insurance for many years, including through a recent global pandemic. Reinsurance of annuities through funded reinsurance can be hugely valuable, supporting UK pensioners through the additional protection of highly capitalised, well diversified global reinsurers.

We believe that the PRA's proposals may have the unintended consequence of limiting access for UK pensioners to reinsurers' capital and diversification, and raising pension provision costs, leading to fewer pensioners protected by a regulated insurance regime.

What is funded reinsurance?

Funded reinsurance typically refers to quota share arrangements, where the full underlying product is reinsured. This form of reinsurance has existed for decades. In the UK, the term "funded reinsurance" is commonly used. In other regions, different terminology is used – "asset intensive reinsurance" in Asia and "co-insurance" in the US.

These structures involve full risk transfer of the underlying product, with counterparty risk being the primary concern for the cedant, as in all forms of reinsurance. Collateral serves as added security.

What did the PRA statement say?

The PRA is challenging whether "the existing Solvency UK framework provides the right framework for these innovative transactions" (i.e. funded reinsurance).

Crucially, the PRA argues that funded reinsurance is "economically similar" to a collateralised loan plus longevity reinsurance. They therefore suggest that funded reinsurance could be "unbundled" into longevity and asset elements, with the asset element being treated in a similar way to a collateralised loan.

Is funded reinsurance "economically similar" to a collateralised loan plus longevity reinsurance?

In materials produced following its initial statement, the PRA highlights the similar economic profile and layers of protection between funded reinsurance and a collateralised loan. However, whilst there may be some similarities, funded reinsurance is fundamentally different to a collateralised loan. We have highlighted the main differences in the table below.

	Funded Reinsurance	Collateralised Loan
Who is exposed to the market risks, including spread and rates movements, and downgrades and defaults?	Reinsurer	Insurer
Who holds capital against the above risks?	Reinsurer	Insurer
Expected term and tradeability	Expected to be held to maturity by the insurer under terms of contract	Can often be traded by the insurer
Nature of collateral assets	Diversified portfolio of liability matched assets	No requirement for liability matching Typically no limits on asset classes, or overall credit quality.

¹ [Funded realignment: balancing innovation and risk](#) – speech by Vicky White | Bank of England

What are the consequences of this “unbundling” approach?

We believe that the “unbundling approach” will have a detrimental impact in several ways.

1) Increasing the cost of pension provision for UK pensioners - treating funded reinsurance as a collateralised loan will result in double capital being held, with the cedant and reinsurer both holding capital against the same asset risk. This will ultimately lead to an increase in the cost of pension provision and fewer UK pensioners having access to a pension managed by a regulated insurance regime.

2) High risk of divergent practices and lack of transparency – the proposal to “shoe horn” funded reinsurance into the collateralised loan module would cause new issues with the insurer having to make subjective adjustments to attempt to model funded reinsurance within this module. These adjustments include (a) allowance for the counterparty being a regulated, highly capitalised reinsurer, rather than a debt instrument; and (b) reflecting the liability matching nature of the collateral assets. This will lead to divergent practices and a lack of transparency which are likely to exacerbate current PRA concerns around current variation in firm practices.

Alternative options to “unbundling”

We understand that the PRA’s main objective is to ensure that the Solvency UK framework appropriately reflects the risks of funded reinsurance. We believe that tailored changes to the existing counterparty risk module and reinforcing risk management processes would be the right way to address those concerns, and we have set out below a few areas for consideration.

1) Enhancing the Counterparty Default Adjustment – to strengthen counterparty capital where necessary.

2) Expanding the “probability of default” framework with specific risk factors and a scoring system to better reflect the risks in the counterparty and the strength and diversification of the counterparty’s balance sheet, and any wrong way risk collateral.

3) Reinforcing current risk management processes – strong risk management processes were introduced as part of SS5/24 and we believe that the PRA should continue to encourage best practices and highlight where they see deficiencies.

“...the unbundling proposal will have an adverse impact on the economic security of UK pensioners...”

Conclusion

Reinsurance, including funded reinsurance, is a force for good and has supported the UK insurance industry for decades through multiple systemic events. Funded reinsurance can be a hugely valuable tool for a UK insurer and benefits UK pensioners who are additionally protected by ceding insurers transacting with highly capitalised, well-diversified global reinsurers.

As reflected above, we are of the view that the unbundling proposal will have an adverse impact on the economic security of UK pensioners and is highly likely to exacerbate the PRA’s concerns around divergent practices. We hope that the PRA will consider alternative options, including refining the counterparty risk module and reinforcing best practices, with the view to ensuring that the risks of funded reinsurance are appropriately reflected without introducing disproportionate capital charges.

Get in touch

As always, we welcome the opportunity to discuss the contents of this publication or other industry happenings so please reach out to any of the below or your regular PL Re contacts.



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