PACIFIC LIFE RE

Funded Re: A Way Forward

In October 2025 we published a paper in response to the PRA's evolving stance on funded reinsurance (Funded Re) in the UK bulk purchase annuity (BPA) market.

Since then, industry engagement has continued, passing two key milestones:

- The second round of PRA-led insurer roundtables, which reinforced the regulator's focus on balance sheet consistency and risk responsiveness whilst opening the door to alternatives to the originally proposed 'unbundling' approach resisted by industry.
- Publication of the Life Insurance Stress Test (LIST) 2025 results, confirming sector resilience, including under severe Funded Re recapture.

Further communication from the PRA is expected during Q2 this year.

In this paper, we set out our view that the robustness of current regulatory frameworks should remain the primary protection to systemic risk. We provide further perspective on the potential balance sheet inconsistencies highlighted by the PRA and propose targeted refinements to address any remaining risks.

Existing regulatory frameworks remain the primary risk mitigant

The PRA's Supervisory Statement SS 5/24 set clear expectations for Funded Re arrangements: internal limits, collateral policies, stress testing and board-approved recapture plans. These frameworks embed strong safeguards and already act to mitigate systemic risk. Firms are required to model the impact of immediate recapture scenarios and set Funded Re limits to ensure balance sheet resilience following recapture.

These recapture scenarios were tested within the 2025 Life Insurance Stress Test (LIST) exercise. The recently published results showed that UK insurers, based on current levels of Funded Re, can withstand recapture scenarios with minimal impact on solvency ratios. A key concern could be whether a more material impact occurs if volumes of Funded Re continue to increase. However, as noted, firms have already implemented volume limits under SS 5/24 which are explicitly tied to balance sheet resilience on recapture. These existing limits will act to prevent a build-up of systematic risk.

Balance sheet consistency

The PRA continue to highlight a potential balance sheet inconsistency between Funded Re and a collateralised loan, noting a desire to at least partially bridge the gap in the amount of capital held by an insurer under both approaches. We believe this gap can be justified from two perspectives:

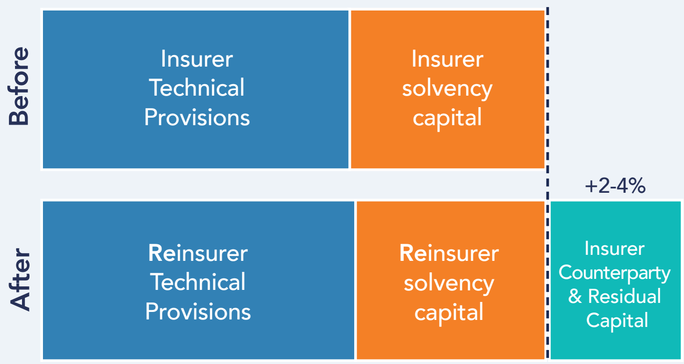
1. From an insurer's perspective, the difference in capital treatment is justified by the fundamental differences in risk between a loan and Funded Re.
2. At industry level, given the reinsurance entity is subject to insurance supervision and holds its own capital against the transaction risks, there is no 'gap' in capital, as the asset risk capital is now held by the reinsurer rather than the insurer.

The key differences between a collateralised loan and Funded Re have already been outlined in our previous paper and by a range of industry stakeholders. In this paper we focus on the level of capital at industry level following a Funded Re transaction, considering both the insurer and reinsurer balance sheets before and after.

In a very basic example, if a UK based insurance company transacted Funded Re with a reinsurer that had a similar risk profile and capital model, the total capital in the system backing the underlying annuity policies would likely see an overall increase following the transaction. This occurs because:

- The reinsurer holds the reserve in full plus a risk margin and solvency capital to cover the asset (and longevity) risks acquired – this will be materially similar to that of the insurer prior to Funded Re.
- In addition, the insurer holds counterparty risk capital against the reinsurer and any residual capital for retained risks.

Fig1: Total industry asset requirements before and after Funded Re (UK insurer to a reinsurer with a similar risk profile)

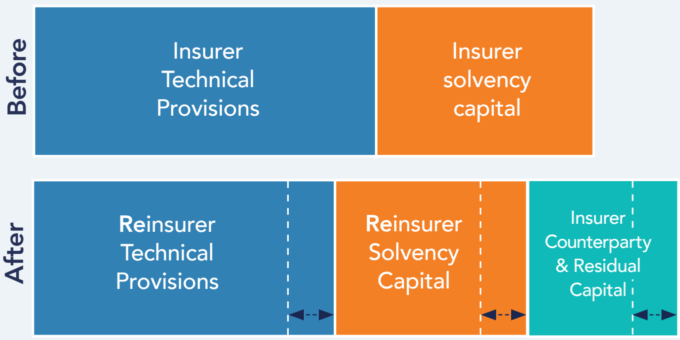


Following Funded Re, pensioners are likely more secure overall – the risk has been spread across two insurance entities and (in this example) the total capital backing their annuity has increased. The insurer holds capital for retained risks (mostly counterparty), and the reinsurer holds capital against the risks it has assumed (mostly asset and longevity risk).

In practice, the total asset requirement across the insurer and reinsurer may differ from the above due to several factors:

- Each entity possesses its own unique risk profile, resulting in differing levels of diversification and resulting solvency capital requirements.
- Variations in investment strategies lead to varying technical provisions and capital requirements.
- Differences in regulatory regimes mean that similar risks could attract varying levels of capital.

Fig2: Total industry asset requirements before and after Funded Re (UK insurer to reinsurers of varying risk profiles)



Reinsurer investments and diversification lead to varying reserves and capital in practice

The above factors could lead to an overall reduction in the total industry asset requirement after Funded Re. Based on high level modelling of typical transactions, we'd expect total asset requirements before and after Funded Re to be within +/- 3-4% of each other.

This highlights the importance of the regulatory regime that both the insurer and reinsurer are subject to. Provided the reinsurer is within a robust capital regime (for example, one that is Solvency II equivalent), then any differences in capital treatment due to the above factors, including where total asset requirement may have fallen post transaction, should be an appropriate reflection of the risks of the transaction and the reinsurer's wider balance sheet.

The PRA has noted concerns that insurers may be seeking to leverage differences in reserving approaches, capital requirement or investment flexibility through Funded Re. Provided transactions continue to be between strong counterparties in robust jurisdictions, Funded Re should be welcomed as part of an effective global insurance market, spreading risk and contributing capital in the most efficient way possible. The PRA's proposals risk creating double capital in the system, effectively removing a valuable risk and capital management tool from insurers, leading to less innovation and growth in the UK insurance sector.

Addressing the remaining risks

In the PRA's second industry round table, the PRA highlighted three key requirements for any solution - Risk Responsiveness, Implementation Simplicity and Application Consistency.

We believe the best approach, which is also an option suggested by the PRA, is to reform the Counterparty Default Adjustment (CDA) to better reflect the risks and protections inherent in any specific funded reinsurance transaction.

To allow for the large range of potential bespoke structures possible, it is important to retain a principles-based approach, rather than an overly prescriptive system.

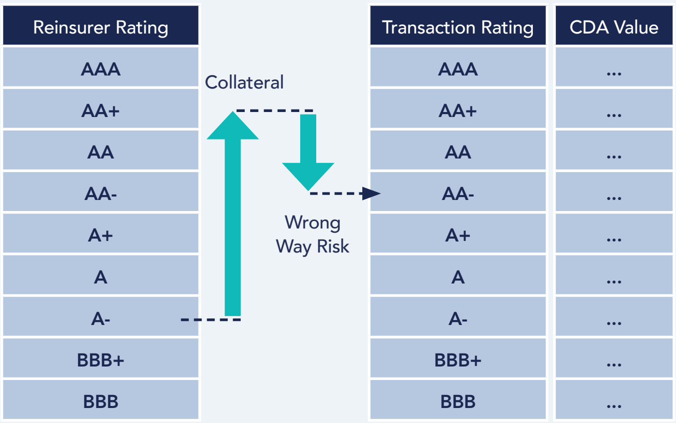
We'd expect the following key factors should be primarily considered:

- Reinsurer financial strength
- Collateral level and quality
- Allowance for risk diversification or wrong way risk
- Transaction basis risk

A high-level framework could start with the reinsurer's credit rating, with notching up and down from this position in consideration of the factors above.

The resulting final notional rating could be mapped to a prescribed table of CDA values to aid consistency – for example using EIOPA published tables of expected default losses, or an equivalent calibration which appropriately captures both probability of default and loss given default. Any reform should ensure Funded Re transactions which are robustly structured with strong reinsurance counterparties remain viable, whilst ensuring adequate differentiation for higher risk transactions.

Fig3: CDA basic mapping example



Many of the positive arguments the industry has made for Funded Re rely on transacting with financially strong global reinsurance companies subject to robust insurance supervision. The risks inherent in transacting with weaker entities could be further mitigated by:

- Applying much stricter limits or prohibitions on transactions with poorly rated or unrated entities.
- Capping the degree to which credit can be claimed for collateral against a low rated entity (e.g. by limiting the amount of notching from the reinsurer's credit rating).

Overall, we consider this approach to score well against the PRA's solution criteria:

Topic	Unbundling	Revised CDA
Risk Responsiveness	× Not sensitive to the primary risks retained by the cedant (i.e. couterparty default).	✓ Sensitive to both the risks relating to the reinsurance counterparty and the collateral assets
Implementation Simplicity	× Complex to implement and introduces inconsistency with other types of reinsurance	✓ Use of existing CDA methodology
Application Consistency	× Unbundling is complex and likely to lead to a range of outcomes	✓ Objective criteria, with potential to link to prescribed probability of default values
Overall	Blunt, economically inefficient, and fails to capture retained risks	Utilising existing methodology with further principles to capture retained risks

Conclusion

Funded Re provides a valuable source of capital to support the UK PRT market and distributes the underlying risks across a larger number of insurance entities, ultimately leading to greater security for pensioners.

Leveraging established regulatory frameworks, notably SS 5/24, should remain the primary regulatory tool to monitor and control potential systemic risk.

Building upon the existing CDA methodology, supplemented with further principles to robustly capture retained risks, offers the best path forward. It maintains coherence across reinsurance types and ensures outcomes that are both economically sound and operationally practical.

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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