Risky business?

Summary
• The use of FundedRe has been increasing, offering one way to improve BPA market capacity amid a time of significant demand from DB schemes.
• Regulatory scrutiny surrounding the use of FundedRe has also been growing in tandem, with the Prudential Regulation Authority releasing new policy expectations for insurers on the issue.
• Many insurers are already taking action or aligned with these expectations, but the true test will be in the PRA's planned stress testing in 2025.

Funded reinsurance has faced growing scrutiny in recent months, but with capacity concerns being raised around the BPA market, it could also present an opportunity to reduce risk and meet the growing demand from DB schemes. Sophie Smith reports

Despite conversations around the potential benefits to run on, many companies have taken the recent DB funding improvements as an opportunity to reduce their pension risk exposure, with bulk purchase annuities (BPA) remaining the chosen method for many schemes.

And with BPA market volumes growing rapidly and unprecedented demand from DB schemes, some insurers have been increasingly choosing to cede both the longevity and asset risk obtained via these BPA deals to reinsurers through funded reinsurance (FundedRe) transactions.

"Used in the right way, FundedRe offers insurers additional scale and potentially improved economics on bulk annuity transactions," Hymans Robertson risk transfer specialist and partner, Lara Desay, says.

"That is to say, an insurer using funded reinsurance can write larger buy-ins/buyouts both from a capital and an investment perspective than it might otherwise have been able to. Less capital is used for writing the business if the risk is shared.

"Furthermore, it allows insurers to invest quickly at scale, e.g. for a £1 billion buy-in an insurer could use funded reinsurance for 50 per cent and only need to source £500 million of assets, rather than £1 billion."

This can be particularly helpful for some of the players who have traditionally operated at the smaller end, Vidett client director, James Duggan, says, agreeing that "it can give them the capacity to quote on larger transactions thus bringing more competition to deals at the larger end".

There are also broader benefits, as S&P Global Ratings EMEA insurance analyst, Charles-Marie Delpuech, says that, for BPA writers, the most important benefits are the opportunity to benefit from reinsurers' asset origination capabilities, and reduce the capital intensity of writing BPA business relative to transferring longevity risk alone.

This could also mean good news for pension schemes approaching the BPA market, as Desay says that the use of FundedRe has the potential to increase the availability and price attractiveness of the BPA market.

Too good to be true?

But FundedRe has faced increasing scrutiny in recent months, particularly around risk mitigation and transparency levels, with both UK and Bermudian regulators sharing new measures to help improve risk management on FundedRe transactions.

In particular, the Prudential Regulatory Authority (PRA) recently outlined its policy expectations on FundedRe, following concerns that the current growth in FundedRe transactions could, if not properly controlled, lead to a rapid build-up of risks in the sector.

The PRA also wrote to the CEOs of a number of life insurance firms to draw attention to its new final policy statement.

In the letter, the PRA clarified that whilst it has seen some evidence of firms developing and improving their risk management practices for these transactions, further improvements are still needed by UK insurers to meet the regulator's policies and expectations.

It stated: "The PRA will continue to monitor market practice and assess the risks to its objectives from this market over the coming months, taking into account growth of FundedRe in individual firms and the market as a whole.

"In particular, we will monitor closely the volume of FundedRe transacted by firms, any change in the quality of the collateral and the nature of FundedRe counterparties active in the market, and the progress firms make in implementing risk management and control arrangements in line with SS5/24."

The PRA's new expectations were broadly welcomed and, according to Delpuech, are set to have a "positive impact" on the insurance industry's risk management practices regarding controls and measurement of the risks related to the use of FundedRe.

"While the new guidance does not fundamentally bring new information to insurers' risk management practices, we think that the proposed measures will support needed discipline in the use of FundedRe," Delpuech explains.

"We are also likely to see enhanced risk management processes on the FundedRe side, as for instance some of the expectations on collateral policies may ultimately rely on the collateral management capabilities of FundedRe providers."

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A starting step

However, Aon has said that while the PRA's new requirements are a positive step, it remains concerned about the lack of public disclosure from insurers.

"We hope the continued attention to this area leads to more public disclosure to provide greater reassurance to customers," Aon senior partner and head of risk settlement, Martin Bird, states. "Despite the lack of disclosure, it is clear that insurers already do spend considerable time on risk controls in this area, and the PRA requirements should drive more consistency in their stringency."

Indeed, Standard Life managing director of DB, Kunal Sood, says that the group has been "actively participating" with the PRA through its thematic reviews and consultation process regarding the use of funded reinsurance.

"We fully support the core principle of the new regulations and will maintain strong risk and financial frameworks that align with them, and we are currently working through the details of the resulting Supervisory Statement," he says.

Both Delpuech and Bird also agree that the BPA market is unlikely to be negatively hit by the new policy expectations, with the annual BPA premium expected to remain about £50 billion over 2024-2026.

But despite the positive signals, Desay warns that the true impact of the policy expectations remains unclear.

"Dialogue with insurers would indicate that these expectations are already being met, but the tone of the PRA 'Dear CEO' letter, published 30 July 2024, which followed a PRA review of insurer practices, would suggest they think otherwise and that more needs to be done," she says.

And if further action is needed, it could impact the BPA market, as Desay warns that FundedRe pricing could increase as a result of tighter contractual requirements, and consequently the pricing that insurers are able to offer to pension schemes on certain transactions may also increase.

Making the right choice

For now, many are looking ahead to the PRA's plans to stress test life insurers and reinsurance, which Delpuech expects to provide useful information for the market regarding the magnitude of exposure and risk, particularly given that transparency regarding the use of FundedRe is "currently lacking".

In the meantime, Desay says that it is important that trustees entering into a buy-in policy have regard to the financial strength of the insurer and their risk management framework, including that related to the use of funded reinsurance.

"Importantly, this should focus on the usage across the portfolio and not just whether funded reinsurance is being used to support the transaction in question," she continues. "Trustees can now take additional comfort from the measures put in place by the PRA and the level of scrutiny being placed on insurers and in particular the focus on risk management."

Written by Sophie Smith