For Professional Clients Only

Funded Reinsurance

PRA Reaffirms Focus For 2025

This note considers the use of Funded Reinsurance by UK bulk annuity insurers following the PRA's continued commitment to ensure appropriate risk management

Summary

On 9 January 2025, the Prudential Regulatory Authority (PRA) issued a 'Dear CEO' letter setting out its 2025 priorities for the UK insurance sector.

The letter covers a number of key focuses for the PRA, including further reforms to the UK insurance regime post-Brexit.

One area covered in the letter is the use of Funded Reinsurance ("FundedRe") by UK bulk annuity insurers. This was a key area of focus for the PRA in 2024, and the letter reaffirms the PRA's intention to increase its scrutiny and regulation of insurers in this area.

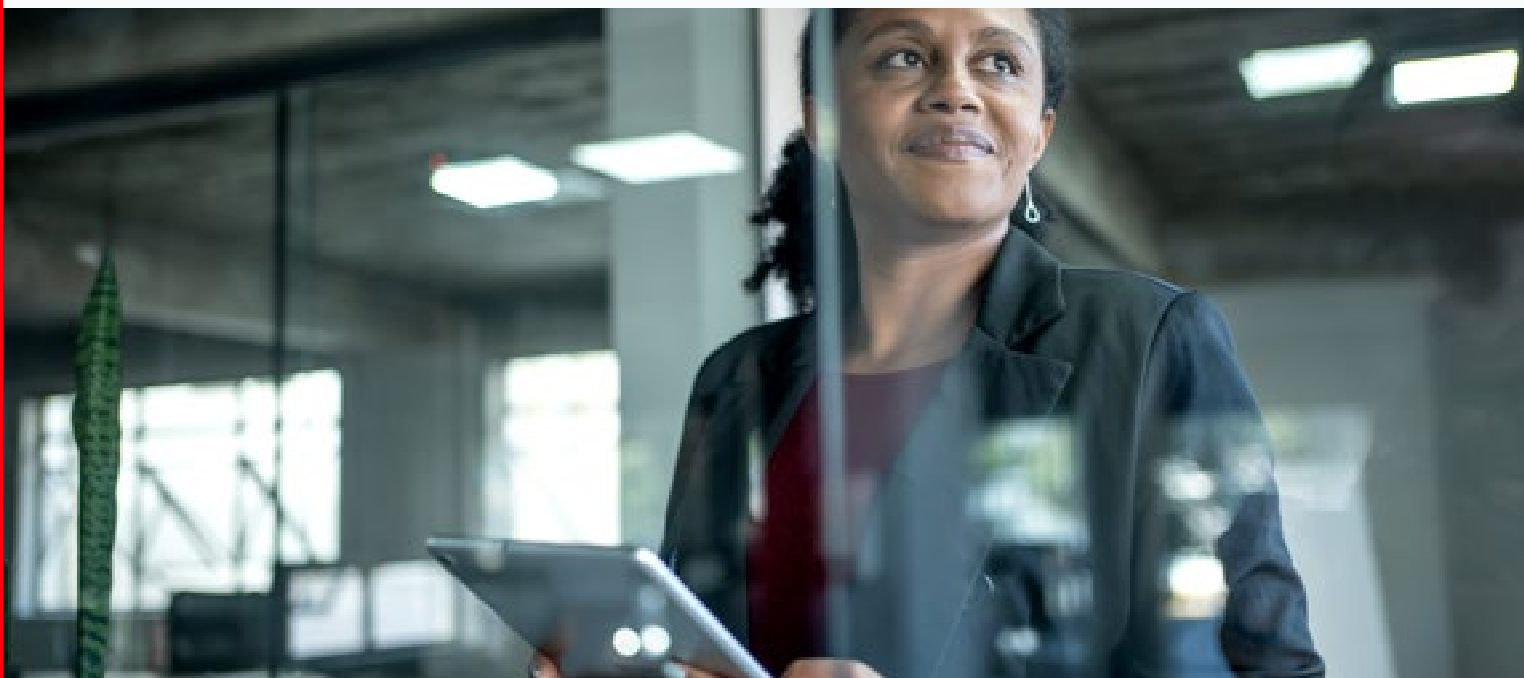
The letter follows a supervisory statement, issued by the PRA in July 2024, which set out expectations for insurers to adopt more prudent risk management procedures and more detailed disclosure requirements in relation to FundedRe.

The PRA required insurers to submit various information on their use of FundedRe by 31 October 2024. In its recent letter, the PRA notes that many insurers have remediation plans in place for areas of non-compliance, and that it will consider further use of its powers if it deems that firms are not doing enough in this area.

Our View

The use of FundedRe can be a useful tool for insurers to enable competitive pricing and capital efficiency, as well as manage risks across their portfolio.

It currently accounts for less than 10% of bulk annuities written to date. However, we continue to support the focus from the PRA on this relatively new form of reinsurance and welcome the scrutiny to ensure appropriate controls are in place to maintain policyholder protection. We also support the need for greater public disclosure from insurers in this area.



Funded Reinsurance: An Overview

What Is It?

Reinsurance is a method of risk transfer, frequently used by life insurers. Traditionally, this was primarily used to transfer longevity risk to the global reinsurance market but is also now increasingly being used to transfer some asset risk. The reinsurance of asset risk (or both asset and longevity risk on a combined basis) is what is called FundedRe.

This has the potential to create counterparty risk exposure to the reinsurer, which is typically based in another regulated insurance market outside of the UK (e.g. Bermuda).

We are aware of five insurers that have used FundedRe to back new bulk annuity business, to varying degrees. Thus far, FundedRe has typically been used on only large transactions written by the more-established insurers (e.g. deals of £500M and above).

Why Is It Attractive to Insurers?

Price Optimisation

The UK insurer can access the regulatory regime of the reinsurer (many operate in territories with different regulatory regimes to the UK) via FundedRe. This may mean that reserving cost is lower for some tranches of business, allowing insurers to optimise the overall bulk annuity price.

Increased Capacity

Through FundedRe, the insurer can reduce the amount of its own capital that is required to back a new transaction, allowing it to increase its capacity for writing transactions.

Support for Asset Sourcing

FundedRe allows insurers to access a greater pool of investment opportunities via the reinsurer, giving faster overall asset sourcing and potentially a better overall yield. Asset sourcing has become a key challenge for insurers amid rising bulk annuity demand.

Risk Mitigation

UK insurers make explicit allowance for counterparty risk in their reserves. This risk is also mitigated in two key ways:

Collateral

Counterparty risk is mitigated via the reinsurer holding ring-fenced collateral which would be passed to the annuity provider in the event of reinsurer failure (i.e. recapture). The reinsurance treaty will include detailed requirements for the quality and magnitude of these assets.

Reinsurer Creditworthiness

Reinsurers involved in FundedRe are typically large multinational insurance groups, with the reinsurance often placed in a Bermuda-based subsidiary. Bermuda has a well-established insurance solvency regime, which has been granted equivalent status to the Solvency II regime.

A more detailed overview of FundedRe is given in our previous update here.

PRA Concerns and Actions

The PRA has remained focussed on the bulk annuity market in recent years following a significant increase in activity. The use of FundedRe has been one factor in supporting insurers to write greater volumes at relatively low capital strains.

In 2024, the PRA initially raised concerns over the use of FundedRe, including the quality of collateral pools, insurers' ability to deal with a recapture event on reinsurer default, and the potential for adverse events to impact insurers and reinsurers at the same time.

The PRA has already taken steps to address these concerns, including new regulations and requiring insurers to submit a suite of information on FundedRe by 31 October 2024.

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> The current growth in Funded Reinsurance transactions could, if not properly controlled, lead to a rapid build-up of risks in the sector and have the potential to pose systemic risks.
>
> *PRA's letter to the UK insurance sector, 9 January 2025*

Regulations

New requirements introduced by the PRA in 2024 include the following:

- Insurers are subject to a number of **additional reporting and governance** requirements, including modelling and calculating risks involved with FundedRe, and implementing appropriate risk management frameworks.
- Insurers are required to **limit exposure to a single counterparty** and **limit the use of FundedRe in aggregate**, with reference to concentration of risks, likelihood of recapture, and quality of collateral available.
- Insurers are required to set **clear collateral policies** for FundedRe transactions, including developing a recapture plan for each individual deal, with associated risks of recapture appropriately assessed.

Insurer Submission to PRA

The PRA required all insurers to submit various information by 31 October 2024.

- **Self-assessment:** an overview of the insurers' practices against the new requirements and any areas of non-compliance.
- **Limits:** summary of the counterparty limits for individual reinsurers, correlated reinsurers, and an overall limit on FundedRe.
- **Remediation activities:** a timeline of the activities expected to fully comply with the new requirements.
- **Level of confidence in modelling:** an overview of the perceived confidence of the insurers' internal modelling for FundedRe.
- **Risk appetite:** summary of the steps the insurer's Board has taken to limit its risk appetite for FundedRe.

PRA Feedback on Insurer Self-Assessments

Whilst the PRA has not provided any public feedback on specific insurer submissions, the PRA did note in its 2025 'Dear CEO' letter that insurers are not yet fully meeting its expectations and some remediation plans require further work. This is perhaps unsurprising given the short period of time since the new regulations were released.

Development Expected Over 2025

Dear CEO Letter, January 2025

Over 2025, the PRA expects to work closely with insurers to ensure that remediation plans are sufficient to meet regulatory expectations and are implemented effectively.

In its letter, the PRA noted that some insurers are falling short of its expectations, in particular around limits for both single counterparty exposure and aggregate FundedRe usage overall. The PRA writes that it expects insurers to make "rapid progress" in addressing these gaps.

2025 Life Insurance Stress Test

The PRA has also reaffirmed its intention to include a specific scenario covering a recapture event of FundedRe arrangements in its 2025 Life Insurance Stress Test — its regular stress testing exercise of the UK insurance market. It is expected that results of the exercise will be available in Q4 2025.

Bermudan Regulatory Changes

Frequently, FundedRe reinsurance entities are based in non-UK jurisdictions — often this is Bermuda, which has a well-established insurance solvency regime.

In December 2024, the Bermuda Monetary Authority (BMA) announced its intention to further increase supervision and regulation — including increasing its workforce, requiring more detailed insurer reporting, carrying out more in-depth on-site visits to insurers, and importantly implementing a tailored supervisory regime for FundedRe.

These latest measures from the BMA follow a number of regulatory changes in recent years that have strengthened the Bermudan insurance regime.

Looking Ahead

FundedRe is not a new concept to the UK insurance industry, but an increase in usage has brought with it appropriate scrutiny.

The inclusion of FundedRe in the PRA's 'Dear CEO' letter was not unexpected. The PRA has previously made it clear that the management of risks associated with FundedRe is a key focus, and it has already engaged with insurers and enacted a number of changes to this end.

Over the second half of 2024, we saw a reduction in the amount of FundedRe sought by insurers, due to low corporate bond spreads making UK gilts a more attractive investment and reducing the relative value of FundedRe. How insurer appetite for FundedRe will evolve into 2025 is as yet unclear, but we welcome the continued focus from the PRA on enhanced risk controls and visibility for FundedRe.

Insurers are already increasing time and resources spent on risk management and mitigation for FundedRe, however we expect that trustees and sponsors will want to carry out appropriate due diligence ahead of any potential transaction.

Whilst the PRA's latest requirements on insurers do clearly raise the bar in terms of risk management and reporting to the PRA, there are as yet no requirements to provide public disclosure in this area.

We would welcome greater public disclosure in this area to provide market stakeholders with greater insight into insurers' risk management strategies.

Contact Us

If any of these areas interest you please get in touch with one of our risk settlement specialists and they will be able to help.

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