
British regulators scrutinize 'FundedRe' in pension deals

By Kerry Pechter Thu, Aug 1, 2024

The Prudential Regulatory Authority, the Bank of England's financial regulatory arm, told UK life insurers in late July that it has concerns about the use of 'funded reinsurance' (FundedRe) to help finance big pension risk transfer (PRT) deals—swaps of defined benefit plans for private group annuities.

While US regulators and ratings agencies have shown little alarm about the financial reinsurance that private equity-led, US-domiciled insurers use to manage their capital requirements, the Bank of England's Prudential Regulation Authority (PRA) is making noise about its use by British insurers.

The PRA, Britain's principal financial regulator, told UK life insurers in late July that it has concerns about the "funded reinsurance" (FundedRe) that helps finance big pension risk transfer (PRT) deals—as swaps of defined benefit plans for private group annuities are commonly called. The PRA set an October 31, 2024 deadline for the boards of companies to report to the PRA on their firms' FundedRe risk management efforts.

In a [letter](#) to the CEOs of UK life insurers, Gareth Truran, head of Insurance Supervision at the PRA, wrote, "PRA is concerned that the current growth in FundedRe transactions by UK life insurers could, if not properly controlled, lead to a rapid build-up of risks in the sector.

"This could arise through underestimation of the counterparty risks on UK insurers' balance sheets, the capital requirements appropriate for these risks, or the risks of recapture of assets onto cedants' balance sheets if a FundedRe counterparty were to default."

A 23-page [policy statement](#) accompanied the letter. It said in part:

- The PRA recognizes that reinsurance is an important part of risk management. However, in the context of funded reinsurance, the PRA's concern is that counterparty risks may be underestimated as a result of the risk profile of the counterparties, the complexities of the arrangements, and the uncertainty around the effectiveness of management actions in stress.
- The PRA recognizes that funded reinsurance arrangements can be used by firms as part of a diversified asset strategy. However the PRA considers that there are increased risks in connection with funded reinsurance, including from a systematic use of funded reinsurance as an integral part of a firm's business model or from the use of more complex arrangements where it may be more difficult for firms to assess the full extent of risks involved.
- Firms may identify some diversification benefits from their funded reinsurance

portfolios which result in lower solvency capital requirements or make higher investment limits appropriate. These may include diversification between the cedant risk profile and the counterparty's risk profile, diversification between the collateral portfolio and the counterparty's asset portfolio, and diversification between the collateral portfolio and the cedant's asset portfolio. Conversely these transactions may also generate material increased risks and a heightened level of uncertainty of risk in stress, for example by impacting the collateral quality, liability valuation, risk of contract recapture, and risk of multiple counterparty failure within a firm's portfolio.

- Without material improvements, the PRA is concerned that UK insurers may use FundedRe, in volume and complexity, in a way that is not consistent with prudent risk management.
- If, in future, we consider that firms are not achieving our expectations on the risk management practices needed to mitigate the risks FundedRe poses to our objectives, we will consider whether it is appropriate to take further action such as exercising any of our powers under the Financial Services and Markets Act (FSMA) 2000 to address those risks, including supervisory powers under section 55M and rule-making powers. This could include, for example, consideration of explicit regulatory restrictions on the amount and structure of FundedRe, or measures to address any underestimation of risk, or regulatory arbitrage, inherent in these transactions.

Truran's letter mapped out the PRA's expectations of insurance company boards:

"We expect the boards of UK life insurers using, or considering using, FundedRe to consider the implications of SS5/24 and to provide their PRA supervisor, by 31 October 2024, with the following:

- **Self-assessment analysis:** An assessment of your firm's current risk management practices against all the expectations set out in SS5/24. This should include a justification if there are areas where your firm has not aligned fully with the expectations of the SS but where its implemented framework is considered to achieve the same outcome.
- **Limits:** A summary table of your firm's board approved FundedRe limits for individual counterparties, for correlated counterparties and your firm's aggregate limit.
- **Remediation activities:** A summary, including a timeline consistent with the implementation approach detailed in the previous section, of the activities that your firm has carried out and intends to carry out to meet the expectations set out in SS5/24.
- **Level of confidence in the modeling:** An overview of the perceived level of confidence achieved in your internal model output, at a transaction level, and how this has been used to shape your FundedRe investment limits.
- **Risk appetite:** An overview of what steps your board has taken to limit its risk appetite for the amount and complexity of FundedRe transactions over the coming

months, where gaps exist against the expectations set out in SS5/24.

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