Argyll Covenant

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Funded Re: re-balancing reinsurer risk

What's the problem with Funded Reinsurance?

For the last 3 years or so the PRA has been publicly voicing its concerns around the use of Funded Reinsurance, in particular within the pensions BPA industry. In short, the PRA believes the treatment of Funded Re within the Solvency II regime is not reflective of the risks to which life insurers are exposed by reinsurance.

The frequency of the PRA's comments on this issue made it unlikely it would let it drop and on 29 April 2026 it published a market consultation (CP8/26) with proposals which will most likely increase the risk capital the PRA expects insurers to hold in respect of Funded Re contracts.

Here's why.

The PRA attaches higher capital requirements to riskier assets held direct by insurers, and rewards insurers for holding higher quality and more closely matched assets through lower capital requirements. As a result, BPA insurers tend to invest in lower risk, matching adjustment eligible assets to maintain competitiveness and keep capital requirements to an efficient minimum.

With Funded Re an insurer writing a bulk annuity policy can cede a material proportion of the liabilities for investment to an offshore reinsurer, often in Bermuda, usually receiving the assets back as collateral. The reinsurer earns a spread on those often private or illiquid assets to generate the return needed to meet its future obligations, while the ceding insurer obtains capital relief with the collateral theoretically mitigating its credit risk exposure to the reinsurer counterparty. Under certain circumstances the initial capital relief may even exceed the value of the liability initially ceded.

Reinsurers based overseas might be subject to lighter touch interpretations of Solvency II and able to invest in more exotic, higher returning and potentially riskier, assets. Despite this, the capital requirements for ceded reinsurance business have been typically 2% to 4% (according to the PRA) compared to 11% to 15% that would apply to the same credit-based investments if held on the ceding insurer's balance sheet. In other words, in addition to spreading risks, ceding insurers can also use reinsurance to gain access to riskier asset classes with higher returns effectively via the 'back door' and for a lower capital cost than holding those assets direct.

Whilst the ceding insurer can take control of the collateral in the event of the reinsurer's worsening financial condition, the PRA points out that risks remain around the suitability of the collateral and the circumstances in which it can be claimed. As such, the collateral may not offer the risk mitigation assumed. Should the insurer have to recapture the risk in the event of the reinsurer's failure, even with the collateral there could still be an adverse effect on the insurer's balance sheet.

Funded Re has enabled some insurers to write substantially more business than their balance sheets might otherwise support, and for several years the arrangement worked well for all involved. Pension schemes received competitive pricing, insurers generated strong returns, and Funded Re became a standard feature of how the market operates.

PRA's proposals

The PRA's position is not that Funded Re is necessarily problematic in principle but rather that the scale, concentration and complexity of these arrangements have grown quickly enough to warrant a closer look at how well the associated risks are being reflected in capital and risk metrics. Insurers will be expected to have clear visibility over their funded reinsurance exposures, backed up with enhanced disclosures to the PRA ensuring that risk ownership is unambiguous regardless of the jurisdictions involved.

In a conference speech on 29 April the PRA's Gareth Truran conveyed the view that these proposals are not an intervention born of crisis but rather those of a proactive regulator looking to how risks in a fast-growing market should be managed.

In short, the PRA is proposing changes to how Funded Re arrangements are valued as assets on firms' Solvency UK balance sheets. This is expected to more closely value the risks of Funded Re compared to those on directly held assets. The changes, which will apply only to new business written from 1 October 2026, include the following:

Counterparty Default Assessment

The current method for assessing risk is quite approximate and non-dynamic compared to the way risk is assessed for direct investments. The PRA proposes a prescribed approach to assessing the default risk of a reinsurer counterparty, more in line with the assessment for corporate bonds. A notching system will be used based on the reinsurer's credit rating which is then notched up or down (ie default risk allowance lowered or raised) depending on the quality of the collateral.

Collateral quality

Since much of the collateral for Funded Re consists of complex or structured credit instruments, the PRA wants greater confidence that such assets would perform as expected under stress. To qualify for any upward notches the collateral must meet certain basic criteria such as the insurer is able to take control of and liquidate the collateral in a timely manner. Insurers will then be able to use favourable upward notches if they can demonstrate the amount of collateral fully covers the ceded liability, it is Matching Adjustment eligible and the collateral is credit enhancing ie has a higher credit rating than the reinsurer.

Limiting the use of bespoke assumptions

Four of the eleven BPA insurers use full internal models, five use a partial internal model and two use the PRA's standard model for calculating their capital requirements. Insurers' use of internal models, tailored towards their specific business profiles, will usually produce lower capital requirements than the PRA's standard model. The PRA proposes to limit the degree to which firms can use bespoke internal model assumptions to reduce the capital attributed to reinsurance recoverables, curtailing what it regards as an undue reliance on favourable firm-specific judgements.

Impact

For BPA insurers

Of the eleven BPA insurers currently, nine use reinsurance for longevity hedging (much less of a concern for the PRA given the absence of a material upfront premium) but seven do use Funded Re for risk management to varying degrees. Interestingly, two insurers do not currently use longevity or funded reinsurance at all.

At present this is a consultation exercise and interested parties may still be able to influence the rules eventually introduced by the PRA. Nevertheless, based on the current proposals their impact is likely to vary considerably from insurer to insurer and while the changes will be prospective, those with business models making more extensive use of offshore Funded Re structures are likely to face more adjustment for future business than those that have relied primarily on organic capital. In some cases, the economics of individual transactions may need to be reassessed and potentially trigger the restructuring of some reinsurance programmes and new business proposals. In particular, for certain structures the increase in capital requirements may be sufficient to render previously viable transactions uneconomic, potentially reducing the overall attractiveness and prevalence of Funded Re as a growth tool. However, for more traditionally capitalised players any changes are likely to be less disruptive and may perhaps even improve their relative competitive position.

For now at least the changes are expected only to apply to business written from 1 October 2026, so there are unlikely to be any material overnight shifts in insurers' overall capital ratios. Nonetheless, for the average Funded Re transaction the PRA has estimated the capital requirement will increase to 10% from the 2% to 4% currently. If there is any immediate impact it is more likely to be around contract pricing from October. This will be unwelcome for the insurers given competitive pressures have already taken their toll on new business margins (another concern of the PRA but for separate discussion).

For pension schemes

For pension schemes seeking buyout, increased insurer capital requirements are likely to contribute to upward pressure on pricing for deals from October. The degree of that pressure will depend both on the final calibration of the rules and the business model of the chosen insurer, and a measured increase of a few percent rather than step change seems more likely. Insurers could decide to cover the increased cost themselves, reducing profitability, to remain competitive. Notwithstanding this, the proposals may introduce a more material repricing of risk than has historically been the case, particularly for transactions heavily reliant on Funded Re structures, and could influence both insurer capacity and deal structuring at the margin. Altogether the fundamental economics of pension scheme de-risking are likely to persist and future demand for buy-out solutions is expected to remain strong.

For reinsurers

For reinsurers, the proposals are more likely to put pressure on offshore counterparties and lead to greater scrutiny of proposed collateral programmes. This could lead to lower volumes of business ceded to reinsurers. This may disproportionately affect lower-rated or newer entrants, while reinforcing the relative position of larger, more highly rated counterparties and potentially contributing to a degree of market consolidation over time.

Globally

CP8/26 is part of a coordinated supervisory shift rather than simply a UK-specific intervention and increasingly global supervisory priorities mirror those of the PRA ie regulators are looking at complexity, recapture risk, concentration risk, and the exploitation of cross-jurisdictional differences in reserve valuation, capital, and investment flexibility.

The International Association of Insurance Supervisors (IAIS), a voluntary membership global standard-setting organisation, comprising insurance supervisors and regulators from more than 200 jurisdictions, have expressed their concerns about cross-border Funded Re ("asset-intensive reinsurance" globally) and growing exposures to alternative assets as systemic concerns that warrant closer oversight. The Dutch regulator now requires prior consent for asset-intensive reinsurance involving non-EU assets, and the US standard setting body the National Association of Insurance Commissioners (NAIC) is apparently considering similar moves in respect of US-regulated entities.

Moreover, reinsurance counterparties in several jurisdictions, especially those with Solvency II equivalence, are increasingly subject to enhanced domestic oversight. In 2024, the Bermuda Monetary

Authority introduced prior approval for life reinsurance block transactions, together with enhanced capital requirements and liquidity risk management standards.

Conclusion

The consultation closes on 31 July 2026. Given the PRA's clear focus on improving transparency around the risks of Funded Re, it would be surprising if the ultimate changes to Solvency UK were materially different to those proposed in CP8/26 following the consultation.

The dynamics of the current BPA market are unlikely to change in our view, nor is the demand for risk transfer transactions, even in the event of a tick up in pricing.

More details on the issues with Funded Re can be found in our previous article here.

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