Overview of funded reinsurance collateral

With the publication of the PRA's Policy Statement PS13/24 and Supervisory Statement SS5/24 last July, the growing use of funded reinsurance and the regulator's expectation around this popular toolkit widely applied by the UK BPA insurers was brought to the forefront of industry attention.

Funded Reinsurance is an attractive tool for insurers looking to optimise their risk and capital management strategies in the UK BPA market and increase their access to suitable investment opportunities, provided any associated risks are managed and mitigated appropriately. One of the key elements of funded reinsurance focused on by insurers and the regulator is the quality and quantity of collateral provided by the reinsurer to the insurer as security against the liabilities ceded.

In this article, we provide an overview of funded reinsurance collateral and outline the deep-dive topics that the IFOA funded reinsurance working party plan to produce in the coming weeks and months.

What is collateral for?

Collateral is used to secure a reinsurer's obligation to pay the claims that have been ceded to the reinsurer by a cedant. A key consideration for any form of collateral is ensuring that the collateral assets provided are sufficient to cover the value of the claims ceded. However, in contrast to other forms of collateralised contracts, such as financial derivatives, there are some important differences with funded reinsurance collateral:

- **Larger absolute exposure**: given the contracts are "funded" i.e. beneficial and/or legal ownership of the assets are transferred to the reinsurer, the exposure is larger from inception relative to an equivalent unfunded contract, and always one-way. This is in contrast to say, a swap contract, where the collateral (or "margin") would effectively start at zero (i.e. be "unfunded") and can move in or out of the money.
- **Potential for more balance sheet risk**: restrictions around the types of assets that can be posted as collateral under derivative contracts tend to be driven by liquidity i.e. there is a preference for liquid collateral by both banks and insurers which would more than likely be sold on recapture. However, under UK BPA funded reinsurance transactions, cedants are reliant on any recaptured assets being Matching Adjustment eligible (or easily traded or transformed into this form) to limit the balance sheet impact on recapture, meaning that longer dated, or illiquid collateral assets can often be posted.
- **Additional uncertainty in actual exposure**: The exposure is based on expected future mortality and an uncertain discount rate.

These considerations place emphasis not just on the amount of collateral, but also the quality and type of collateral used. Generally, the closer the match between the collateral assets and the insurer's own matching adjustment eligible investment strategy, the lower the recapture risk. To minimise this risk, the collateral assets will be managed according to aset of investment guidelines agreed between the reinsurer and insurer. By placing limits around what the collateral

assets can be invested in and how they should be managed, the cedant can control the potential impact should a recapture event materialise.

Collateral structures

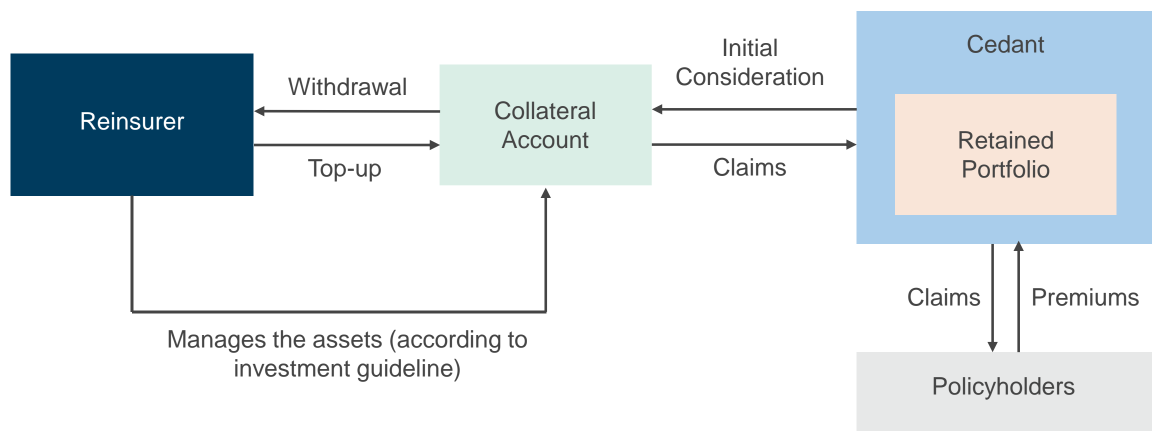
UK funded reinsurance structures fall under one of two high level structures:

- **"Funds Transferred"**: this is where the reinsurance premium assets are legally transferred to the reinsurer's balance sheet in the form of cash or other assets. The premium is then pledged as collateral to the insurer, generally in either a trust account or custody account, or some combination of the two. The accounts are either directly in the name of the reinsurer, or opened in the name of some form of Special Purpose Vehicle (SPV) over which the cedant has a legal charge. The collateral assets are owned, invested and managed by the reinsurer according to agreed investment guidelines.

  Whether assets are held in custody accounts or trust accounts generally depends on the specifics of the assets that the reinsurer is seeking to post as collateral. Typically custody accounts would be used for more liquid collateral, with trust accounts providing additional flexibility around some illiquid asset classes. These accounts would be set up at the inception of the reinsurance contract to receive the premium assets.

  UK insurers have also been exploring more complex collateral arrangements such as the use of investment funds (e.g. ICAV) or repacks (e.g. SPIRE) to better allow assets which are collateral eligible but are practically difficult to pledge to custody or trust accounts, such as private assets and derivatives.

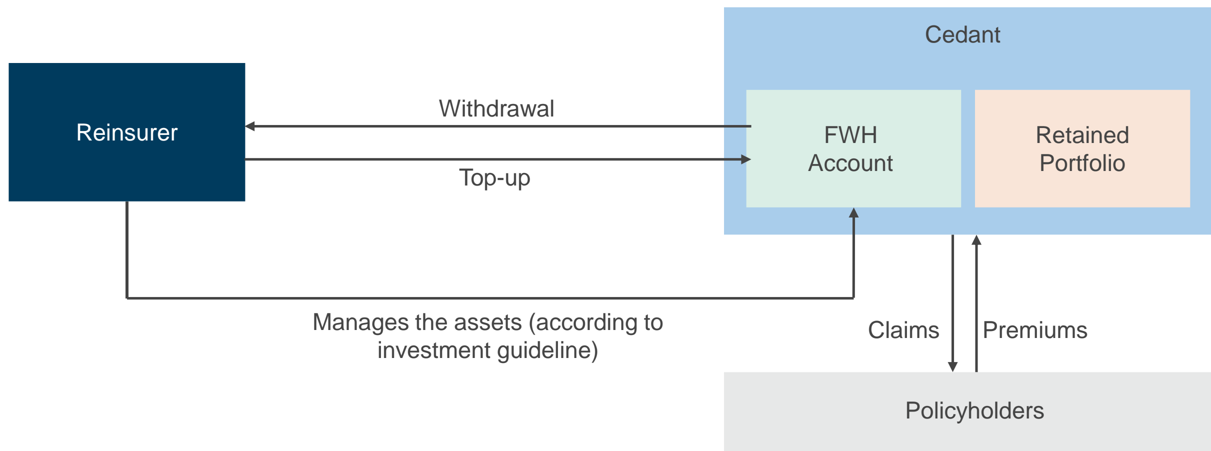
Exhibit I – Fund Transferred Structure Illustration



- **"Funds withheld" (FWH)**: this is where the legal ownership of the assets is retained by the cedent with the economic or beneficial interest associated with the assets being transferred to the reinsurer. The assets are managed in accordance with agreed investment guidelines, either by the cedant on behalf of the reinsurer, or the reinsurer (or a third party) may act as investment manager for the assets directly. While less common in the UK, this format of collateral structure has historically been preferred by local regulators in some European jurisdictions such as Switzerland as the cedant retains

greater control of the underlying assets and the assets remain within the jurisdiction of the cedant country.

Exhibit II – Fund Withheld Structure Illustration



The key requirement of any collateral structure is that the assets are readily available to the insurer to take ownership and control of in the event of default of the reinsurer.

Further deep-dives

This is the first of a series of articles planned by the IFoA funded reinsurance working party focusing on collateral. In the next few articles, we are aiming to cover the following areas in further detail:

- **Collateral Legal Structures:** Collateral security and asset specific considerations – explore the features and security specificities of different collateral structures and the implications for different types of asset classes
- **Ongoing collateral management** – step through the key components of ongoing collateral management including what the essential components for the collateral investment guidelines are, how to define the required amount of collateral , what are the asset substitution and replacement rights and how these are linked to the termination provisions of the reinsurance arrangements under recapture scenarios.