What we really mean when we talk about collateral – Part 2

In our previous article, we deep dived into the investment guidelines of the collateral for Funded Re transactions. In this paper, we will continue the collateral discussion and focus on what approaches have been incorporated for the ongoing management of the collateral, especially around protecting the cedant, which includes:

- Over-collateralisation and asset haircuts
- Asset substitution
- Termination

Over-collateralisation and Asset Haircuts

Over-collateralisation and haircuts are two common protective mechanisms used by cedants, providing additional risk buffers in a recapture event. While they are not strictly speaking "investment" guidelines, they do impact the way that the collateral portfolio is invested.

These mechanisms aim to protect against:

- Market risk: assets falling in market value between the last valuation and recapture, which may include spread or interest rate movements, as well as unhedged foreign exchange risk (for non-GBP assets) ;
- Credit risk: assets are downgraded or default between the last valuation and recapture;
- Liquidity risk: potential value discounts if quick asset sales are needed; and
- Basis risk: asset values and liability values move to a different extent to each other.

These protections are particularly important given that a recapture event is likely to be during the time of wider market distress. In SS5/24, the PRA states that it expects firms to use haircuts and/or over-collateralisation, and ensure that these are properly calibrated to an appropriate level to control counterparty risk.

Haircuts are asset-specific discounts applied to individual asset values. For example, a 5% haircut means a £100m bond provides only £95m of recognised collateral value. Typically, the riskier and/or less liquid the asset, the higher the haircut. This approach tends to be more complex to agree and implement (and hence costly), but is a more granularly alignment to risk.

Over-collateralisation, on the other hand, is a portfolio-level mechanism, which requires the total collateral pool to exceed liability value by a specific amount. For example, total collateralisation value– must be 105% of liability value. This approach tends to be simpler to agree and implement (and hence cheaper), but is a more broad alignment to risk.

Not all Funded Re transactions include over-collateralisation or asset haircuts. This depends on the cedent's risk tolerance, as well as the reinsurer's credit rating and liquidity strength. For example, if the cedent has a large back book and the Funded Re transaction represents only a small portion of its overall business, the financial impact under a stress scenario may be minimal — reducing the need for over-collateralisation. Similarly, a reinsurer with a strong credit rating and ample liquidity may also justify a lower level of collateral enhancement.

For transactions that do include over-collateralisation, it provides additional security to the cedent. However, it's important to note that the over-collateralised amount may not correspond directly to the termination payment the cedent would receive. Please refer to the Termination section for further details.

Asset substitution

When considering the effectiveness of collateral management, it is not only about day 1 collateral requirements, but it is critical to consider ongoing collateral management too. The key focus area is "Asset Substitution".

Asset Substitution

Asset substitution occurs when a reinsurer **swaps** one pledged asset for another, while maintaining the continued adherence to the agreed investment guidelines (and hence the associated constraints on collateral risk). This can be done for several reasons:

- **Liquidity management**: Replacing an illiquid asset with a more liquid one.
- **Collateral optimization**: Using lower-cost collateral while meeting risk thresholds.
- **Regulatory compliance**: Adjusting assets to comply with evolving regulations placed upon the reinsurer.

Asset substitution will typically include normal-course trading of the collateral portfolio too, whereby a public bond may be sold into the secondary market and settled with cash into the collateral account. Thereafter, a new public bond may be bought for the collateral account using the cash therein, ensuring the overall portfolio stays compliant with the agreed investment guidelines. This allows the reinsurer to manage risk in the portfolio over time, and ensure it remains compliant with the requirements of the reinsurance agreement.

Example:

Even if the current collateral portfolio fully meets the investment guidelines, the reinsurer may still choose to proactively replace certain assets if there are credit concerns — for example, assets at risk of being downgraded from BBB to BB. This allows the reinsurer to maintain the overall quality of the collateral portfolio before any actual downgrade occurs.

BAU Period vs Enhanced Control Period

For UK-funded Re transactions, the treatment of asset substitution in the collateral account depends on whether the transaction is in a **Business-as-Usual (BAU) Period** or an **Enhanced Control Period**.

- **Business-as-Usual (BAU) Period**:
  During normal operations, the reinsurer can substitute assets in the collateral account on an individual transaction basis, as long as the assets comply with the agreed investment guidelines. The reinsurer would provide periodic reporting to support this activity, including updated asset listings, compliance reports, and a compliance certificate, giving the cedant comfort that the collateral continues to be managed in accordance with the reinsurance agreement.
- **Enhanced Control Period**:
  When an Enhanced Control Period begins, the reinsurer must first seek agreement from the cedant before proceeding with any asset substitutions. This adds an extra layer of security and strengthens collateral protection. This may also go hand-in-hand with enhanced reporting requirements.

An Enhanced Control Period is typically triggered under the following conditions:

- The reinsurer's **capital falls below a specified percentage** of the solvency ratio.
- A **potential reinsurer termination event** is ongoing.
- The reinsurer has consistent failed to adhere to the investment guidelines.

Following the execution of a Funded Re transaction, the reinsurer is typically granted a ramp-up period to reposition the assets. During this period, a temporary waiver from full investment guideline compliance is usually permitted.

Termination

"Termination" refers to the process of ending a reinsurance agreement, typically due to the trigger of a particular condition either by the cedant, by the reinsurer, or by some other neutral condition.

Termination of a reinsurance contract is an extremely rare occurrence and is typically not expected by either party to ever happen. However, in this rare event, the collateral provided by the reinsurer for the contract provides a crucial layer of risk protection for the cedant.

Upon termination, the ceding company will recapture those assets to cover the agreed termination payment that is outlined in the reinsurance contract (and it typically linked to the value of the underlying insurance liabilities)Those features described above – for example, investment guidelines, over-collateralisation, and enhanced control periods – help to constraint the collateral portfolio during the period of recapture and unwind of the reinsurance contract.

Termination Triggers in Reinsurance Contracts

Termination triggers are critical in reinsurance agreements as they establish clear exit mechanisms for both the ceding insurer and the reinsurer under predefined conditions. These triggers help manage risk and bring clarity to the functioning of the reinsurance contract.

The table below provides an illustrative example of typical termination triggers. Please note that these may vary by transaction, as each deal is structured based on its specific terms and risk considerations.

Who can trigger	Trigger Category	Description
Ceding company	Reinsurer's Credit Downgrade or Solvency ratio deterioration	If the reinsurer's solvency ratio or credit rating falls below a predefined level (e.g., agreed regulatory solvency level, or below A- by S&P or Baa by Moody's).
	Non-Payment or Breach of Contract	If the reinsurer fails to pay claims, investment proceeds, or other contractual payments on time.
	Investment guideline breach	If the reinsurer fails to comply with the agreed investment guideline and not being able to remediate it within the allowed period
Reinsurer	Failure to pay by the Cedant	If the cedant fails to transfer the premium assets to the reinsurer
	Fundamental Warranty Breach	If the cedant misrepresent or disclose material risks or breach of regulatory or solvency compliance
Both	Mutual Agreements	If either party undergoes an acquisition, merger, or ownership change, the other party may terminate to mitigate risk. Or If new laws or regulations make the contract non-compliant or commercially unviable.

Typically, both parties will enter a negotiation period to explore potential solutions before formally triggering a termination event.

Regulators like the Prudential Regulation Authority (PRA) in the UK closely monitor asset-intensive reinsurance transactions due to potential risks associated with termination. Depending on the market value of the assets at the time of termination, and the terms of the termination, the ceding company's balance sheet is likely to be impacted by the recapture, as assets and liabilities are returned to the cedant's balance sheet. Where termination is due to Reinsurer's fault, it is typical to see a certain penalty be applied when calculating the termination amount, adding further risk protection to the cedant, as well as creating a strong incentive for the reinsurer to continue to perform under the reinsurance agreement.

Conclusion

In Funded Re transactions, multiple layers of protection safeguard the ceding company’s risk management and policyholder protection. Collateral investment guidelines ensure prudent asset management. Asset substitution rights provide flexibility in response to market changes, and termination triggers serve as a structured exit mechanism to mitigate risks. Together, these measures enhance liquidity, solvency security, and overall financial resilience for the ceding company.

In the next chapter, we will discuss the required amount of collateral – which defines collateral amounts and valuation methods in order to maintain financial stability.