

Understanding Required Collateral Recalculation in Funded Reinsurance Agreements

Funded reinsurance agreements require collateral to secure the reinsurer's obligation to pay claims. For the cedant, it is essential that this collateral dynamically reflects its evolving exposure, prevailing market conditions and evolving regulatory expectations. The PRA has underscored the importance of a robust, transparent and well-governed approach to collateral calculation. This article outlines these key considerations for designing a compliant and effective collateral recalculation framework.

1. Regulatory Context

In its latest supervisory statement, the PRA clarifies that if assets and liabilities are recaptured from a funded reinsurance arrangement, these may only be transferred into the cedant's Matching Adjustment portfolio if it can demonstrate that this "would not result in non compliance".

This regulatory stance means that the Solvency II requirements must shape the cedant's collateral framework, including the design of the required collateral calculation, especially in relation to:

- The "market consistent" valuation approach for liabilities.
- A "risk-based" approach incorporating reinsurer health.
- Mechanisms to ensure this is being carried out through time.

2. Market Consistent Calculation

The collateral requirement calculation is a valuation approach for liabilities. It typically represents, for a given valuation date, the present value of future expected liability claims and expense payments, informed by:

- Ceded liabilities – the types of liabilities that are covered by the reinsurance agreement, e.g. pension annuity obligations.
- Market factors – the prevailing macroeconomic environment, e.g. interest rates, exchange rates, credit spreads, inflation indices (although uncommon).

Agreements typically define methodologies in relation to the calculation of:

- Risk-free rates, including the bootstrapping of market curves.
- Credit risk adjustments to these discount rates: weighted indices, or calculation of collateral portfolio credit risk.
- Haircuts to account for liquidity and credit risk.
- Any relevant adjustments to reflect ESG scores.

Two common approaches to valuation link to:

- The collateral portfolio itself.
- A fixed set of indices.

The cedant may prefer the portfolio linkage if it intends to retain the collateral without much alteration. However, if it plans to rely on management actions to transform the assets received into a different portfolio then an index approach could mean recovering an amount more closely aligned with the market value of the assets it ultimately seeks to retain.

A simple expression of the two approaches:

$$\text{Portfolio Discount Rate} = \sum_i [(Yield_i + Haircut_i) \times Allocation_i] + Adjustments$$

$$\text{Index Discount Rate} = RFR + \sum_i [(Spread_i + Haircut_i) \times Weight_i] + Adjustments$$

The approach of applying a spread over the risk-free rate (RFR) to determine the collateral discount rate aligns naturally with the Matching Adjustment framework, ensuring consistency in the discounting methodology. As a result, this approach is preferred by insurers and is increasingly becoming the market standard.

3. Solvency and Credit-Based Considerations

Beyond market and liability updates, collateral requirements may change based on the reinsurer's financial health, according to triggers linked to:

- A downgrade in the reinsurer's credit rating below a threshold.
- A decline in the reinsurer's solvency to a level considered problematic.
- Potential disruptions to the reinsurer's capital structure, perhaps resulting from M&A or other significant corporate events impacting their creditworthiness.
- A deterioration in general financial market indicators, according to some agreed measure.

4. Maintaining Collateral Requirement Alignment

To ensure the collateral requirement remains appropriate and aligned with the underlying risks, the following considerations apply:

- Recalculation frequency – Regular collateral requirement updates (e.g. monthly) help mitigate risks of shortfalls or breaches of investment guidelines.
- Ad hoc valuation triggers – An ad hoc collateral valuation may be initiated if the reinsurer experiences a material credit rating downgrade or significant deterioration on its solvency ratio.
- Repositioning period – The period immediately after the reinsurer receives the premium from the cedant, during which the collateral may temporarily diverge from final target asset allocation as the reinsurer transitions into the intended portfolio.

This is particularly important when the collateral requirement is benchmarked to indices rather than the reinsurer's actual holdings, as it may result in a temporary mismatch between required and posted collateral. Where appropriate, the cedant may grant a waiver during this repositioning period to the reinsurer.

- The valuation of non-traded assets (e.g. private credit) that might require:
 - Pre-agreed haircuts to account for valuation uncertainty.
 - Third-party valuations to ensure transparency and reduce disputes.

5. Transparency, Dispute Resolution and Risk Mitigation

To ensure mutual trust and operational efficiency, collateral processes must ensure:

- Clear contractual terms for liability updates, asset valuation and margining calculations.
- Independent reviews of collateral values.
- Dispute resolution mechanisms, such as:
 - Regular reconciliation reporting.
 - Custodial arrangements to secure and manage collateral assets.

Agreements may also include safeguards, such as provision of the disclosure of additional information regarding illiquid assets if the reinsurer's financial position deteriorates.

Conclusion

Collateral recalculation is central to the integrity of funded reinsurance agreements. A well-designed framework ensures regulatory compliance, protects both parties from financial risk and supports operational resilience.

Key Takeaways:

- Collateral must reflect market risk, credit risk and regulatory changes through transparent, pre-agreed methodologies.
- Effective asset management and dispute resolution mechanisms are critical to maintaining trust and operational resilience.
- Transparency, liquidity and independence are essential to the success of collateral roll-forward processes in a volatile financial landscape.

Finally, as we have seen in prior topics in this Funded Reinsurance series, insurers will seek to find the right balance when designing the package of collateral calculation methodologies and controls, to ensure they meet their regulatory and own risk management needs, whilst also meeting the pricing objectives of their pension fund trustee clients.