The Financial Inclusion and Markets Centre

Promoting finance that works for the economy, environment, and society

Bank of England/Prudential Regulation Authority (PRA)
CP8/26 Funded Reinsurance

Submission by The Financial Inclusion and Markets Centre (FIMC)

About The Financial Inclusion and Markets Centre

The Financial Inclusion and Markets Centre (FIMC) is a dedicated unit of the Financial Inclusion Centre which focuses on financial services policy and regulation, financial market reform, and evaluating the economic, environmental, and social utility of finance. The new unit also covers work evaluating the impact of developments at the intersection of finance and technology including AI.[1]

[1] About | The Financial Inclusion Centre

Introduction

We are pleased to submit a brief response to this consultation. For further information, please contact Mick McAteer, Co-Director, FIMC mick.mcateer@inclusioncentre.org.uk. We consent to FIMC's name being published.

Summary

We are pleased that the PRA has recognised the significant risks associated with the growth in the use of funded reinsurance in the life insurance market and, specifically, in relation to the bulk purchase annuity (BPA) market. We support the PRA's intention to better align the regulatory treatment of funded reinsurance with that of economically similar assets in the market.

We appreciate that the proposals in CP8/26 are intended to deal with the specific risks associated with funded reinsurance going forward. But, assessment of the risks associated with poorly regulated funded reinsurance activities cannot be considered in isolation and should encompass two other interconnected risks: the widespread use of the Matching Adjustment (MA) facility allowed in Solvency UK; and the growing use of opaque, illiquid, hard-to-value private assets with questionable risk-adjusted return potential. The growth in the use of funded reinsurance has exacerbated the MA- and private asset- related risks.

We are hopeful the proposals in CP8/26, with respect to future arrangements, should: i. encourage a more responsible approach to the use of funded reinsurance by insurers; ii. address competitive distortions in the BPA market between insurers that use funded reinsurance and those who do not; and iii. force insurers to adopt a more realistic approach to pricing of BPA deals and cause pension scheme trustees to reconsider transferring pension liabilities to life insurers covered by the weak Solvency UK regime.

But, we do not think the proposals go far enough to mitigate the funded reinsurance risks related to *future* arrangements. For future arrangements, rather than aim for a capital charge of around 10% of liabilities, we argue the PRA should aim for the upper end of the 11-15% range currently applied to economically similar assets.

Moreover, for *existing* arrangements (including those made between now and the cut-off date) the CP8/26 proposals will not address the funded reinsurance risks clearly identified by the PRA – risks exacerbated by the widespread use of the MA and private assets. We appreciate that that the PRA cannot apply the capital charge measure retrospectively to specific in-force funded reinsurance arrangements due to the disruption this would cause. However, now that the PRA has quite rightly raised major risks associated with funded reinsurance, it surely cannot leave these legacy risks unaddressed. Therefore, we urge the PRA to consider deploying supplementary capital tools to ensure equivalent prudential regulatory treatment of firms which used funded reinsurance for previous BPA arrangements and those who did not.

Key risks in the market

We appreciate that, going forward, the proposals in CP8/26 focus on the specific risks relating to funded reinsurance. But, as mentioned, funded reinsurance risks cannot be considered in isolation. In addition to the increased use of poorly regulated funded reinsurance, there is the widespread use of the Matching Adjustment (MA) facility allowed in Solvency UK and the growing use of opaque, illiquid, hard-to-value, poorly regulated and governed private assets with questionable risk-adjusted return potential.

Considering the funded reinsurance risks first, for the average existing funded reinsurance transaction firms currently hold capital worth 2–4% of the value of the underlying annuity liabilities, compared to 11–15% for similar investments. With the new proposals, the PRA estimates that the capital charge for the average funded reinsurance transaction would shift to around 10% of the liability.

We agree with the goal of increasing the capital charge. We support a tougher approach as we question whether funded reinsurance used in BPA activities, up to now, should be considered reinsurance in its proper form.

Effective reinsurance should mean that a primary insurer (eg. provider of annuities) achieves an actual risk transfer to a well-regulated external party that is able to absorb risk and adopts suitable risk management approaches.

To understand the risks associated with funded reinsurance, we need to consider the commercial imperatives of the primary insurers and funded reinsurance providers. From the perspective of primary insurers, funded reinsurance is commercially attractive because it exploits regulatory weakness to free up capital for further market expansion and creates opportunities to generate higher value for shareholders.

Funded reinsurers have a number of revenue streams including the opportunity to reinvest assets received from primary insurers into supposedly higher-yielding alternative assets with the objective of earning a higher return than the cost of servicing the future liabilities transferred. If the reinsurer is earning a higher return than the primary insurer from a portfolio intended to meet the same liabilities then, by definition, they are taking a higher risk than the primary insurer was in meeting those liabilities. Therefore, the risk is not actually properly transferred or reinsured.

Funded reinsurance has been commercially attractive for both parties because the regulatory regime covering BPA activities has not, until now, properly reflected the risks of using higher risk/supposedly higher return assets to meet the same liabilities. As with the widespread use of the MA facility by insurers, see below, funded reinsurance relies on the regulatory system allowing the illusion that higher rewards (through return arbitrage and freeing up capital on the primary insurers balance sheet) are possible without commensurately greater risk being taken and greater provision for risk being made.

So, increasing the capital held should ensure that the actual risks associated with funded reinsurance are better accounted for and opportunities for return arbitrage are reduced to encourage more accurate pricing of BPA transactions.

But, we are unclear as to why the PRA would aim for an average capital charge of 10% of liabilities rather than adopt a higher level. If the PRA believes that both types of assets should be treated similarly based on the underlying financial fundamentals (which we agree with), then surely the starting point should be to aim for the midpoint of the 11-15% range for direct assets. Indeed, there is a case for aiming for the upper end of that range (15%) given the additional legal, corporate, and regulatory risks associated with funded reinsurance operated from overseas jurisdictions.

We do not know at this stage what the effect of the PRA's current proposals would be on the market for funded reinsurance and BPA related activities. It may well be that the effect will be to deter insurers from using funded reinsurance or at least slow down the growth. If insurers continue to use it then at least some new business will, on the face of it, be conducted on more responsible terms by requiring higher levels of capital to be held (even if this should be higher in our view). It may also deter some pension schemes from transferring business to poorly regulated life insurers.

We say 'on the face of it' because the proposals do not address the other two key risks related to the use of the MA and growing use of illiquid, opaque private assets. It is one thing requiring firms to hold X% of capital against funded reinsurance risk. But, the quality and soundness of the capital held by individual life insurers also matters.

The use of the MA is fundamentally flawed. Financial engineering enabled by the use of the MA and MA-eligible private assets artificially inflates the capital resources held by insurers - significantly so, in some cases.[2] It enables insurers to create fictional regulatory capital by allowing them to recognise, up front, future returns from investing in MA assets that may never materialise.

Previous analysis shows how much certain major UK insurers have relied on the MA to inflate their Solvency Coverage Ratios (SCRs). Regulation is masking the true condition of insurers The gap between the SCRs of major firms as measured *with* and *without* MA provisions means we take limited comfort from the Life Insurance Stress Test (LIST) 2025. Life Insurance Stress Test (LIST) 2025 | Bank of England

Linked to the increased use of funded reinsurance and MA facilities, we have watched with growing concern the trend of life insurers specialising in pension transfers making greater use of hard-to-price, illiquid, and opaque private assets. UK pension insurers raise exposure to opaque private credit

[2] Submission to HM Treasury Review of Solvency II consultation | The Financial Inclusion Centre

Insurers claim these private assets offer the potential for superior risk-adjusted returns. The claims for superior risk-adjusted returns are questionable to say the least given the methodology used to calculate returns. Moreover, the perverse incentive structure embedded in the MA provisions in Solvency UK means that firms can get additional MA benefits into the bargain by increasing exposure to higher risk assets claiming to offer superior returns.

With UK BPA funded reinsurance transactions, primary insurers benefit from recaptured assets being eligible for MA treatment (or easily traded or transformed into this form) to limit the balance sheet impact on recapture. So, even if the capital charge is increased to address collateral risk, the fact that hitherto reinsured assets can now be recaptured into MA portfolios undermines the potential security provided by the capital charge uplift.

Furthermore, the new approach outlined in CP8/26 would apply to arrangements entered into after 30th September 2026. We understand why the PRA has adopted this approach given the difficulties involved in retrospectively applying any new rules to specific in-force transactions. However, this means that while the PRA rightly recognises the risks associated with funded reinsurance and is acting to mitigate future risks, the regulator is leaving legacy risks unaddressed.

In summary, the proposals in CP8/26 address the first of the three risks highlighted above but only for arrangements entered into after 30th September 2026. New business will still be exposed to the risks associated with the widespread use of the MA and private assets. This means the positive impact of the specific capital charge proposal will be limited.

Worryingly, existing funded reinsurance business will still be exposed to all three risks. This, surely, cannot be acceptable.

Conclusion

In conclusion, FIMC is concerned about three interlinked risks in this market - the increased use of funded reinsurance, the widespread use of the MA facility, and growing use of opaque, illiquid, hard-to-value private assets with questionable risk adjusted return potential.

We support the proposals in CP8/26 and think that these should address some of the more obvious risks associated with funded reinsurance going forward. But, we do not think the proposals go far enough. The starting point for capital held as a proportion of the value of the underlying annuities should be the midpoint of the current 11-15% range for direct assets rather than the 10% envisaged. Indeed, there is a case for requiring the upper end of that range (15%) given the other legal, corporate, and regulatory risks associated with funded reinsurance operated from overseas jurisdictions.

Moreover, the proposals do not address the other two key risks related to the use of the MA and growing use of illiquid, opaque private assets. It is one thing requiring firms to hold X% of capital against risk. But, the quality and soundness of that capital also matters.

Finally, the understandable decision to apply the specific proposals to new business after 30th September 2026 means that embedded risks created by funded reinsurance transactions prior to this date will be left unaddressed. Having identified major risks associated with funded reinsurance, the PRA surely cannot ignore those embedded legacy risks. We urge the PRA to consider applying supplementary provisions to address these legacy risks.

This marks the end of our submission.

Financial Inclusion and Markets Centre (FIMC)
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