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# Life Conference 2022

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**#LifeConf**





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# **A2: Funded reinsurance and the impact on the Pension Risk Transfer market**

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# Agenda

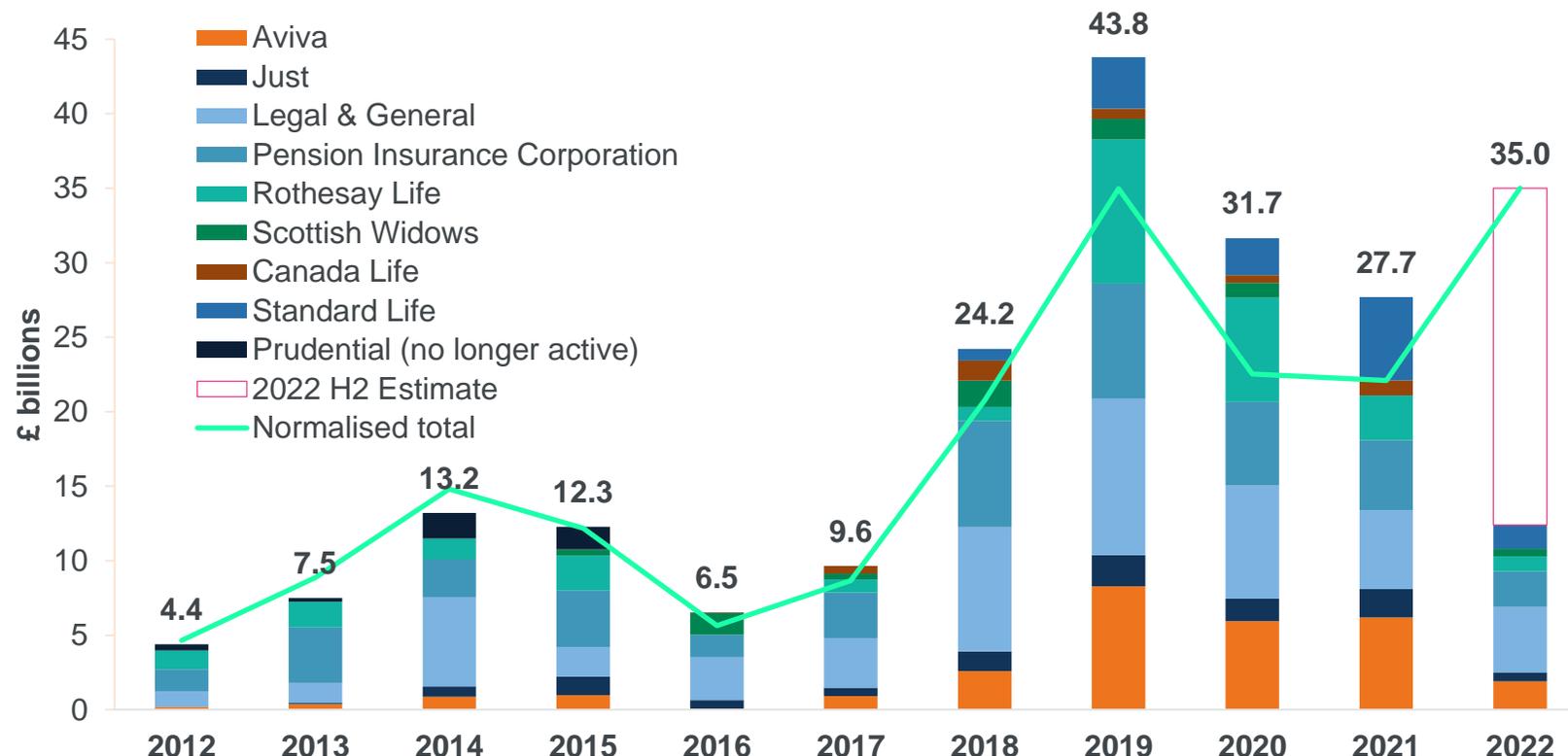
- Overview of Bulk Purchase Annuity market
- Introduction to funded reinsurance
- Illustrative case study
- Perspectives on funded reinsurance
- Market volatility
- Regulatory change



# Reinsurance Market Changing

## Increasing volume of BPA deals driving and changing reinsurance demand

- Current UK regulatory regime:
  - Relatively high capital requirements for longevity risk
  - Strong focus on the treatment of illiquid assets (credit rating, illiquidity benefit)
- Upward trend in bulk purchase annuity (BPA) deals driving a corresponding increase in need for reinsurance capacity



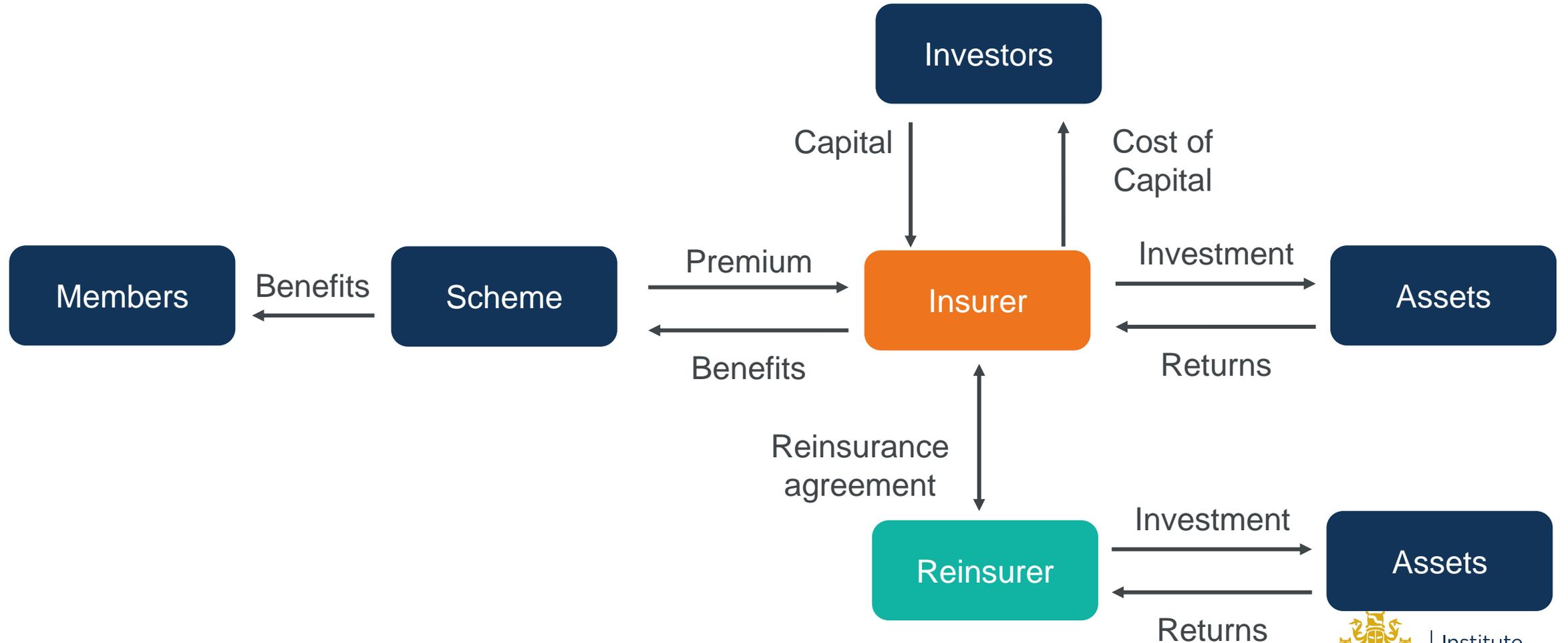
Note: "normalised total" line rebases historic totals to 2022 interest rates

Source: EY analysis



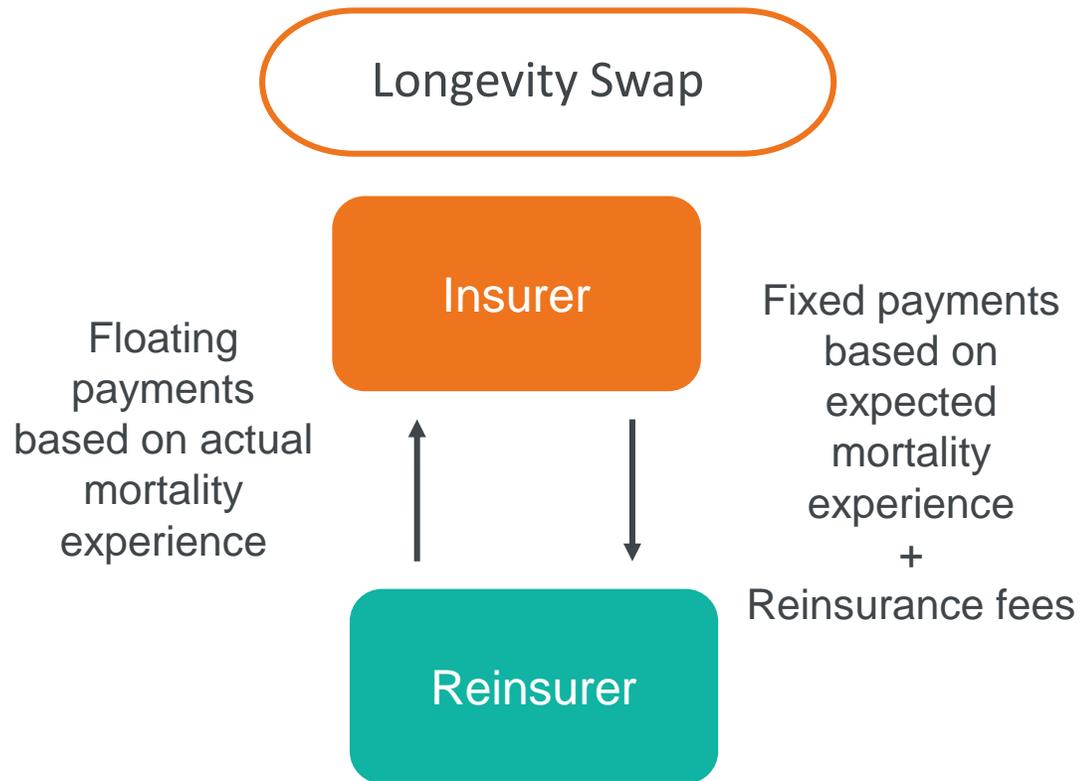
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# Different stakeholders within a BPA transaction

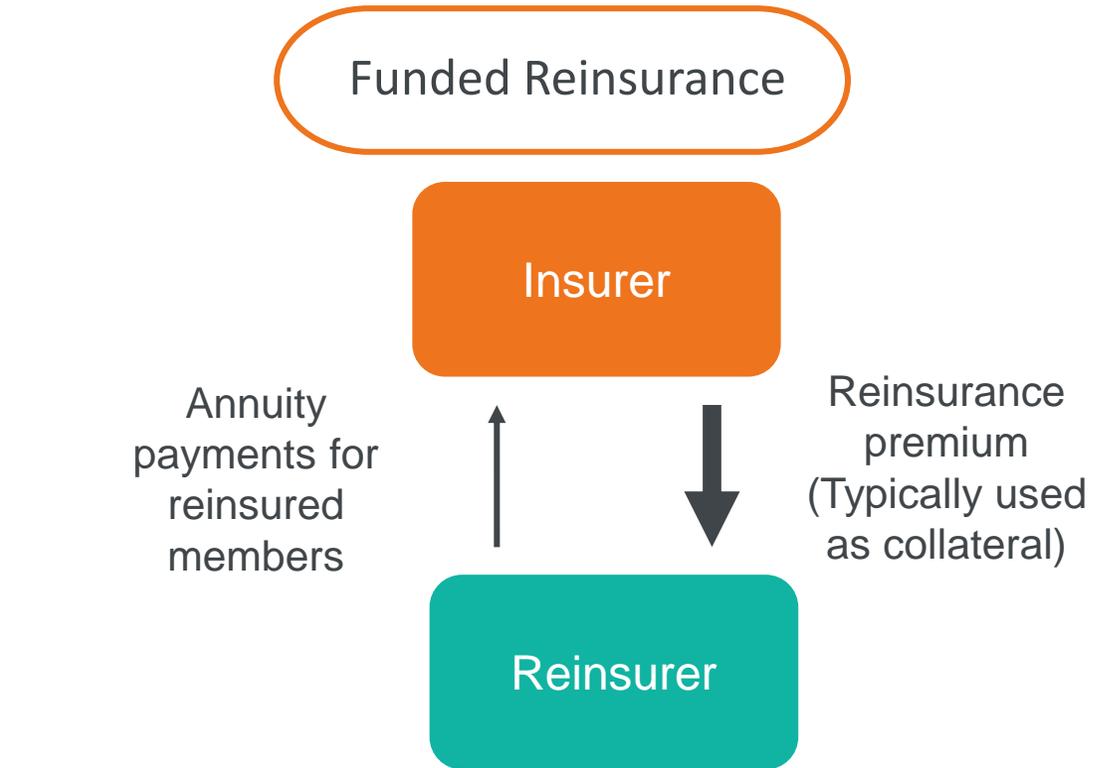


# Types of BPA reinsurance

## Two primary structures for reinsurance contracts of annuity liabilities



*Insurer and reinsurer typically settle the net difference between the floating and fixed payments*



*Insurer pays single upfront premium which the reinsurer invests to make annuity payments*



# Types of BPA reinsurance

## Two primary structures for reinsurance contracts of annuity liabilities

### Longevity Swap

- Initial growth from 2014
- Typically only removes longevity risk component. Swaps out uncertain longevity cashflows for certain fixed cashflows
- Manages down Solvency II risk margin and SCR
- Some insurers positioning as facilitators for Pension schemes to access reinsurers

### Funded Reinsurance

- Also called asset backed reinsurance, asset re, or quota share
- “Breakthrough” of deals in 2019-20 by insurers seeking to increase risk capacity overall
- Removes longevity and market risks
- Allows cedant to leverage the asset sourcing capability of the reinsurer
- Drawing in new entrants (asset management firms, hedge funds, PE funds) into reinsurance market



# Illustrative case study

## Directional impacts of funded reinsurance for cedants

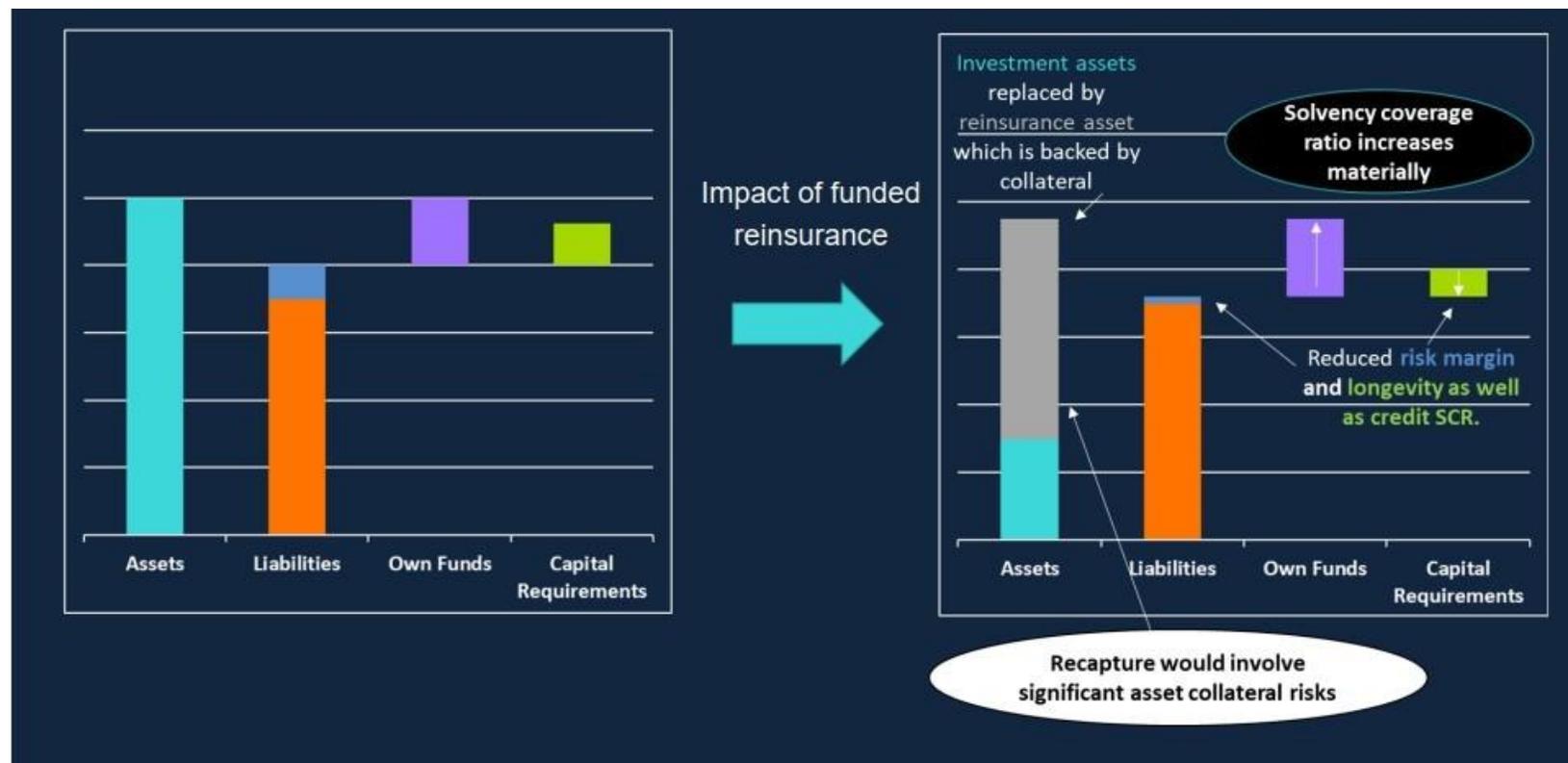
Metric	Directional impact of funded reinsurance for cedant	Comments
Capital strain		<ul style="list-style-type: none"><li>• Reduction in strain due to lower risk margin and SCR from ceding longevity risk and credit risk to reinsurer</li><li>• Amount of reduction in strain dependent on level of premium agreed with reinsurer</li></ul>
Earnings		<ul style="list-style-type: none"><li>• Lower expected earnings as potential sources of return (e.g. investment, longevity upside) ceded to reinsurer</li><li>• Earnings expected to be more stable, since reinsurance is designed to provide certainty to cover the claims (as opposed to having potential variability)</li></ul>
Return on capital / internal rate of return		<ul style="list-style-type: none"><li>• Increase in return as reduction in capital often expected to be greater than reduction in earnings</li></ul>



# Illustrative case study

## Impact of funded reinsurance on cedant's Solvency II balance sheet

- Reinsurance premium often withheld by cedant as collateral
- Cedants typically delegate the collateral asset strategy to the reinsurer, but also set investment guidelines and restrictions (market practice varies)
- Cedant recognises a reinsurance asset, for future claims under the reinsured business
- Reduction in SCR due to ceding market and longevity risk to reinsurer, partially offset by increased counterparty default risk SCR
- Reduction in risk margin due to ceding longevity risk



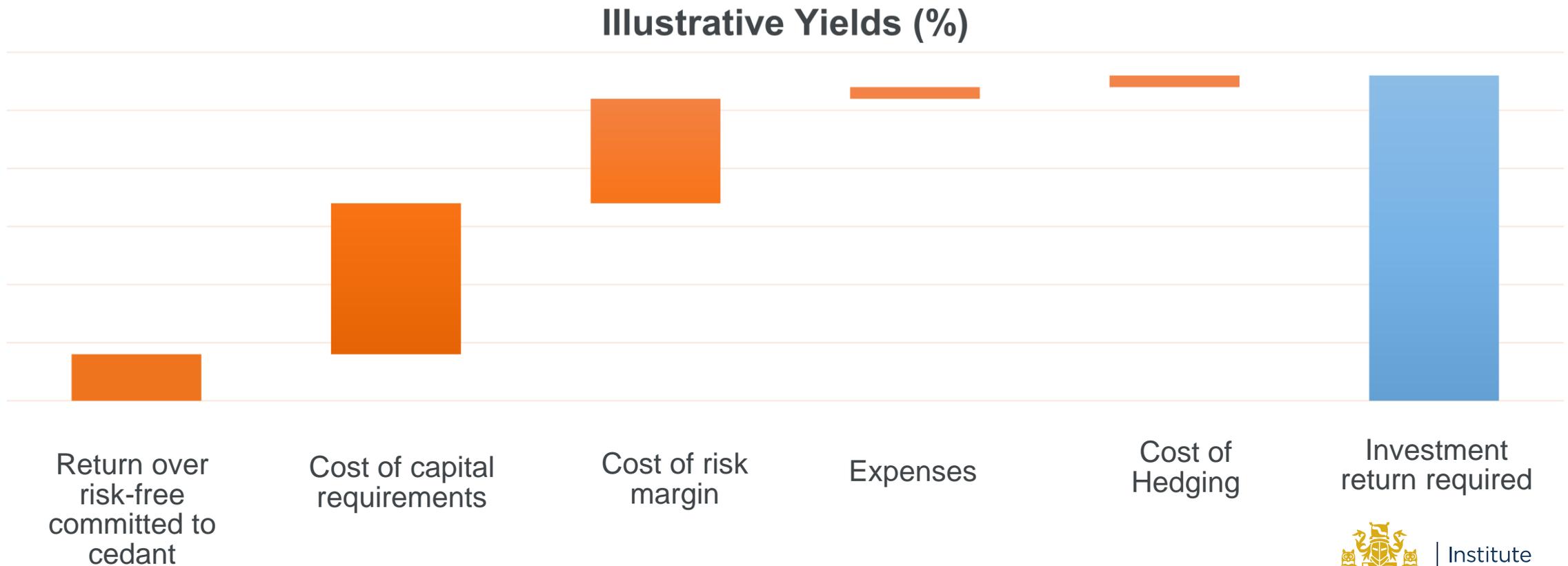
Source: Bank of England, Charlotte Gerken 20 September 2022 speech



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# Reinsurer perspective

Illustrative example of what reinsurers consider when reinsuring BPA business

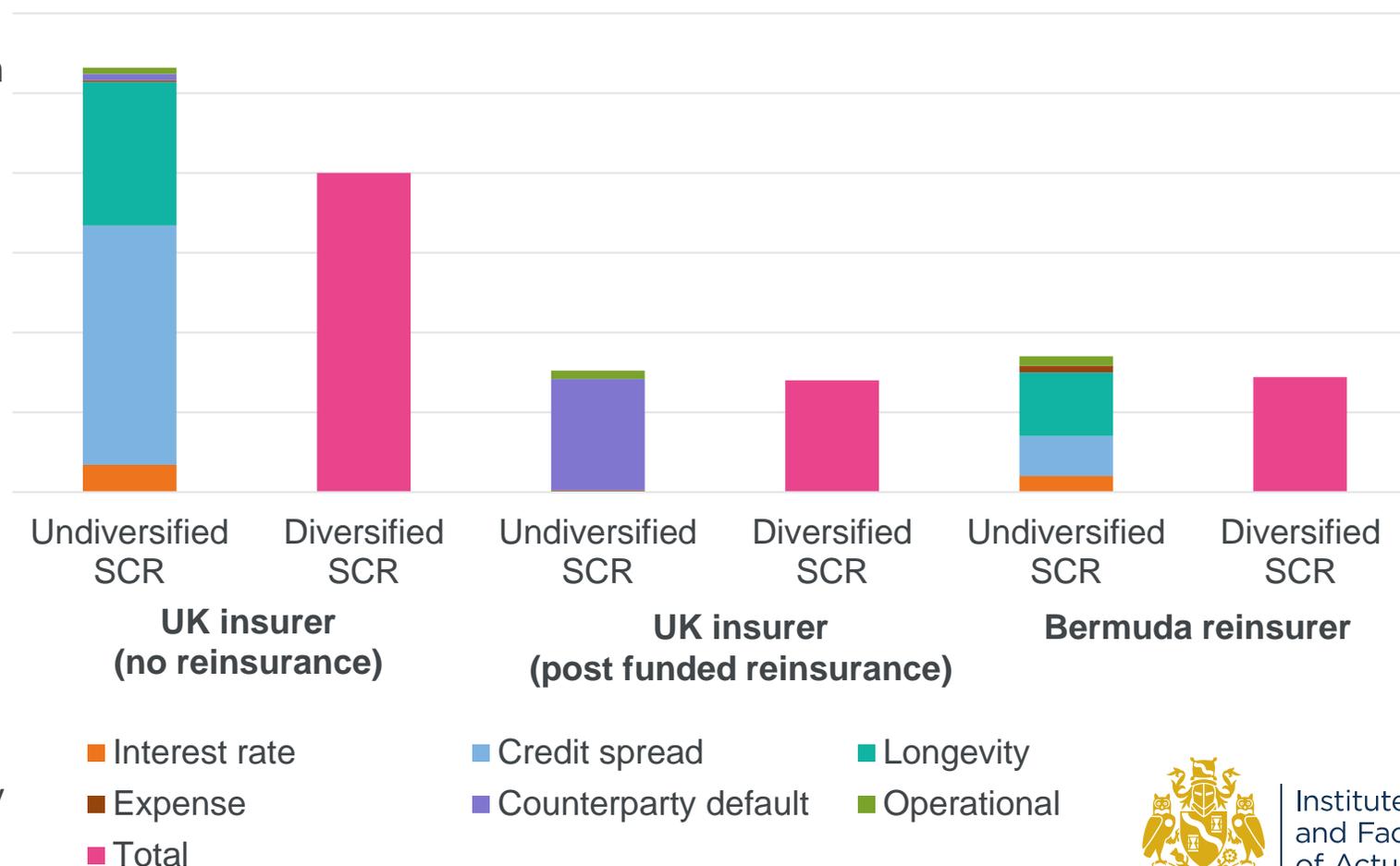


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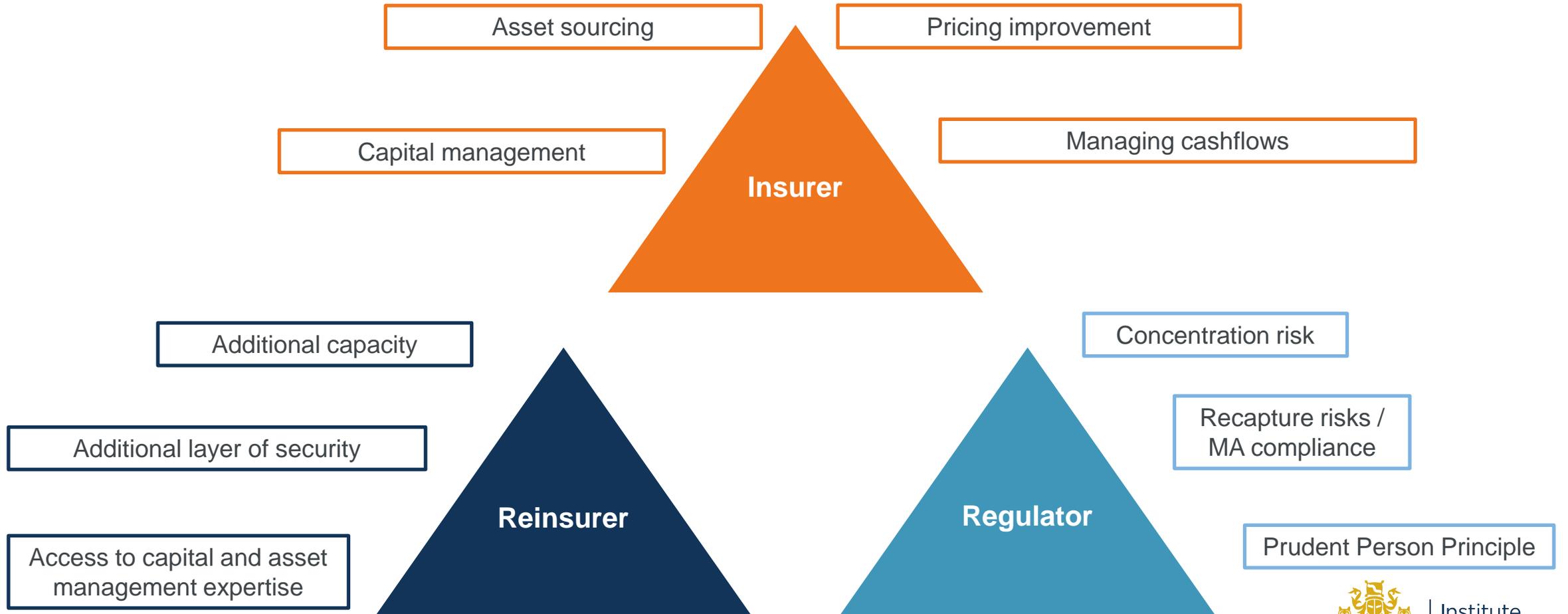
# Illustrative case study

## Bermuda capital requirements more efficient than Solvency II for annuities

- Range of reinsurers from North America and Bermuda involved in the BPA funded reinsurance market
- Illustrative capital requirements for an example annuity portfolio
- UK figures based on Solvency II standard formula (SII SF)
- Bermuda figures based on Class E Bermuda SCR (BSCR)
- UK insurer cedes market and longevity risk under funded reinsurance, with increase in counterparty default risk
- BSCR for credit risk and longevity risk significant lower than SII SF



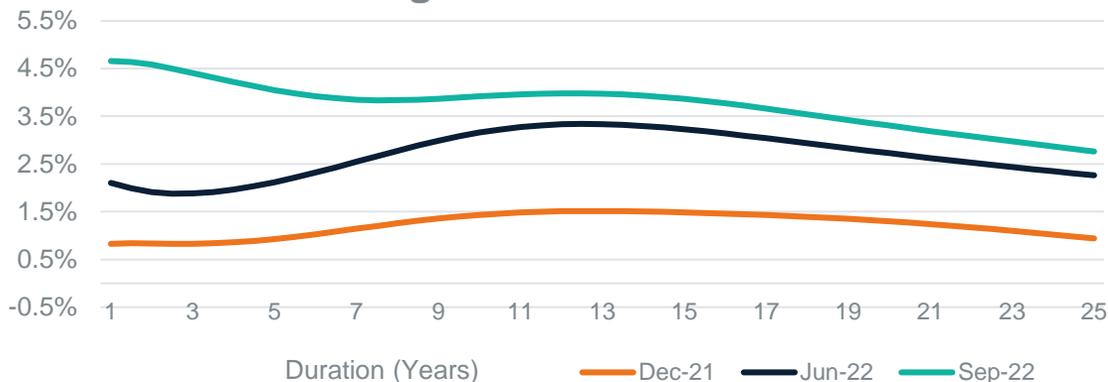
# Perspectives around funded reinsurance



# Market volatility

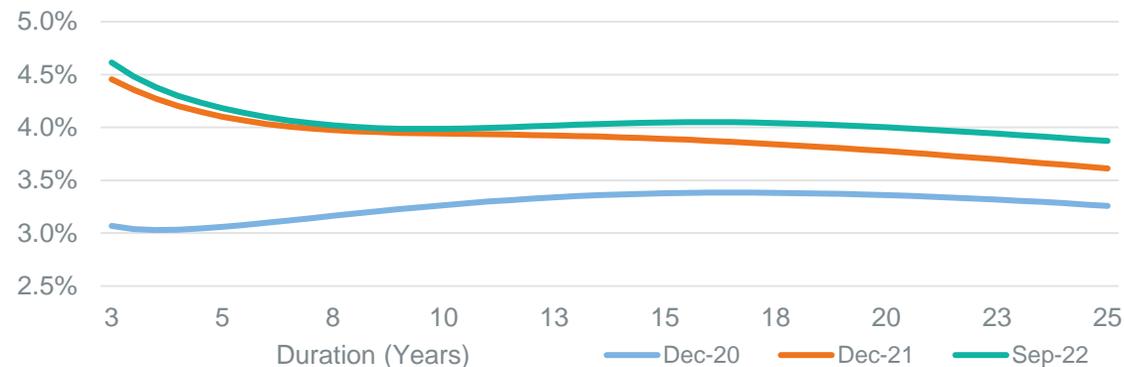
## How might market movements impact BPA and funded reinsurance?

### Bank of England Gilt Nominal Forward



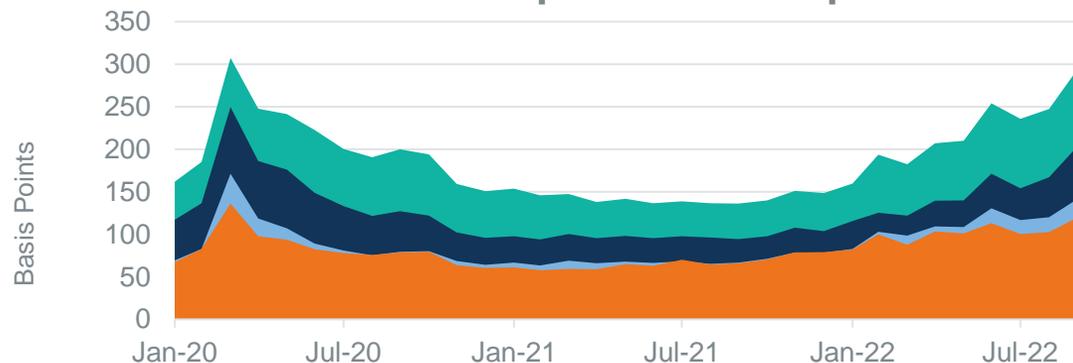
Source: Bank of England

### Bank of England Implied Inflation



Source: Bank of England

### Markit GBP Corporate Bond Spreads



Source: Markit

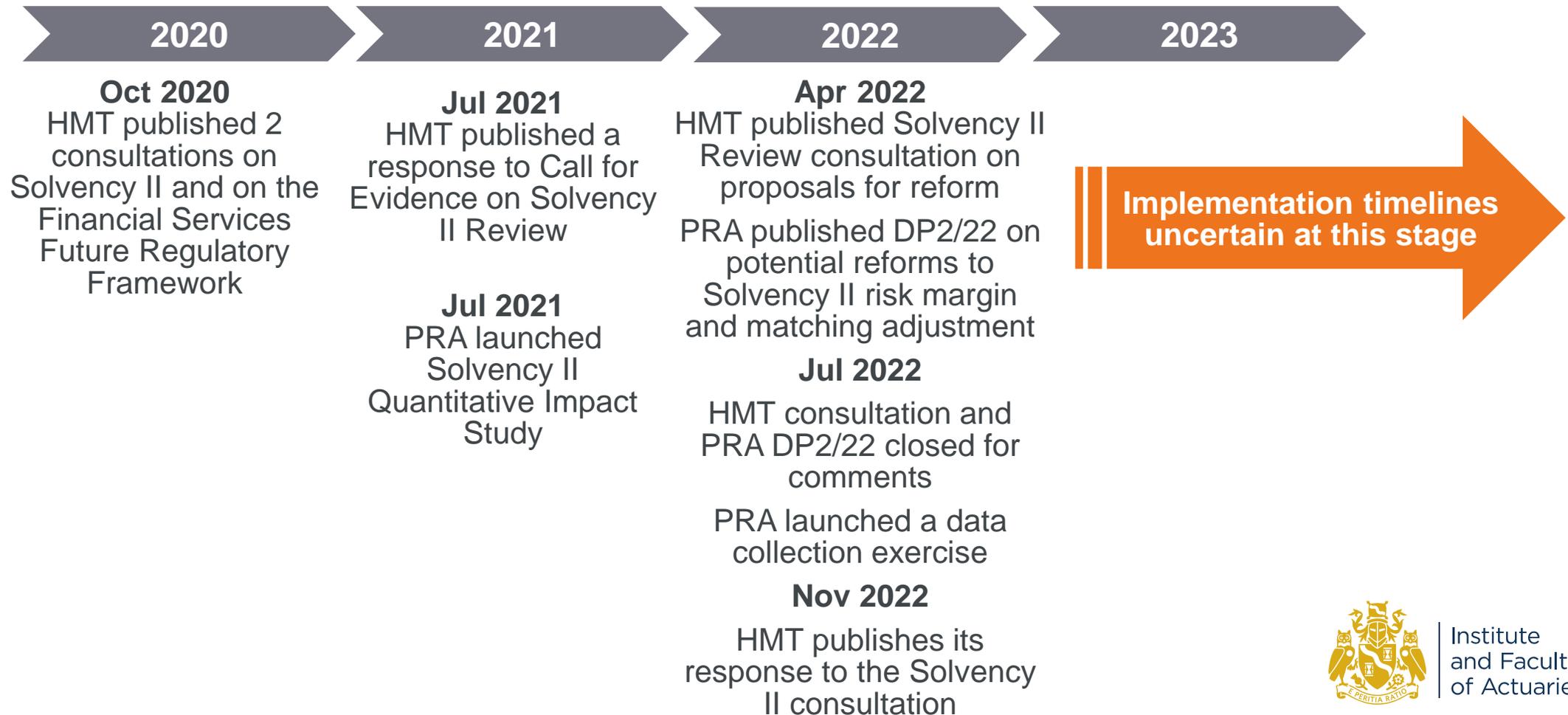
### GBP to USD exchange rates



Source: Wall Street Journal

# UK Regulatory Changes

The Matching Adjustment (MA) and Risk Margin have been focus areas of the reforms to Solvency II



# UK Regulatory Changes

The potential impact of regulatory changes on reinsurance is unclear at this stage!

Insufficiently reduced risk margin leading to more longevity reinsurance



Continued demand for BPA and hunt for yield leading to more funded reinsurance?



How will increase in funded reinsurance impact on longevity reinsurance? Will more reinsurers take both risks together?



Matching adjustment benefit reduced leading to more funded reinsurance?

Sufficiently reduced risk margin leading to less longevity reinsurance?



Increase asset flexibility in matching adjustment criteria leading to less funded reinsurance?



Longevity reinsurance

Funded reinsurance



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# Thank you

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# Questions

# Comments

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenter.



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