Gallagher Re

Navigating the Evolving Dynamics in the UK BPA and Funded Reinsurance Market

Introduction

The UK's bulk purchase annuity (BPA) market has gone through a step change, seeing a substantial rise in transaction volume during 2023, when it hit £50bn*. Higher volumes are expected over the next 5–10 years, driven by improved funding levels and more schemes becoming transaction ready. Such deal volume growth has prompted new entrants to participate in the market, either as BPA insurers or as reinsurers providing them with funded reinsurance services.

The UK Defined Benefit Market

For many years, actuaries provided continuous bad news to defined benefit (DB) scheme trustees. Increased regulation and increasing life expectancies, plus lower and lower gilt yields, led to sponsors pouring more of their hard-earned profits into illiquid DB schemes. But rising gilt yields changed all that, especially for those schemes that had not fully hedged interest rate risk.

Today, demand for BPAs is outstripping the resource needed on the supply side. Transactions hit 250 in 2023. New small scheme streamlined solutions have helped, now with four in the market. But insurers continue to need more people and cannot grow fast enough.

New entrants are set to join the market, following in M&G and Royal London's recent footsteps. Entering the market is a huge investment that takes time to establish, so the presence of interested parties is a testament to how attractive the market is.

We are currently working on over 40 transactions, from initial feasibility to completing of the wind-up. While schemes are in a better financial position to transact, many have work to do to prepare their data for an insurer, simplify benefits, or just secure the internal agreements needed to proceed. This preparatory work can take time, which is one of the reasons that demand for BPAs is expected to remain high for many years.

Looking into that future in more detail, there are approximately 5,000 uninsured DB pension schemes, with the majority at the smaller end of the spectrum. This brings an interesting dynamic, as currently, less than half of the insurers in the market are looking to transact small schemes. Furthermore, there are technical complications that come with advising the very smallest schemes. Insurers and consultancies will need to decide their willingness to change their offering to service smaller schemes and how this may impact pricing.

Our risk transfer team has been brokering buy-ins for over 15 years and has been involved with a significantly higher number of transactions in the past two years. We pride ourselves on providing the personal touch, with only our most senior advisers leading pricing discussions with insurers, no matter what scheme size. Our project managers are actuaries who have worked on all aspects of DB pension strategy over many years, so they understand how to get things done and how to communicate the complex simply. Such efficiency is a key component of our ability to provide value for money.

*Calculated by Buck, a Gallagher company, from insurers' annual reports

We have overcome all the challenges that can arise in a transaction — from removing underpins to codifying integrated state benefits, solving the illiquidity problem, and breaking the link to salary — so that all of the schemes we bring to market are attractive to insurers. Importantly, we are highly regarded by the insurers, as we work hard to treat them well and respect their place in the market. This leads to smooth project execution, in which everyone wins.

Funded Re, also known as asset-intensive reinsurance or asset-backed reinsurance, allows an insurer to reinsure both biometric and asset risk, a well-known concept in the UK. It is increasingly being used by BPA insurers, both as a balance sheet optimisation tool to support BPA volume while managing the required Solvency II capital amount, and as a pricing enhancement tool to improve the competitiveness of their front-end BPA bids.

As the UK BPA market continues to grow, the market dynamic is rapidly evolving. Not only are there more new entrants in the BPA market, but also more global and Bermudian reinsurers have entered the UK market. Although insurers put strong focus on counterparty risk limits, collateral packages, risk assessment, and recapture scenarios, the number of transactions has not reduced. However, more bespoke, funded reinsurance solution structures have not been explored in the market.

We really look forward to the developing BPA and Funded Re landscape, and being a big part of it in the years to come, for the benefit of both our clients and their pension scheme members and policyholders.

Funded Re — The Global Overview

Funded Re is not only familiar in the UK market but has also been transacted in parts of Continental Europe, Asia, and the US.

- **US:** Applied across annuities, long-term care, and individual life blocks, the US Funded Re market is the most mature among the regions, highly saturated by a long list of PE-backed Bermudian or Cayman domiciled reinsurers.
- **Asia:** Funded Re activities have ramped up in the region over recent years, applied to both in-force portfolios (e.g., Japan, South Korea, and Hong Kong) and new business such as savings products (e.g., Singapore and Hong Kong). FX hedging remains a key focal point in execution discussions, with reinsurers' investment capabilities/returns primarily driven by USD assets, while liabilities are defined in local currencies.
- **Continental Europe:** There are also a few precedents of both internal and external Funded Re transactions, in France, Germany, Belgium, and Switzerland, focusing on pension and savings portfolios. Continental European regulators are yet to form a consistent regulatory approach in reviewing such transactions, while the local specific product features, such as profit-sharing requirements, present unique challenges for such transactions.

Why Funded Re?

INSURERS

Risk mitigation: Reinsurance can be used as a risk mitigation tool while securing the interest of the scheme members with an established reinsurer.

Capital relief: Insurers can bid on schemes that they may not have the appetite or capital to retain in their entirety, for example on schemes with a large proportion of deferred members, or schemes that are too large to retain on their own balance sheet.

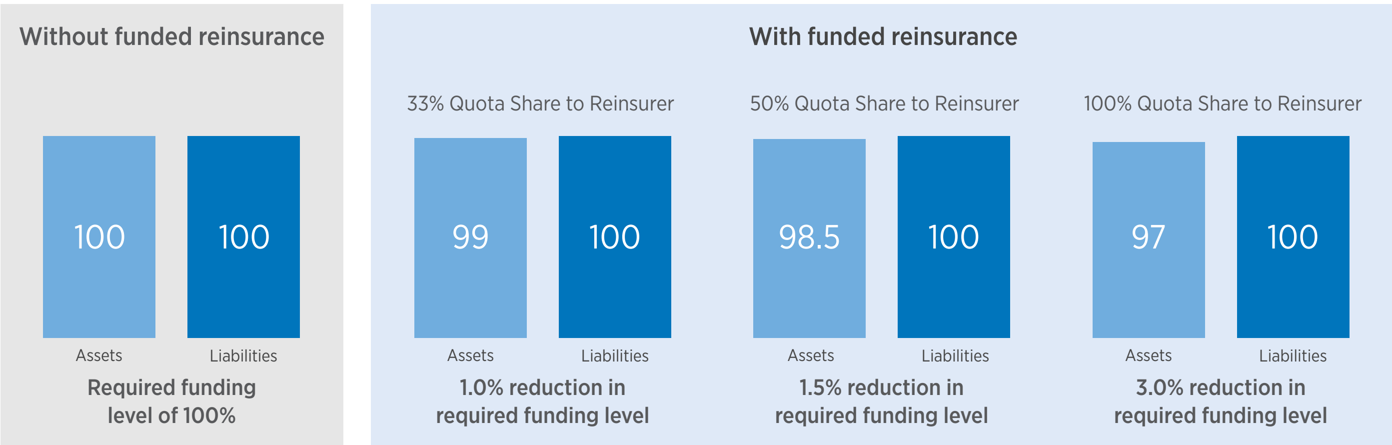
Enhanced pricing: Reinsurers have diversified balance sheets as well as deep knowledge and access to a wide variety of asset classes, meaning they can often provide competitive pricing, ultimately improving the pricing offered to pension schemes by the insurers. As shown in the following chart, funded reinsurance can significantly reduce the required funding level required for a pension scheme to complete buyout transactions. The example assumes a scheme of 10-year duration, demonstrating that funded reinsurance can improve BPA pricing by ~30bps.

REINSURERS

Revenue generation: Some reinsurers, particularly those with strong asset origination and management capabilities, can earn substantial fees on assets under management through Funded Re transactions. In addition, they can also benefit from the investment upside, especially for long duration blocks of business.

Diversification benefits: Reinsurers have well-diversified balance sheets, but those that hold both mortality and longevity risk will benefit from the natural offset between the two risks, meaning they can hold longevity risk on their balance sheet more efficiently.

Low administrative workload: While the reinsurers become liable for their portion of the biometric and asset risk, the insurers are still responsible for dealing directly with the scheme members, meaning the administrative workload on the reinsurers is low.



Challenges Faced by UK (Re)insurers

The business growth and increasing use of funded reinsurance, however, is set against the backdrop of increasing regulatory scrutiny, as highlighted in the PRA Consultation Paper 24/23. This requires BPA players to actively review and manage their collateral arrangements, and recapture provisions to adopt a balanced approach between robust risk management principles and commercial viability.

Insurers are taking additional measures to ensure full asset recapture under recapture scenarios. Additional protection mechanisms are also incorporated in the transactions, such as having rating and solvency ratio-based special termination triggers, ensuring that premiums are fully collateralised in conjunction with look-through of the collateral assets under investment guidelines.

Counterparty exposure management is also a key area of focus. Many BPA players are now exploring new credible counterparties on their panels or investigating innovative options to lower the risk, such as ensuring longevity risk remains completely reinsured even if the Funded Re reinsurer defaults.

Gallagher's Service Offering

At Gallagher, we can provide end-to-end pension risk transfer placement and advisory services for bespoke de-risking transactions across the full spectrum of transaction sizes and deferred proportions.

- With significant experience in the bulk purchase annuity space, our specialist in-house team can advise pension schemes of all sizes and across all sectors. Our close relationships with pension insurance companies, together with our deep understanding of the market, enable us to build truly bespoke solutions and provide recommendations tailored to clients' specific needs
- We provide end-to-end advisory and placement services for bespoke Funded Re transactions across the full spectrum of transaction sizes and deferred proportions
- We provide clients with access to our panel of over 20 established Funded Re reinsurers with deep investment expertise and reinsurance capacity. Our connections to top-level management and in-depth knowledge of reinsurers' solvency, ratings, and accounting regimes enable us to negotiate effectively on behalf of our clients and focus on win-win solutions
- We structure and execute framework reinsurance contracts (i.e., 'flow arrangements') for BPA insurers with reinsurance counterparties. This streamlines small schemes' reinsurance journeys through both longevity flow and asset-intensive (AI) flow reinsurance.
- We support new entrants in the UK bulk-purchased annuity market by designing their reinsurance strategies and executing reinsurance transactions

Should you wish to learn more about our services, please do not hesitate to contact us.

Produced by Gallagher Re's Global Life & Health team and Gallagher's Benefits & HR division in the UK

Wei Hou
Head of Life UK & Ireland and Asset Intensive for Europe
wei_hou@GallagherRe.com

Mark van den Berghen
Principal and Head of Risk Transfer
mark.vandenberghen@buck.com

It's the *way* we do it.

Gallagher Re