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The UK PRA Warns the Bulk Purchase Annuity Market

The UK's Prudential Regulation Authority (PRA) has reiterated its concerns regarding the UK bulk purchase annuity market. This contributes to a broader international theme of regulators expressing concern regarding the rapid growth of life insurers, their asset mix and their use of funded reinsurances, particularly to non-UK reinsurers. Market participants should expect PRA challenges in structuring deals that do not comply with regulatory expectations for concentration, investment and other risks.

- In a speech on 27 April 2023, the PRA reiterated its concerns in relation to the UK bulk purchase annuity (BPA) market, with the PRA again urging restraint and discipline.
- The BPA market, whereby UK defined-benefit pension schemes off-load liabilities and assets to specialized life insurance carriers, continues to expand. Industry estimates predict that the UK life insurance industry could onboard more than £500 billion of pension liabilities and associated assets over the coming decade.
- Little in the speech was new, but the force and emphasis given to BPA protocols is noteworthy. The authority's observations should be viewed as PRA policy, on par with the authority's more formal rules and guidance.
- The PRA's address also contained some implicit messaging:
  - The PRA will take a favourable view of (re)insurers that take advantage of the BPA upsurge and/or the liberalization of the Solvency II regime in the UK to make investments that further the UK government's strategic interests. This includes investments in education, social housing/infrastructure and renewable energy infrastructure/technologies.
  - In contrast, BPA deals that send assets out of the UK (*e.g.*, by way of funded reinsurance), that are structured for tax, capital or asset management optimization reasons or that generate concentration risk are likely to face greater challenges by the PRA.
- We expect to see negotiations with the PRA becoming as important as negotiations with counterparties in executing deals.

The PRA Speech

This latest PRA speech — delivered by Charlotte Gerken, the executive director of the Insurance Supervision — is the most recent "warning" from the PRA regarding the BPA market, previously referenced in the authority's stated priorities for 2023 (as discussed in our 30 January 2023 edition of *The Standard Formula*). Two short-term factors also provide context for the authority's comments:

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- The turbulence in the UK financial markets in October 2022, and the manner in which liability-driven investment (LDI) funds used by pension funds struggled to source appropriate collateral to cover widening spreads.
- Increased UK interest rates, which have generally reduced the value of schemes' liabilities and increased funding ratios. This has greatly improved the affordability of BPA buy-ins/buyouts for many pension schemes, creating a present or imminent opportunity for pension scheme buy-ins/buyouts that did not exist before.

The PRA highlighted that BPA writers need to exercise moderation in the following key areas:

Expansion of Risk Appetites

The PRA has observed increased risk appetite:

- **Among trustees for "jumbo" schemes**, whereby the scheme will execute a BPA deal in "one go" (as opposed to a series of smaller "buy-ins" spread over several years).
- **Among BPA carriers**, in particular:
  - **To insure younger, not yet retired individuals** (so-called deferred pension scheme members), as well as older scheme members already receiving payments. This involves greater uncertainty regarding longevity risk, together with risks stemming from policyholder options, such as cash commutation, flexibility on retirement age and transfers.
  - **To accept illiquid assets as part of the BPA premium.** This results partly from the disruption in the UK gilt market in autumn 2022, which caused some pension schemes to be overweight in illiquid assets as gilt values fell significantly and schemes sought to reduce their implied leverage under liability-driven investment strategies.
  - **Alternatively, to accept deferral of the BPA premium**, giving schemes an opportunity to dispose of such illiquid assets in an orderly fashion and to (try to) avoid disposal at a large discount.

Although the PRA welcomes innovations in this market, the authority will challenge whether the carrier (and in particular its board) have considered whether these risks are appropriate and whether this question has been considered over the full lifetime of the contract.

Reliance on Third-Party Reinsurance Capacity

The PRA also reiterated its concerns regarding reliance by direct BPA carriers on third-party reinsurers to support new BPA business (and the resulting counterparty risk), in particular, the following:

Recapture Risk

- **The risks arising from circumstances where business ceded to a reinsurer end up back on a direct carrier's own balance sheet.** The PRA will increasingly focus on termination rights under the reinsurance treaty: in particular where the rights are linked to solvency coverage ratios, credit ratings or legal and regulatory environments; and whether the rights are voluntarily selected or automatically granted.
  - Relatedly, insurers should consider whether returning assets would meet matching adjustment (MA) or other asset requirements under the "prudent person principle" once the assets again appear on the direct carrier's balance sheet.
- **The cost to the direct carrier of implementing mitigating actions**, *e.g.*, as to capital, entering replacement contracts, asset portfolio rebalancing, unpredictable prices as market liquidity runs out, and unwinding or replacing large cross-currency hedging exposures.

Collateral Risk

- **"Wrong way risk"**: *i.e.*, the risk that investment/other issues affecting a reinsurer in times of stress also impact the collateral pot that is intended to support the reinsurers obligations.
- **Inclusion of less liquid assets in premium/collateral portfolios** such as structured products, commercial mortgages and other private credit.

Market Risk

- **The risk that taking on new BPA business in volume over a relatively short period** will — as a result of interest, currency and inflation hedging programmes and more complex investment arrangements — increase interconnectivity with the wider financial market and potentially increase the sources or amplifiers of liquidity risk.

General

More generally, the PRA will consider the role of (re)insurers in making investments in the wider UK economy. While free market participants have no purpose or obligation to support or further government policy, the PRA's implicit message is clear: Efforts to invest in the UK economy will be rewarded.

The PRA also provided updates on the additional measures announced in the UK government's Solvency II reform package, which will create the Solvency UK regime. The PRA has accepted the government's final proposals and is now focused on implementation, subject to approval/legislation from the UK Parliament. You can review a summary of these proposals in our 23 November 2022 edition of *The Standard Formula*.

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Practical Implications

So, what are the likely practical implications of the PRA's stated concerns? We speculate as follows:

- **The PRA will carefully scrutinize the growth of BPA insurers**, regulating the pace of growth where the authority feels doing so is appropriate. This may simply be in response to the volume or changes in the characteristics of the risks being written, but it may also result from concerns about the availability of sufficiently diverse and appropriate reinsurance or simply about an insurer's operational ability to take on the business safely (*e.g.*, does the insurer have enough of the right type of staff?).
- **Asset portfolios will undergo even further scrutiny, particularly in the context of funded reinsurances and recapture.** We expect that non-UK funded reinsurances will require a high degree of matching adjustment compliance and localization of collateral in the UK, whether by funds withheld or otherwise.
- **The PRA will view skeptically capital release to shareholders as a result of offshore reinsurance** or due to the Solvency UK reforms, firmly encouraging that released capital either remain with insurers or at least within their domestic UK groups, and that insurers invest it in a manner consistent with UK government objectives.

Nonetheless, officials and practitioners generally accept that the movement of defined benefit pension obligations from the corporate sector to insurers is highly desirable. To increase the rate at which that happens, more reinsurers and more reinsurance capacity will be required — and inevitably a large part of that demand can only be satisfied by including offshore providers. Thus the insurance industry will require workable solutions to meet reinsurance needs that also address the above-mentioned concerns.