Institute and Faculty of Actuaries

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PRA CP8/26 – Funded reinsurance

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 34,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers. Actuaries are big-picture thinkers who use mathematical and risk analysis, behavioural insight and business acumen to draw insight from complexity. Our rigorous approach and expertise help the organisations, communities and governments we work with to make better-informed decisions. In an increasingly uncertain world, Actuaries help stakeholders to act in a way that makes sense of the present and plans for the future.

Key points

The IFoA welcomes the opportunity to provide a response to this consultation based on our members' expertise of the bulk purchase annuity market, and the investment and risk strategies associated with it.

In developing our response, we have drawn upon input from the IFoA Funded Reinsurance Working Party, with review and oversight from the IFoA Life Board and the IFoA Policy and Regulation team. This provides a wide range of technical and domain knowledge, from a public interest perspective. Our response continues the positive engagement with prior significant Solvency UK consultations issued by HMT and the PRA.

The IFoA acknowledges the consistent message, and actions, from the PRA over the last few years, in relation to the growth of funded reinsurance ('Funded Re'), and the risk management applied to it. We also acknowledge the stakeholder engagement the PRA has undertaken, including with the IFoA, prior to the consultation publication, and that the consultation has considered points raised in that engagement. We believe that both the existence of funded reinsurance as a risk mitigation option, and proportionate regulation for its treatment, are in the public interest.

We believe that firms should be permitted to develop, justify and validate internal rating methodologies that more accurately determine the appropriate credit rating to use for a specific funded reinsurance structure, which would be subject to existing Solvency UK rules, in particular assurance and validation aspects associated with internal ratings.

The key areas of technical feedback in our response are as follows:

- The proposed application of a (financial) corporate bond fundamental spread (FS) within the Counterparty Default Adjustment (CDA) for funded reinsurance calibrates the calculation to downgrade risk and long-term average corporate bond spreads, which does not directly relate to funded reinsurance counterparty default risk; and
- The proposed notching framework does not fully capture the underlying risk profiles of funded reinsurance arrangements or fully compensate for the limitations introduced by the proposed FS. This may lead to misestimation of the credit enhancement provided by many reinsurance structures.

Our response sets out areas where we believe the proposals could be refined to better reflect and incentivise robust risk mitigation techniques within funded reinsurance structures, whilst still achieving the PRA's stated objectives.

We would welcome the opportunity to discuss the details of this response with the PRA.

Detailed response

1: Introduction

1.1. From our reading of the consultation and interactions with the PRA team we understand the following guiding principles in the proposals:

- The PRA are seeking to create a form of level-playing field in the treatment of reinsurance and investment assets on a Solvency UK basis given the economic substance of these assets is viewed as similar in the context of bulk purchase annuity portfolios.
- The Fundamental Spread (FS) for financial sector bonds reflects exposures beyond banks and is most appropriate for a reinsurer. Differences will then be recognised through the notching approach.
- The approach taken by credit rating agencies in their assessments of default and downgrade risk is the standard against which the approach to notching is measured.
- Simplicity, consistency and objectivity are the key design principles, recognising judgements and compromises within the overall methodology.

1.2. The IFoA welcomes the PRA's continued focus on ensuring the prudential treatment of funded reinsurance appropriately reflects the underlying risks. There are aspects of the proposed technical approach that we would like to provide feedback on, and where relevant, counter proposals for consideration.

1.3. In developing our response, the main input has been from the IFoA Funded Reinsurance Working Party, with review and oversight from the IFoA Life Board and the IFoA Policy and Regulation team.

1.4. Our response has been informed by the Working Party gathering views through a combination of technical discussions, member input and industry engagement, including roundtable discussion with (re)insurers and advisers active in the UK pension risk transfer market. The response seeks to provide technical input and identify where the proposed framework could be refined, whilst recognising the PRA's objective of establishing a simple and pragmatic approach that can be consistently applied across the industry.

1.5. The PRA's proposed changes in CP8/26 seek to address a potential inconsistency in the Solvency II framework, whereby funded reinsurance does not currently receive capital treatment equivalent to perceived economically similar investments, particularly assets held directly by insurers. By seeking to address this point, CP8/26 aims to address the incentives driving what the PRA considers to be excessive growth in the use of funded reinsurance in the UK market. We have some concerns that the proposal may have an unintended impact on the competitiveness of the market.

1.6. We believe that firms should be permitted to develop, justify and validate internal rating methodologies that more accurately determine the appropriate credit rating to use for a specific funded reinsurance structure, which would be subject to existing Solvency UK rules, in particular assurance and validation aspects associated with internal ratings. However, we acknowledge that at this juncture the PRA has a preference to proceed with a more simple and objective approach.

1.7. We have therefore focused on how the PRA's proposed changes to the prudential treatment of funded reinsurance reflect the underlying risks, and we have the following two main elements of feedback:

a. the proposed application of a (financial) corporate bond fundamental spread (FS) within the Counterparty Default Adjustment (CDA) for funded reinsurance calibrates the calculation to downgrade risk and long-term average corporate bond spreads, which do not directly relate to funded reinsurance counterparty default risk; and

b. the proposed notching framework does not fully capture the underlying risk profiles of funded reinsurance arrangements or fully compensate for the limitations introduced by the proposed FS. This may lead to misestimation of the credit enhancement provided by many structures.

1.8. The remainder of this response focuses on these technical considerations and sets out areas where we believe the proposals could be refined to better reflect and incentivise robust risk mitigation techniques within funded reinsurance structures, whilst still achieving the PRA's stated objectives.

2: Technical Review of CP8/26

2.1. We understand that the PRA wants to update the Counterparty Default Adjustment (CDA) methodology for funded reinsurance and improve consistency with the regulatory treatment of directly held assets that can be viewed as economically similar. We believe there are two possible ways to capture the underlying risk profiles of funded reinsurance arrangements, both with associated advantages and disadvantages:

- The first is to start with the reinsurer's Insurer Financial Strength (IFS) rating and apply a bespoke Fundamental Spread (FS) or CDA calibration that reflects contract-specific features.
- The second, which is the approach proposed by the PRA, is to use the published FS associated with the reinsurer's IFS rating and then adjust the rating through a notching framework to reflect contract-specific features.

2.2. A bespoke FS calibration (i.e. option 1 above) could, in principle, provide greater risk sensitivity by allowing the capital treatment to fully reflect the extent of credit enhancement provided by features such as collateralisation, regular margining, overcollateralisation, substitution rights, recapture provisions and termination rights. However, such an approach may be challenging to implement consistently across the market and would not necessarily establish a simple and pragmatic approach, which is the PRA's stated objective.

2.3. The second approach meets the simple and pragmatic objective. However, we have concerns that it will not allow sufficient adjustment from the reinsurer's IFS credit rating, through the notches as currently specified, to materially capture the counterparty risk mitigation features of a funded reinsurance arrangement and hence the approach risks misestimating the residual counterparty credit risk.

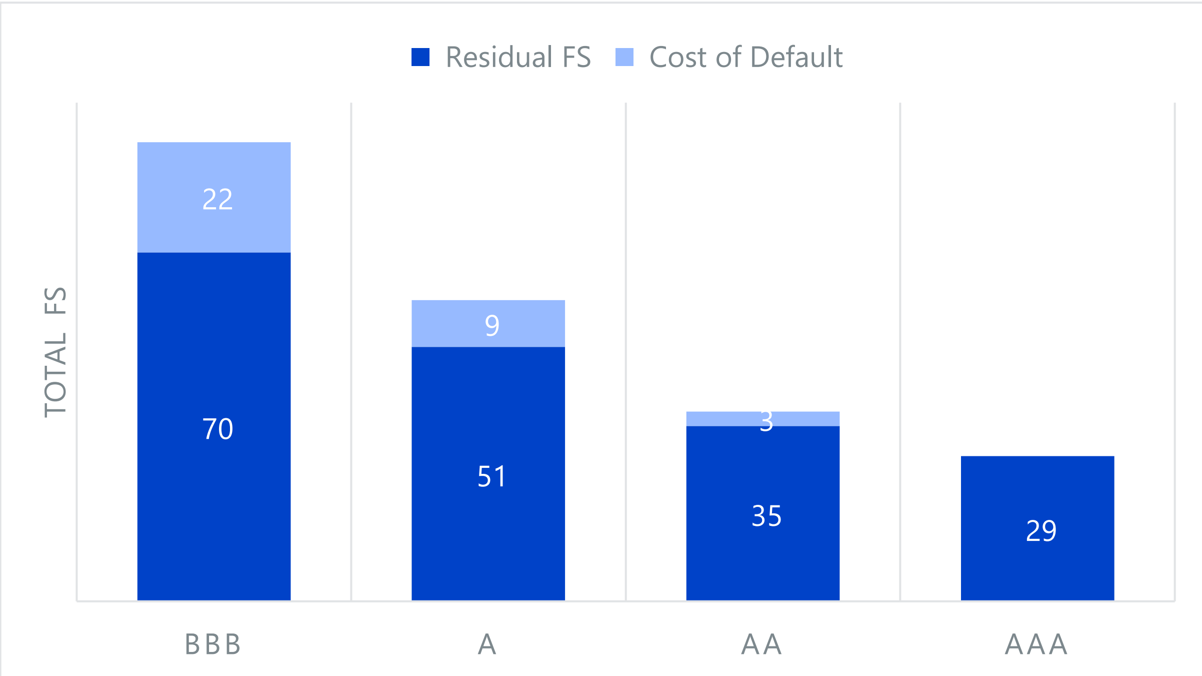
2.4. A robust notching framework is essential because the FS framework underlying the PRA's proposed CDA assumes a 30% recovery rate which we believe understates the counterparty risk mitigation provided by funded reinsurance, including collateral quality, sufficiency, enforceability and recapture resilience. Where collateral is high quality, fully funded and operationally recapturable, expected recovery on reinsurer default should be materially higher than implied by a mechanical FS mapping, particularly due to the solvency-based termination triggers included in most funded reinsurance contracts typically being well above the regulatory intervention level. We note that the existing CDA approach (Technical Provisions – Further Requirements 24.4 of the PRA Rulebook) requires a Loss Given Default no lower than 50% (corresponding to a recovery rate no higher than 50%) unless a reliable basis exists for a lower assumption, and we think this would be a more risk reflective approach.

2.5. The PRA's proposed approach of using a corporate bond FS, whilst achieving an element of capital outcome consistency between the treatment of reinsurance and investment assets on a Solvency UK basis, introduces additional features into the CDA, which, prior to these proposals, only captured expected losses due to counterparty default.

2.6. Given the FS is calibrated using corporate bond experience (asset risk) rather than reinsurance experience (counterparty default risk), it reflects both downgrade costs and an allowance for uncertainty arising from the long-term average spread floor (see Graph 1). Whilst some margin for uncertainty is appropriate within the FS, neither of these elements are directly relevant to funded reinsurance, and both extend beyond the definition of the CDA as an expected loss based on PD (Probability of Default) and LGD. We have some concerns that the proposed CDA may misestimate residual counterparty risk unless sufficient recognition is given to the credit enhancement provided by funded reinsurance structures. For example:

- The structure may require the reinsurer to increase collateral in the event that the reinsurer's own credit rating is downgraded, offsetting the resulting increased counterparty default risk, unlike a corporate bond where the cost of rebalancing required for risk management would be borne by the insurer.
- The structure may afford a termination right to the ceding insurer in the event that the reinsurer's credit rating is downgraded returning the full collateral pool. The early recapture is not, in itself, a credit event and is unlike a corporate bond work-out. The contractual terms available in the funded reinsurance market may not be equivalent with some remaining residual risk for the insurer.

Graph 1: Breakdown of the FS components



Source: Risk-free Fundamental Spreads, Probability of Default and Cost of Downgrade as of 31 May 2026 from BoE

2.7. This underlines the importance of the notching framework in the overall recognition of risk. We believe that the proposed notching approach risks placing insufficient weight on collateral structures and associated assets, with the possibility that robust examples of counterparty default risk mitigation are understated. Other aspects which may not be fully captured include collateral resilience, legal certainty, liquidity, wrong-way risk, operational dependencies and jurisdictional risks. Table 1 below summarises our feedback on the PRA's proposed notching criteria focusing on practical ways in which the approach might be adjusted. We would value the opportunity to discuss this aspect further with the PRA.

Table 1: Feedback on the existing notching criteria

Notch	Comments
1. 100% Collateral	The simplicity of the PRA's proposed notches necessarily means that they are binary and do not distinguish between genuinely different risk profiles, particularly where valuation basis risk, haircuts, over-collateralisation or recapture mechanics provide equivalent or stronger protection. An argument could be made that notches might act in both directions. For example, in cases where funded reinsurance is not fully collateralised, the credit rating could be notched down where other risk mitigation does not compensate.
2. 100% MA eligible collateral & matching	It is sensible to reflect the benefits of the collateral meeting the Matching Adjustment (MA) eligibility criteria and close cashflow matching. The threshold of 100% is restrictive and does not reflect a firm's ability to rebalance following recapture (as recognised in SS5/24), although we recognise challenges in setting and justifying any particular level. Existing risk management processes around % of MA eligibility and cash flow matching and the prudent person principle (PPP) already incentivise firms to target a high % of MA eligibility. We believe that allowing some leeway in this notch could be justified given overall risk management requirements (i.e. catering for a notch if a high % of collateral, but not 100%, is MA eligible).
3. Collateral credit quality higher than reinsurer	For highly rated reinsurers (the majority of the reinsurance market are rated A or above) the Insurer Financial Strength Rating (IFS) will itself be high and so allowance will be made for the high credit quality of the reinsurer before any notching is applied. This notch is therefore more relevant to lower-rated reinsurers, with limited scope for strong collateral credit quality being rewarded in the case of higher-rated reinsurers.

3: The notching framework - benchmarking and refinement proposals

3.1. We believe that the right balance needs to be struck between the PRA's objectives of simplicity, consistency and objectivity, and appropriately recognising risk sensitivity across different structures. A broader notching approach could provide more scope for recognising clear examples of enhanced risk mitigation. For example, Covered Bond rating agency methodologies typically have notching criteria that are broader (in terms of number of notches and substance) than what has been proposed by the PRA in CP8/26.

3.2. Please see Table 2 below which benchmarks a potential expanded notching framework against S&P's covered bond methodology (this was chosen to illustrate the example; other rating agency methodologies could be equally as valid). Where a criterion is not 100% objective, this could be subject to approval by a Senior Management Function. The individual criteria would also not necessarily be viewed as mapping to a single notch movement, allowing for an element of expert judgement as to an overall outcome reflecting the risk characteristics of the funded reinsurance arrangement (with any application of expert judgement being subject to existing internal model guidelines, in particular assurance and validation aspects associated with internal ratings set out in SS3/17). The number of notches applied, for any given criteria, or overall, could be subject to a cap (as can be the case for rating agency covered bond methodology).

3.3. The reinsurer's Insurer Financial Strength Rating (IFS) remains the appropriate starting point from which notches are applied. Default is fundamentally driven by deterioration in the reinsurer's own financial strength, which the IFS measures directly. A further reason is that the solvency triggers commonly included in funded reinsurance arrangements allow the cedant to terminate and recapture the transaction before the reinsurer becomes insolvent, effectively placing the cedant in a stronger position than the reinsurer's most senior creditors.

Table 2: Benchmarking of a proposed expanded notching framework against S&P's covered bond methodology

Factor	Proposed Notch criteria	Comparison to S&P covered bond methodology[1]
Collateral Level	As per current CP8/26 proposals to provide a simple baseline test for collateral at 100% premium. Overcollateralisation - where collateral coverage remains at least 100% under a defined recapture stress, allowing for appropriate haircuts, liquidity discounts, basis effects and the timing of asset realisation.	This maps to S&P's collateral support analysis, where support from the cover pool and overcollateralisation is assessed under stress. S&P states that collateral-based uplift is a distinct component of the framework and allows up to two notches of collateral-based uplift on the basis of credit risk coverage alone.
MA Eligibility	Collateral is at least X% MA eligible (with "X" being an appropriate % below 100% tested against a firm's specific MA portfolio permissions), provided that the firm can demonstrate compliance on recapture in its MA portfolio (which includes replacing MA ineligible assets with alternative MA eligible assets of suitable quality). No liability matching criteria (see proposed ALM notch below).	n/a
Collateral quality	Collateral is predominantly investment grade, diversified, governed by clear eligibility criteria and demonstrably suitable for recapture into business-as-usual balance sheet management. No test of collateral relative to reinsurer rating.	This corresponds to S&P's assessment of cover pool credit quality and risk characteristics, which forms part of the collateral support analysis and influences whether the pool can sustain stressed outcomes.
Jurisdiction	Reinsurer is in a Solvency II equivalent regime or other robust regulatory regime (for example, the United States).	S&P's jurisdictional / legal framework uplift, which recognises the role of statutory protections, dual recourse and programme structure in supporting uplift above the issuer. S&P expressly identifies legal and jurisdictional support as one of the core building blocks of the covered bond rating.
Asset-liability matching	Asset-liability mismatch is limited under defined duration, inflation, currency and optionality stresses, and any required derivative continuity or rebalancing is operationally credible on recapture.	This maps most closely to S&P's cash flow / refinancing analysis, including the extent to which asset cash flows and funding needs remain aligned after issuer default.

[1] See Criteria | Structured Finance | Covered Bonds: Me | S&P Global Ratings

		Covered bond analysis is not based solely on asset default risk; it also considers timing and refinancing integrity.
Diversification benefit beyond cedant exposures	Collateral and reinsurer exposures are demonstrably diversified relative to the cedant's principal balance-sheet stress drivers, reducing wrong-way risk and correlation of loss on recapture. Whilst this implies that two cedants with identical reinsurance contracts with the same reinsurer could get different treatment, we think a cedant who has contracted with a reinsurer that offers diversification is something that should be rewarded.	Conceptually closest to stronger cover pool quality / resilience and lower correlation of stress outcomes and resembles the broader collateral support logic used by S&P rather than a standalone legal uplift factor.

4: Conclusion

4.1. We support the PRA's objective of minimising systemic risk, protecting policyholders and ensuring that funded reinsurance is used prudently within a robust risk management framework. The main features of SS5/24 provide clear expectations on governance, exposure limits, collateral management, recapture planning and ongoing monitoring. We also believe that any approach to funded reinsurance risk management, including appropriate capital requirements, should seek to maintain bulk purchase annuity market resilience and avoid unnecessary disincentives to well-governed arrangements.

4.2. Our feedback on the CP proposals focuses on two key aspects. A mechanical mapping to a corporate bond FS may misstate the expected loss arising from funded reinsurance transactions (in comparison to having a bespoke FS calibration) and insufficiently distinguish between structures with materially different risk profiles. Additionally, the proposed framework gives limited recognition to collateral quality, over-collateralisation, legal enforceability, recapture resilience, reinsurer capitalisation and jurisdictional oversight. This may reduce the availability or efficiency of an important risk management tool for the UK bulk annuity market and may have an unintended impact on the competitiveness of the market.

4.3. We have set out how the proposed counterparty default adjustment could be refined, to better recognise the risk-mitigating effect of funded reinsurance arrangements, including quantum of credit quality and MA eligibility of collateral, contractual protections and the prudential regime applying to the reinsurer. We believe our proposed refinements to the approach would encourage well-governed and robust, funded reinsurance arrangements, further supporting policyholder protection and market resilience. The IFoA would very much welcome the opportunity to discuss with the PRA in more detail both the technical and practical aspects of our alternative proposed approach.