Trends in insurance transactions part 2: pension risk transfer and funded reinsurance

Stephen D’Ardis

Hello and welcome to the A&L Goodbody Insurance podcast. My name is Stephen D’Ardis and I am a partner in the insurance and reinsurance group. Today I'm joined by my colleague David Main, a partner in our pensions group.

David Main

Hello everyone, today in part two of our focus on trends in insurance transactions, we're going to be discussing pension risk transfer deals, also known as bulk purchase annuities. These are complex transactions which are often backed by funded reinsurance transactions, sometimes known as asset intensive reinsurance.

Stephen D’Ardis

So David, for those who don't already know, what is a bulk purchase annuity?

David Main

Good place to start, Stephen. A bulk purchase annuity, or BPA, is an insurance policy taken out by the trustees of a defined benefit scheme with a life insurer. The word bulk refers to the fact that the policy covers a cohort of scheme members under a single contract, as opposed to under individual retail annuities. The insurer assumes responsibility for making pension payments to those members in exchange for a premium, which is funded by the scheme's assets.

BPA transactions take two forms. The first is a buy-in, where the policy is held as an asset of the pension scheme. The insurer makes payments to the scheme, and the trustees remain responsible for paying benefits to members.

The second form is a buy-out. Here, the insurer steps into the shoes of the trustees entirely, and issues individual annuity policies directly to each member. The members cease to be members of the scheme, and become policyholders of the insurer instead.

Stephen D’Ardis

Thanks for that explanation David. What then are the main reasons why the trustees of a pension scheme would buy a BPA policy?

David Main

Well, trustees like BPA's because they transfer longevity and other risks to the insurer and they provide a high degree of certainty that the members will get their benefits. Scheme sponsors also like BPA's because they remove volatile liabilities from the balance sheet. A BPA transaction may well originate with the sponsor requesting the trustees to purchase a BPA.

Stephen D’Ardis

BPA transactions seem to be happening frequently in the UK pensions market, which is relatively similar to our own. So why have we not seen so many of these transactions in Ireland to date?

David Main

Well, Stephen, there are a number of reasons, not just that trustees have been busy focusing on immediate compliance obligations.

First off, there's the size of the market. The Irish DB sector comprises approximately €70bn euro in assets compared to approximately £1.5tn pounds in the UK. There was also a view that most Irish schemes are simply too small for BPA transactions to be viable. However, looking at the UK in 2024, 80% of the nearly 300 BPA transactions there involved schemes with under £100m pounds in assets. So if the UK market is now being driven by smaller schemes, something similar could develop here.

Stephen D’Ardis

And what about the number of insurers in the Irish BPA market, is that holding back growth?

David Main

Well, that brings me to my second point. There have historically been very few active insurers in the market. The lack of competition has meant less innovation, less capacity to absorb pension risk, and expensive pricing. By contrast to the Irish market, the UK market now has more than 10 active BPA insurers.

Stephen D'Ardis

Right. And are there any other key reasons?

David Main

There are two, I think, worth bringing up.

The first of these is pension increases. For context, pension increases are one of the main sources of complaints by scheme members in these inflationary times. Some scheme benefits are inflation linked. Irish CPI is the usual benchmark for these obligations, but there isn't any asset that can directly match Irish CPI. This has meant insurers are reluctant to cover these increased liabilities, or they'll only do so at prohibitive cost.

Many schemes will also provide for discretionary increases to pensions in payment. Insurers won't cover those types of increase. They're simply too uncertain. A BPA transaction may therefore lead to the loss of discretionary increases, which won't go down well with the pensioners.

The second of these reasons relates to deferred annuities. Insurers have been very reluctant to provide annuity cover for deferred pension liabilities. There are some difficult technical legal questions about whether it's possible to buy out deferred liabilities with an annuity. And this has had an influence on the market, and BPA transactions to date have tended to be limited to current pensioners.

Stephen D'Ardis

So having discussed the main issues that have held back the growth of the BPA market in Ireland prior to now, what would you say is the current outlook for this market, David?

David Main

Well, it's interesting. The conditions for growth in the market are now arguably more favorable than at any point in recent memory. Insurers are pricing annuities more competitively, as they diversify away from pricing solely by reference to government bonds. Irish DB schemes are generally well-funded. 99% of them meet the Pensions Act solvency standard. And as these schemes mature, they get closer to buyout levels of funding.

Many larger schemes are now preparing to downsize or wind up when sufficient funding levels are reached. And new solutions are being found. For example, one insurer has just announced the launch of a deferred annuity product.

Another example is that schemes are going through pension increase exchanges, where members give up their right to a CPI-linked increase in return for a restructured benefit.

So all in all, I think we're going to see an increase in the number and scale of BPA transactions, particularly over the medium term or the next two to five years.

Stephen D'Ardis

That's very interesting, and I'm sure reinsurers in Ireland and elsewhere will be thinking about what capital optimisation structures they might be able to put in place to help Irish insurers price BPA transactions more keenly.

David Main

So Stephen, it seems that you can't fully consider BPA or Pension Risk Transfer transactions without looking at the reinsurance arrangements behind them, which have come under significant scrutiny from insurance regulators globally, particularly in light of the growing influence of private equity in the insurance sector.

So what is funded reinsurance?

Stephen D'Ardis

Essentially, David, funded reinsurance involves a reinsurer taking on assets or investment risk and longevity risk from a sedent life insurer. The assets backing the life insurance liabilities are transferred by the sedent to the reinsurer, usually as full or partial payment of the premium due.

While the assets are usually held as collateral for the reinsurer's obligations for the duration of the arrangement, the reinsurer will also manage the collateral during that time. The main questions for the sedent and its regulator are how much the collateral assets will change over that time and whether the reinsurer might seek to exploit regulatory arbitrage between different jurisdictions to invest in riskier assets and increase its investment returns.

This is the key tension at the heart of this market between the reinsurer improving its investment returns and keeping flexibility in its investment strategy versus the insurer optimising its capital position and delaying any regulatory concerns about the collateral.

David Main

So thank you Stephen, you mentioned regulatory concerns. What are the regulatory attitudes to funded reinsurance and what are the key risks?

Stephen D’Ardis

Well, I think the regulatory attitudes have been driven by rapid growth in funded reinsurance, particularly in the US and the UK, and this in turn has been driven by the requirement for capital to back BPA deals, as you discussed, and this has resulted in a lot of regulatory attention. The key concern is that the sedent can be left with considerable recapture risk if the reinsure becomes insolvent or undergoes another event of default.

David Main

Tell us what is recapture risk.

Stephen D’Ardis

Essentially, it's the risk that on termination of the reinsurance, the collateral assets returned to the sedent are insufficient or somehow inadequate to meet the reinsured liabilities.

This risk is potentially more severe in the context of the market for reinsurance of BPA deals, as regulators have highlighted that the business models of many reinsurers in this space focus on investment in private credit assets.

This means a downturn in private credit markets more broadly could result in somewhat of a domino effect, leading to widespread defaults by reinsurers and recapture risk for sedents.

David Main

And what can sedents do to mitigate those risks?

Stephen D’Ardis

Well, traditional collateral arrangements, like placing assets in a custody account subject to a charge in favour of the sedent, may not be sufficient here. From the sedent's perspective, the transaction documents should include clear investment guidelines to ensure the quality and diversity of collateral, to align with regulatory requirements and to limit the recapture risk.

David Main

Has there been any regulatory guidance perhaps on this topic which might assist Irish sedents?

Stephen D’Ardis

Yes, usefully the CBI and some other regulators have published good risk management practices.

They include having a clear risk appetite in place for these exposures, regular monitoring and reporting on exposures on collateral assets, having restrictions on eligible collateral such as limits per asset category and minimum credit ratings, using a range of reinsurers to reduce concentration risk, including the impact of a default in the ORSA and the pre-emptive recovery plan of the sedent, and having a detailed recapture plan, essentially a step-by-step process where termination rights are triggered and the insurer seeks to enforce security over collateral in the event of a default.

And finally, a recent point, in the UK the PRA is proposing to significantly limit the regulatory capital relief available to UK sedents for funded reinsurance, so watch this space.

David Main

Thank you, Stephen, and there's plenty to think about there for Irish sedents and overseas reinsurance in this market.

Stephen D’Ardis

Thanks, David. I hope our listeners found this podcast helpful. If you've any questions on what you've heard today, I can be reached at sdardis@algoodbody.com.

David Main

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