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Funded reinsurance as a divestment tool for life insurance books with financial guarantees

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Funded reinsurance as a divestment tool for life insurance books with financial guarantees

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Abstract

A decade of low interest rates and the implementation of Solvency II prompted European life insurers to shift their business from traditional life insurance policies with minimum guarantees to capital-light, unit-linked, and protection businesses. This structural change created a demand for divestments of traditional saving products with financial guarantees. This paper discusses the economic and regulatory aspects of divestment strategies, including traditional portfolio transfer and legal entity sales. It also explains and analyzes funded reinsurance, which is an emerging divestment strategy where reinsurers assume the risks and rewards of a portfolio of life insurance or annuity contracts. We assess and compare the impact of divestment strategies from the perspective of different stakeholders, such as policyholders, shareholders, and regulators.

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Introduction

Guaranteed life insurance liabilities account for €4 trillion of the technical reserves across Europe,[1] a phenomenon that is particularly pronounced in Belgium, Germany, France, Italy, and the Netherlands. Following the global financial crisis (GFC) in 2008, an expansionary monetary policy, continued falling interest rates, and the introduction of the Solvency II regime led to a substantial increase in the cost of these liabilities for life insurers. Many European insurers have found themselves with large portfolios of long-duration life insurance products with high minimum guarantees that are extremely capital intensive, loss making, or projected to deliver long-term profitability well below the cost of capital. In addition, these portfolios contain capital markets and credit exposures and can be highly volatile in terms of projected earnings and capital intensity under Solvency II. Volatility exposure further amplifies the costs of legacy business for listed insurance companies who are often penalized by the shareholders and the market for volatile performance.

The European life insurance industry has been adapting to these headwinds. A growing number of large listed insurers are actively divesting legal entities and portfolios of traditional life insurance products and shifting toward a new business mix of capital-light, fee-generating products, such as unit-linked contracts and protection business. According to the European Insurance and Occupational Pensions Authority (EIOPA) Financial Stability Report[2] in December 2022, European life merger and acquisition (M&A) deals reached €636 billion from 2016 to 2021. So far, most divestments in Europe have taken place through the sale of legal entities or portfolios of insurance contracts to another legal entity, which is often labeled as share deals or asset deals, respectively.

Divestments using share and asset deals have limitations in reallocating life insurance liabilities. European insurers are now running out of legal entities that can be sold without impacting the customer relationships of the core customer groups, distributors, or other core lines of business. As for portfolio transfers, these deals are operationally demanding and have a complex transaction structure, resulting in lengthy deal execution, operational risks, and reputation risk for the insurer.

Funded reinsurance is an emerging divestment strategy in Europe that offers an alternative mechanism to address some of these concerns. The basic mechanism of funded reinsurance of a large endowment of annuity portfolios is similar to standard quota share (QS) and loss portfolio transfer (LPT) reinsurance transactions in the non-life insurance market, including biometric, lapse, and financial risks. In exchange for receiving a premium in the form of insurer's assets, the reinsurer is liable for its QS of future benefit payments to policyholders, that is, surrender, death, disability, annuity, or maturity benefits. From the perspective of an insurer seeking to reduce its exposure to legacy books, funded reinsurance permits the transfer of risks on existing capital-intensive, in-force portfolios without the actual sale of an entity or portfolio to new owners.

In the present paper, we first analyze the supply and demand drivers in the life insurance legacy portfolio market. Then, we present the funded reinsurance divestment strategy and compare it with the other divestment strategies, including the portfolio transfer and the entity sale, from the perspective of policyholders, insurers, and regulators. We conclude with a discussion of the aspects of insurance supervision in the life insurance legacy book divestments market while offering some policy implications.

Our findings can be summarized as follows. We argue that the structural changes in the European life insurance industry can explain insurers' divestment activity and that the desire to divest legacy portfolios with guarantees is likely to persist, despite the recent rapid changes in interest rates and inflation. Hence, an effective divestment market can improve the efficiency of capital allocation in the insurance industry, ultimately benefiting policyholders. On the demand side of the market, insurance legacy book liabilities are acquired by a diverse range of investors, including private investors. Investors also employ a variety of business models and, to a different extent, rely on leverage to generate returns. Compared with the sellers, the acquirers aim to improve the operational efficiency and diversification of the legacy portfolio and to increase risk-adjusted returns by pursuing alternative investment strategies.

Next, we explain funded reinsurance, which is an emerging divestment strategy for legacy books in the European market. When compared with the portfolio and entity sale, its main distinctive feature is that the insurer remains the counterparty to the policyholder, while it transfers the risks and rewards of the legacy portfolio to the reinsurer. We discuss two common forms of funded reinsurance: funds transferred and funds withheld. Although the two forms can be structured equivalently from the perspective of policyholders, we describe their differences for insurers and reinsurers. We also compare funded reinsurance to the other divestment strategies: portfolio sales and entity sales.

Finally, we discuss funded reinsurance in the context of the European reinsurance market, summarizing the current regulatory concerns. The primary responsibility of insurance supervisors is policyholder protection, and the impact of the funded reinsurance on policyholders is the core supervisory concern. Here, the issue is that the policyholders should not be disadvantaged by the divestment, which also requires that the reinsurer have high credit quality. Another concern is that the insurer and reinsurer need to have operational processes in place to manage the transaction. In addition, the insurer needs to sufficiently understand and be able to manage the assets in case the reinsurer defaults.

The rest of the current paper is organized as follows. The next section explains the supply and demand factors in the market and provides a classification of the participants on either side. Section 3 provides an overview of the funded reinsurance transaction, puts funded reinsurance in the context of the European life reinsurance market, discusses the regulatory considerations related to funded reinsurance, and compares funded reinsurance to other divestment strategies. Section 4 contains a summary and policy considerations.

Supply and demand in secondary market of traditional guaranteed life portfolios

Who are the sellers and buyers in the run-off market? In this section, we discuss the run-off market's supply and demand drivers. We first summarize the reasons for divestment decisions by life insurers on the supply side of the market. Next, we turn to the demand side and describe investor types in the run-off market. Finally, we discuss the potential for value creation by matching the skills and needs of the two sides of the market.

Supply side

Economic drivers of life insurers' divestment decisions

Life insurance products with financial guarantees have been the main offering of European life insurers for decades. However, after the GFC, the unit-linked reserves have experienced faster growth compared with the guaranteed life insurance reserves, with the latter still representing 73% of the life insurance market. Figure 1 further illustrates the importance of non-unit-linked reserves in the EU.

Low interest rates resulting from the accommodative monetary policy by the European Central Bank (ECB) and other major central banks and Solvency II implementation in 2016 are the two main factors that have led to a significant change in the economic value of traditional life insurance liabilities and required regulatory capital. Given the embedded guarantees and domestic insurance regulations, the traditional savings business often produces either accounting losses or very low profits but consumes risk capital. Figure 2 illustrates that, in recent years, European life insurers have suffered more from both duration mismatches and negative investment spreads when compared with 2017 and 2018.

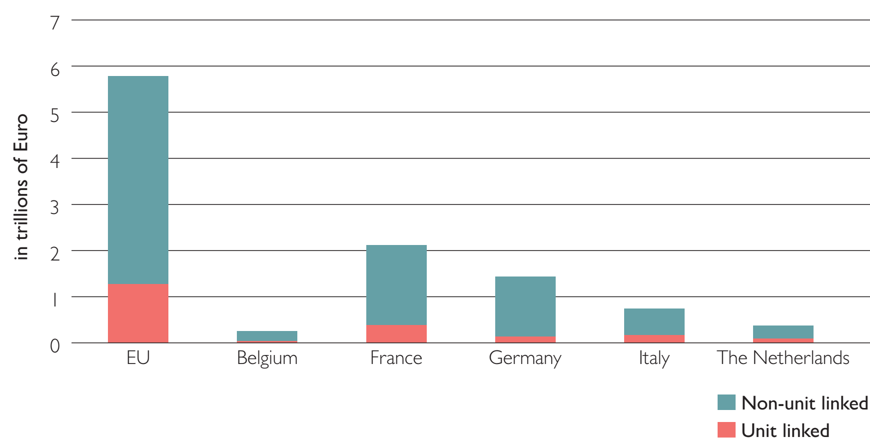
To hedge their liabilities, European insurers using the Solvency II standard formula hold large amounts of sovereign debt because of its zero-risk weight. However, this asset-liability management (ALM) approach further depresses insurer's profitability, which is detrimental to its policyholders and shareholders. In addition, research suggests that EU insurers' portfolio adjustments aimed at containing duration mismatches can amplify bond market shocks and contribute to systemic risk.[3]

As a result of these developments, the profitability of the guaranteed business has decreased over the past decade. Starting from the second half-year EIOPA report in 2011, a prolonged period of low interest rates has been identified by the European insurance supervisors as the most significant factor impeding life insurers' profitability and solvency; it has remained a significant macroeconomic factor impacting the life insurance sector for 10 years, until the rise of inflation in 2021.[4] Many insurers have accepted an environment of "low for long" interest rates during the last decade. The high duration mismatch that was observed in the European life insurance industry prior to the introduction of Solvency II was addressed by investing in government bonds, further decreasing asset returns but stabilizing the regulatory capital position.

The recent rapid and substantial increase in yields from 2021 implies that insurers with better matched portfolios face the challenge of recognizing significant losses on fixed income portfolios and increased capital requirements because of lapse risk. For many insurers, the market value of investment assets is below the statutory technical provisions and surrender values of insurance contracts. In most continental European markets (e.g., Belgium, France, Germany, Italy), policyholders have surrender rights. The mark-to-market losses on investment assets and lower guarantees being out of the money have led to significant exposure to increased lapses. Prior to 2021, despite having guarantees that were also deep in the money, life insurers' liabilities and capital requirements could be considered rather stable and predict-

Figure 1: Mean values of unit and non-unit linked volume of life insurance technical reserves in the European market for the period 2016–2022

Source: European Central Bank

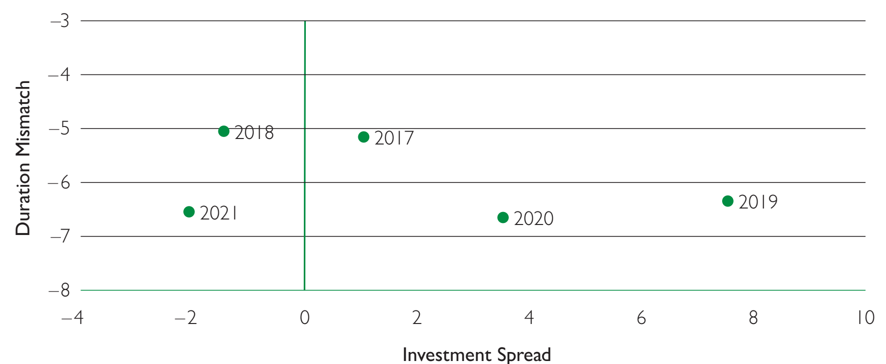


able. Currently, with guarantees of these portfolios being in the money, the combination of rates and other market movements and policyholder behavior and biometric risks may lead to unexpected volatility, which is not reflected in Solvency II single-risk shock standard formula approach. This suggests that poor return on equity (ROE) during a period of low interest rates will remain during high and rapidly changing rates. Thus, the abrupt change in yields is likely to further amplify divestment pressure for these life insurers.

Figure 2: Duration mismatches and negative investment spreads for the period 2017–2021

Source: European Insurance and Occupational Pensions Authority

Investment spread is the median of the spread of the investment return over guaranteed interest rate. Duration mismatch It is based on the modified duration of the fixed income assets and of the liabilities. Duration of the liabilities does not take into account optionalities such as a future profit participation.



Life insurers' response: Product mix redesign and divestment of legacy business

Life insurers have been actively redesigning their product mix by increasing the share of unit-linked and protection businesses while reducing the generosity of guarantees in non-unit-linked businesses. However, the new business accounts for only about 10–15% of the earnings sources for life insurers, while the rest comes from their in-force business. Having an impaired ability to offer financial guarantees in the current economic and regulatory environment and competitive pressure from other financial institutions offering investment products to customers can thus encourage insurers to discontinue offering financial guarantees and put legacy insurance books in the run-off.

An insurer holding a legacy book with guarantees in the run-off can either select to organize it internally or try to find an external buyer. The external run-off can be implemented in three ways: sale of a legal entity/subsidiary ("share deals") that contains the legacy portfolios for divestment, a portfolio transfer ("asset deals"), and funded reinsurance, which we discuss in Section 3.

The challenge of the internal run-off is that the factors leading to the decision to close the book can be further amplified if the legacy portfolio is run off internally.[5] As the premium income ceases and the portfolio size shrinks, the diversification of the portfolio decreases, and the technical results become more volatile. This implies higher overhead costs and higher regulatory capital requirements per unit of liabilities. In addition, if the customers' perception is that the insurer in the run-off is less reliable or that the quality of the customer service is lower, the increasing lapse rates will increase the liquidity needs of the run-off portfolio. As a result, the average investment returns will decrease because of the need to reallocate to liquid assets with lower returns.

For an internal run-off, the insurer also has low incentives to devote human capital to advanced asset management for the legacy book, which does not generate new business. Furthermore, the insurer may have limited capability to maximize the value creation of the closed book. One reason is the lack of management's full attention and focus. Another reason is the limited ability to achieve operational efficiencies and cost cutting for the closed books, which are separate from the strategy and focus of the insurer more broadly. Finally, the insurer needs additional effort to convince shareholders that the allocation of incremental capital to generate improved investment returns of the closed book is in line with the insurer's strategy and risk appetite. Therefore, an insurer may have incentives to find an external buyer for the legacy book.

For policyholders who are accustomed to dealing with the original insurance company, the change of ownership may raise concerns. Arguably, insurance is a product based on trust.[6] Policyholders who purchased a policy for life from a brand they trust may feel deceived when their policy has been sold to an unknown acquirer. Two prominent examples of portfolio transfers in the UK life insurance market illustrate this issue. One is when, in 2018, Prudential UK announced plans to transfer a portfolio to Rothesay Life, a specialist consolidator of closed books, here by using the commonly used Part VII transfer mechanism in the UK. Despite the positive conclusion of the independent expert and approval of the regulator, the High Court refused to approve the transfer

because of policyholder objections, citing the differences in the reputation and likelihood of parental support in the case of financial distress of the applicants being among some of the reasons. Subsequently, the decision was appealed, and the transfer was approved in 2021. Another example is LV= demutualization and proposed (and failed in 2021) sale of LV= to Bain Capital, the US private equity firm, where LV= policyholders would have lost their mutual status and voted against the sale.

Often, the opinion of the general public is that an external run-off disadvantages the affected policyholders. One possible reason for policyholders' concerns is the perception that external run-off investors are not motivated to build a reputation to attract prospective customers. Hence, in the case of the external run-off, the profit participation would be reduced to the legally possible minimum and the customer service quality would be compromised. A related set of considerations applies to the distributors of insurance products. Often, there is a long-standing distribution relationship in which the distributor manages the customer relationship on existing portfolios (and still collects commissions) and sells new policies. The transfer of the portfolio to a new owner impairs this relationship. As a result, it makes portfolio transfer operationally and reputationally costly.

However, these concerns are countervailed by the incentives of external run-off investors to maintain low lapse rates for the transferred legacy books. Furthermore, their business model is built on the ability to maintain the legacy book deal flow, and here, a good reputation is pivotal for securing future transactions. Therefore, divestment may also improve the efficiency of interaction.[7]

More broadly, the decision of an insurance company to divest a legacy book should be considered in the context of its corporate, risk management, and capital management strategy. Besides improving low or volatile solvency ratios, the divestment can revamp the insurer's balance sheet through other channels. It can release capital to strengthen insurer's solvency for the benefit of other policyholders. In addition, the released capital can be deployed elsewhere for product innovation and creating new business. For listed insurers, the improved ROE raises valuations and reduces the cost of access to new capital and equity. Thus, a divestment can enable the generation of adequate ROE on life business in the case where the legacy portfolio generates insufficient net fees on the unit-linked business. These considerations are also relevant to regulators. Improving insurers' profitability and enhancing their financial strength ensures stronger policyholder protection by permitting insurers can easily access capital when needed.

Furthermore, divestment can streamline the business, allowing management to focus on the stated strategic goals. Large composite European insurers can use the proceeds to pay down debt, pay dividends to shareholders, improve the volatility management of sovereign bond portfolio vis-à-vis the EIOPA curve, or reorient to high-growth markets, including overseas. For some European bank-owned insurers, divestment can decrease the IFRS or local GAAP earnings volatility while improving bank regulatory capital ratios.

Despite the potential advantages of the external run-off solution for insurers, portfolio transfers and entity sales have a few hurdles. Legacy portfolio transfer transactions are operationally demanding and have a complex transaction structure. Most change-of-control M&A transactions have a standardized process for the regulator to provide the approval or nonobjection. However, portfolio transfer transactions lack process consistency in Continental Europe. As for legal entity sales, European insurers are now running out of legal entities to sell without materially impacting the customer relationships of core customer groups, distributors, or other core lines of business. These reasons partially explain the growing prevalence of funded reinsurance as an alternative mechanism to divest legacy portfolios.

Demand side: Investors in life insurance liabilities

Growth of the legacy portfolio market in Europe

Concurrently with the growing pressure on European life insurers to divest their capital-intensive portfolios with guarantees, there has been increasing interest from private market investors when it comes to acquiring legacy portfolios. Based on data collected from Capital IQ, media announcements, and various industry reports,[8] we have identified 122 deals in the European life insurance run-off market during the period between 2008 and 2021Q1, of which 35 (29%) are portfolio transfers and 87 (71%) entity sales. Table 1 provides an overview of the European life insurance legacy book divestment market based on the summary statistics of our sample.

Table 1: Overview of the European life insurance legacy book divestment market for the period 2008–2021 Q1

Sources: Capital IQ, media announcements, company reports and press releases, own research

	N° of Deals
Total Sample	122
Portfolio Transfers/Asset deals	35
Entity Transfers/Share deals	87

Acquirer Type	N° of Deals
Consolidator	84
Insurance Group / Consolidator	42
Reinsurance Group/Consolidator	21
Private equity/Investment banking/Asset management	21
Not consolidator	38
PE/IB/Asset Management	5
Insurance Group	24
Commercial Bank	8
Conclomerate	1

	N° of Deals				
Headquarter Country	Target Country	Direct Seller	Parent of the Seller	Direct Acquirer	Parent of the Acquirer
UK	51	46	41	46	54
Italy	21	21	21	20	16
Netherlands	8	13	13	6	3
Ireland	17	12	3	16	1
Germany	13	10	8	12	3
Belgium	6	6	6	3	0
France	3	4	9	4	5
Switzerland	0	3	6	2	8
Bermuda	0	2	4	9	20
USA	0	2	5	1	6
Luxembourg	2	1	2	2	0
China	0	1	1	0	4
Others*	0	1	3	1	1

* Others include countries which were involved in less than two deals in all categories. Those countries are Austia, Canada, Isle of Man, South Africa, and Norway.

The data show that, although the UK market has the highest number of deals, other markets such as Germany, Ireland, Italy, and the Netherlands also have a significant activity. These countries are also the domiciles of legacy portfolio buyers. Furthermore, Figure 3 reveals that sellers and buyers in Continental Europe – rather than the UK – have become more prevalent in the legacy books market in recent years.

The expansion of private investors in the life insurance market contrasts with the strategy of the major listed European insurers, who have instead sought to redeploy capital away from life insurance products with guarantees. As demonstrated in Figure 4, during the period 2018–2022, these insurers have extracted capital from the life insurance industry, by paying out significant dividends and buying back the shares. At the same time, several alternative asset managers have been raising and deploying capital in the life insurance market in Continental Europe. For example, Athora has raised more than €6 billion to invest in the European life insurance market.[9]

Several factors can explain the growing interest of private market investors in European life insurance legacy books. One possibility is that these investors can generate higher risk-adjusted returns compared with traditional insurers. The buyers of legacy portfolios are often affiliated with alternative asset managers, enabling them to access investment opportunities that can generate an illiquidity premium. In contrast, the common investment strategy of the life insurers is primarily focused on the fixed income market, with significant holdings of sovereign bonds. Another explanation is that private investors can improve the operational efficiency of legacy books by consolidating the books on a single platform and providing higher-powered incentives to management.

Another factor driving the demand for private investors is that legacy portfolios can reduce their cost of capital. Due to the illiquid nature of life insurance liabilities, life insurance books provide private investors with access to long-term capital that is less prone to drying out during economic downturns. As a result, it allows private investors to invest throughout the economic cycle.

The form of ownership, that is, the difference between being a listed public company and private company that is unlisted on the stock exchange, can also affect the alignment of shareholders' support of the business model, hence making guaranteed life insurance books more attractive for private rather than public companies. Global publicly traded composite insurers have a significant number of shareholders with different views on the type of business model and geographic markets that they should

Figure 3: Comparison of the divestment market in the Continental Europe and the United Kingdom

Sources: Capital IQ, media announcements, company reports and press releases, own research

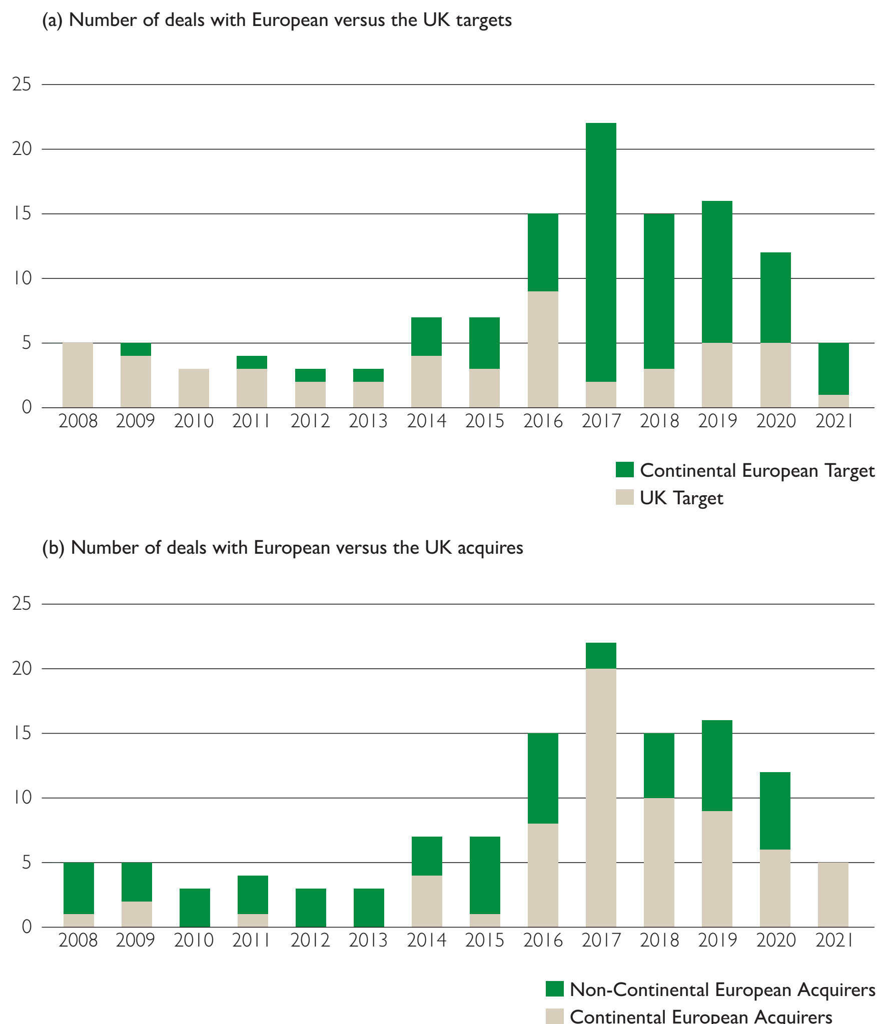
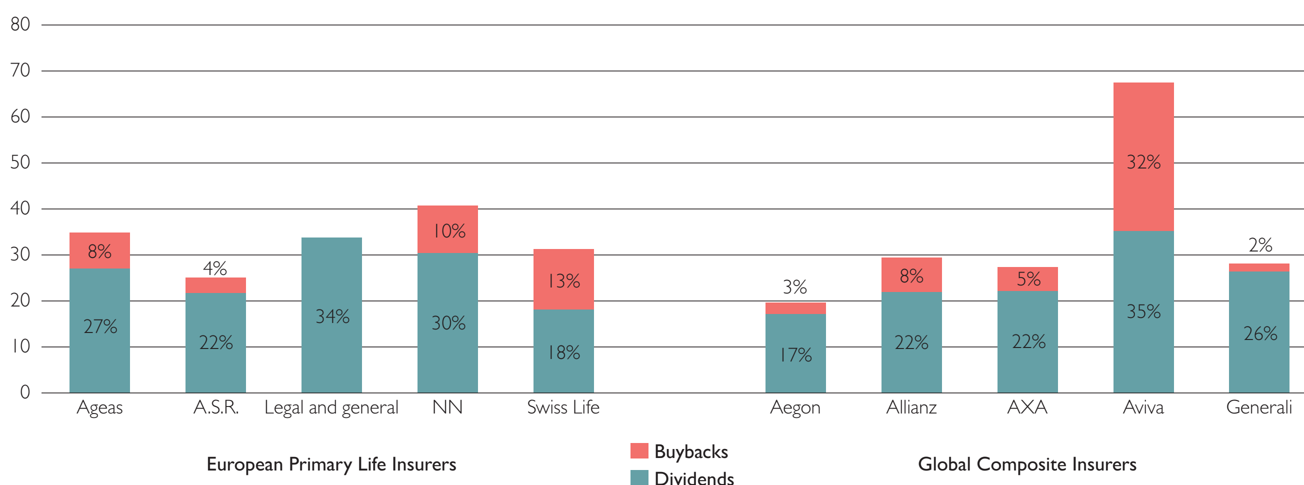


Figure 4: Cumulative capital returns (dividends, special dividends and share repurchases) in 2018–2022 versus 31 January 2023 market capitalisation

Sources: Capital returns data sourced from company financial statements; market capitalisation from Bloomberg

Cash payments to shareholders during the calendar years 2018–2022, comprising dividends, special dividends and share repurchases as per company financial statements.



pursue. Because life insurers are complex and less transparent, shareholders often rely on dividends, capital returns, high-growth markets, and earnings that are uncorrelated with capital markets, which are the criteria to assess public insurers' performance. Consequently, the need to excel on these metrics constrains their ability to pursue investment strategies other than those relying on sovereign bonds and other perceived low credit risk assets.

Although public insurers may be capable of creating value with guaranteed life insurance businesses and currently focus on building asset management businesses, generating adequate investment returns to sustain life insurance policies with guarantees would require a different investment strategy. Alternative investment strategies that are marked to market quarterly necessarily create volatility in earnings that is penalized in view of the metrics used to assess public companies. A notable exception is Berkshire Hathaway, a large US conglomerate that also includes insurance and reinsurance businesses. Despite its large shareholder base, the company has managed to persuade investors to see through significant mark-to-market volatility and quarterly earning losses. In return for shareholder support, Berkshire Hathaway managed to deliver compounded book value and value-per-share growth over several decades.

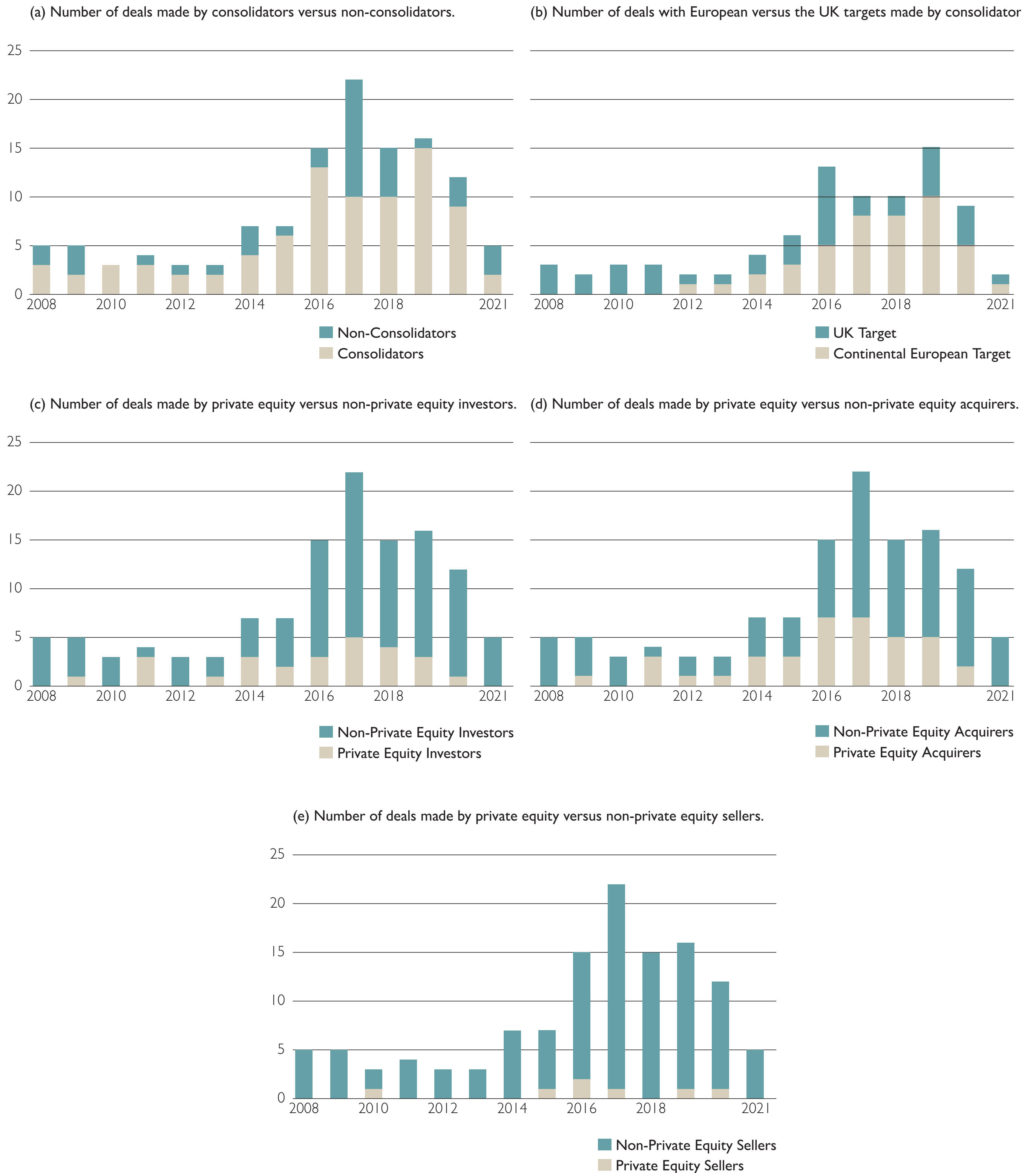
Private insurers with a significantly smaller number of shareholders may have a better-informed and more sophisticated shareholder base that endorses a specific business model perused by the insurer. Then, the quarterly mark-to-market balance sheet volatility is not penalized because the focus remains on long-term stable and sustainable value creation. The significance of these and other factors varies depending on the buyers' business models, which we discuss next.

Types of legacy book buyers

The buyers of the legacy books can be categorized into three types, depending on their ownership structure: (1) private equity fund-owned players where the private equity fund is a closed-end fund with a finite investment horizon (e.g., Eurovita, Viridium, Gama Life), (2) privately owned limited insurance companies with permanent capital investments (e.g., Athora, Monument, Resolution), and (3) publicly owned insurance companies that specialize in closed life insurance books consolidation (e.g., Chesnara, Phoenix). Figure 5 provides more details about the market activity of different types of investors.

Figure 5: Investment activity in the legacy book divestment market by investor type for the period 2008–2021 Q1

Sources: Capital IQ, media announcements, company reports and press releases, own research



The proposed categorization is fluid and may evolve depending on the business focus and success of the buyers. In terms of the volume of transactions, the companies with permanent capital (2) and listed companies (3) represent the largest share of the market participants. The publicly owned companies (3) operate primarily in the UK mature market; these consolidators of life insurance legacy books were originally built with private capital, but once they reached a meaningful size and profitability, they were listed in the public market. Private equity fund-owned players (1) may enter the market by starting to acquire legacy books in the aspiration to develop their business model and expand to become type (2) and, eventually, become type (3). However, type (1) buyers may also include opportunistic buyers who are willing to commit capital according to the fund-limited investment horizon before then selling the legacy books portfolio to the other two types of buyers (2) and (3).

Within each of these types, which are distinct in the ownership structure and the investment horizon of the shareholders/owners, there are further important characteristics that determine the buyers' business models and value drivers. Some investors operate with significant leverage akin to leveraged buyout (LBO) structures, while others have low leverage. Some acquirers have financial strength ratings from A.M. Best and other major credit ratings commonly used by traditional insurers, while other acquires are unrated. In addition, buyers can either operate across multiple geographic markets or focus on one market. Some buyers primarily target smaller transactions – also driven by their limited access to capital – while others increasingly look for larger transactions.

The source of value creation can also differ across buyers. Mature life insurance closed-book consolidators generate cost efficiencies and scale benefits driven by their experience and operational and IT infrastructure created by the consolidation platforms. Some buyers are more focused on generating incremental value from the balance sheet by improving risk and capital management and revising their asset allocation. Among these buyers, private companies with permanent capital aim to create long-term businesses with differentiated investment strategies. Finally, in each of the categories, there are buyers who rely on significant leverage and financial engineering to boost their returns.

Some examples illustrate the diversity of buyers' business models. In the type (2) category, international portfolio consolidators, for example, Resolution, are built to be large and are focused on acquiring entities or portfolios; they have a worldwide scope and seek economies of scale and diversification. Larger players do not consider portfolios less than €1 billion. In contrast, local portfolio accumulators, for example, Monument Re, target smaller portfolios in selected geographical markets. Because of their limited capital, these buyers are unable to acquire large portfolios. Instead, they buy portfolios at a deep discount and seek opportunities in a pool of portfolios in the €50 to €300 million range. Many direct insurers are willing to sell these portfolios to remove their administrative burden.

In the type (1) category, there are large private equity (PE)–owned insurers focused on one geographical market, for example, Viridium in Germany or Eurovita[10] in Italy, which are controlled by the UK-based private equity firm Cinven. Type (1) entities use the common PE fund structure and sometimes aim at fast growth during a limited investment horizon. Also, there are PE-backed insurers focused on the acquisition of portfolios across Europe, like GamaLife in Italy and Portugal and MEDVIDA in Spain.

Creating value by matching the investor's skills and the insurer's needs

The active life insurance legacy portfolio transfer market demonstrates that value can be created by matching the skills of buyers and divestment needs of sellers. Though business models vary significantly across the buyers, the value is created by diversification benefits of the consolidation of legacy portfolios on a single platform, the platform's ability to create operational efficiency, improve risk and capital management, and implement a revised asset allocation with a focus on alternative investment strategies. For insurers divesting in their legacy books, an additional value is created by improving the organizational and management focus on in-force and new businesses. The active divestment market creates additional demand for reinsurance of the biometric risks of the legacy portfolios. Indeed, for some acquirers with a business strategy specializing in operational efficiencies, risk and capital management, and asset allocation, the transfer of biometric risks to a reinsurer can improve legacy book performance.

Funded reinsurance

In this section, we provide an overview of the funded reinsurance structure, compare it with the common QS and excess-of-loss reinsurance in non-life insurance, and discuss the relevant regulatory considerations.

Overview of the funded reinsurance transaction

Funded reinsurance treaty

Funded reinsurance is an alternative to entity sale or portfolio transfer that allows the insurer to remain as the counterpart for policyholders and the ultimate obligor while still transferring the economic risk of life insurance liabilities. The reinsurance treaty is defined on a book of policies. Under the reinsurance treaty, the reinsurer receives an upfront premium approximately equivalent to the reserves backing the policies. In return, the reinsurer assumes all the risks and rewards of a portfolio of life insurance contracts. For the insurer ceding the risks to a reinsurer, funded reinsurance transactions can result in a complete and full transfer of all biometric, policyholder lapse, and financial risks related to reserves and profit participation commitments.

The funded reinsurance contract is set up on an original basis; that is, the reinsurer assumes the obligations and rewards of the original policy. Specifically, the reinsurer is liable for its QS of all benefit payments to policyholders, including surrender, death, disability, annuity, or maturity benefits. In exchange for assuming the policyholder liabilities, the reinsurer is paid a premium equivalent to the assets corresponding to these liabilities. The assets are invested by the reinsurer, and the associated investment risks are borne by the reinsurer.

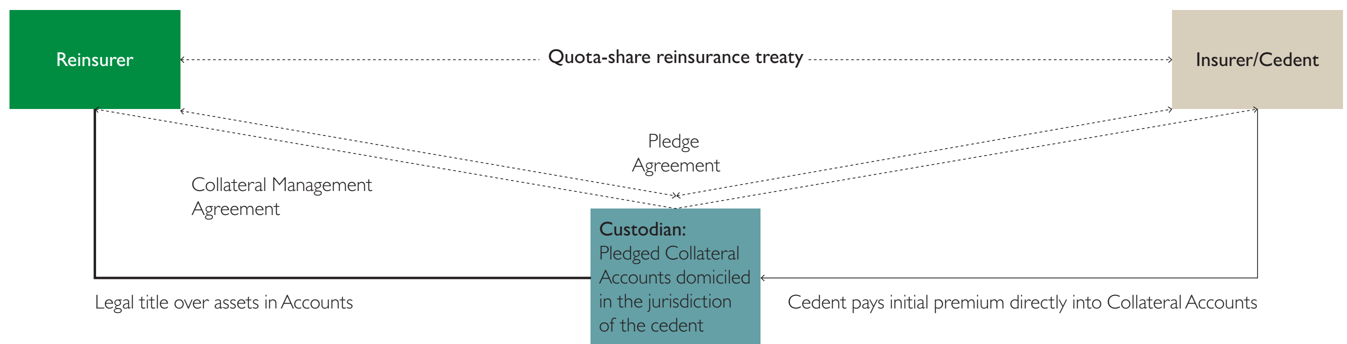
A funded reinsurance treaty may also include a provision that the reinsurer pays the insurer's profit commissions and expense allowances over time or that the reinsurer may agree to leave all cost loadings from premiums with the cedent. Although periodic payments would increase the upfront reinsurance premium paid by the insurer, this provision may be valuable to some insurers because of capital management, accounting, and liquidity considerations.

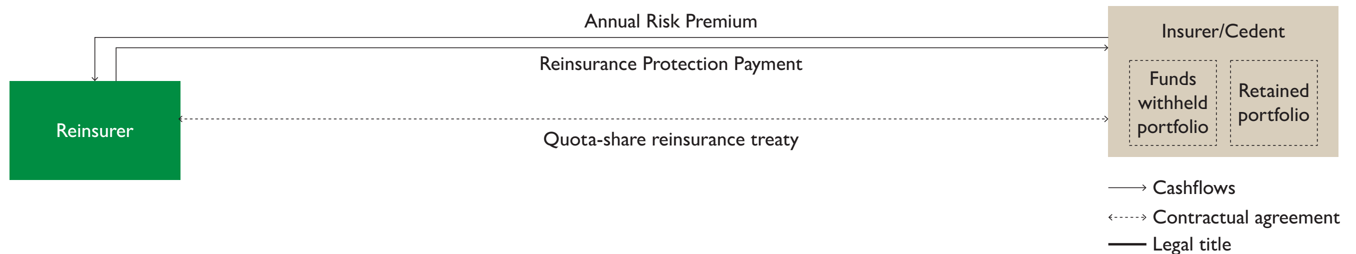
Funded reinsurance is analogous to QS reinsurance, which is common in the non-life insurance market. Under QS reinsurance, the insurer cedes a fixed percentage of the risks of a portfolio of policies in exchange for a reinsurance premium. In exchange, the insurer's liability (i.e., the insurer's premiums and losses) is reduced by the QS percentage ceded. Hence, QS reinsurance improves the insurer's solvency by reducing the variability of the insurer's liabilities. At the same time, the insurer remains the counterpart for policyholders.

Reinsurance has the dual nature of being a means of risk management and being a financing tool. Namely, insurance regulators and rating agencies recognize reinsurance as an (imperfect) substitute for capital. Thus, the reinsurance purchase reduces the regulatory minimal capital requirement under Solvency II and other major regulatory regimes while improving the insurer's financial strength rating.[11]

Figure 6: The overview of the funded reinsurance transaction

Source: Author's representation





Keeping the analogy of non-life reinsurance in mind, funded reinsurance has distinctive features. Because funded reinsurance allows the insurer/cedent to transfer all the biometric, policyholder lapse, and financial risks of the portfolio, it requires a significant insurance premium to be paid by the insurer. To pay the premium, the insurer can either sell some assets for cash or transfer the assets in kind to the reinsurer; as another option, the premium can be withheld on the balance sheet of the insurer. As a result, the risk and rewards of the portfolio of assets corresponding to the reinsurance premium are abandoned by the insurer and assumed by the reinsurer.

Funds-transferred and funds-withheld structures

In a funded reinsurance deal, the reinsurer can be paid a reinsurance premium on a funds-transferred basis or a funds-withheld basis. On a funds-transferred basis, the reinsurer is paid a reinsurance premium through the transfer of cash or assets paid in kind. This premium is then invested by the reinsurer who has legal titles on such investments. The assets are deposited into a custody account in the jurisdiction of the cedent and pledged back to the cedent. On a funds-withheld basis, the reinsurance premium, which is made of selected assets belonging to the cedent, is withheld by the cedent on its balance sheet. Thus, legal titles to the assets remain with the cedent, while the economic risks related to the assets are with the reinsurer. The reinsurer is allowed to change the asset allocation for these assets according to contractually agreed upon investment guidelines. The structure of these reinsurance transactions is summarized in Figure 6.

On a funds-transferred basis, a funded reinsurance transaction consists of the reinsurance agreement, the collateral management agreement, and the pledged account documentation. The reinsurance agreement specifies the products and policies within the scope of the agreement, as well as the risks and cashflows transferred by the agreement. In addition, it defines the collateral requirements and exceptional termination

conditions and amounts. The collateral management agreement defines the roles of the custodian, cedent, and reinsurer. It also details the investment guidelines for collateral assets. The pledge agreement on collateral assets is created over a set of collateral accounts that are in the favor of the insurer/cedent.

The pledged account is domiciled in the jurisdiction of the cedent, and the collateral management agreement and pledged account documentation are both under the law of the jurisdiction of the cedent. Like well-established ISDA/CSA requirements, the arrangement outlines the collateral's investment guidelines. In the scenario of default of the reinsurer, if the reinsurer does not pay the termination amount, the assets will be transferred to the insurer/cedent. The pledged collateral secures the claim of the insurer/cedent against the reinsurer in the actual amount of the ceded reserves ("reinsurance claim") and the related recovery claim of the reinsurer upon the occurrence of a recapture event. In a scenario where the secured obligations become due and payable and a recapture event in relation to the reinsurer has occurred, the insurer/cedent will be entitled to enforce its rights under the pledge agreement.

On a funds-withheld basis, the reinsurer also enters into a QS agreement with the cedent, covering a portion of the liabilities in scope. However, the premium is not paid but rather withheld by the insurer/cedent, consisting of selected assets. The segregated portfolio of assets and liabilities is synthetically split into the funds-withheld portfolio and a retained portfolio, corresponding to the reinsured QS and retained QS of the risks, respectively. The reinsurer is not the legal owner of assets in the treaty on a funds-withheld basis but is solely protecting the cedent for underperformance, that is, the difference between the value of the funds-withheld portfolio and reinsured liabilities. The assets are invested as directed by the reinsurer in line with the agreed investment guidelines.

Stakeholders' perspectives on funds transferred and funds withheld

Funds-withheld and funds-transferred reinsurance transactions have similar economic rationales and the same benefits and risks from the policyholders' perspective. Both reinsurance contracts define the obligation of the reinsurer toward the cedents to pay the QS of all claims and benefits on the relevant policies. In terms of counterparty exposure, the two contracts can be structured equivalently. Although under the funds-withheld structure the cedent holds the legal title to assets, in the funds-transferred structure, collateral is pledged to the cedent.

However, the two structures have some important differences when viewed from the insurer's and reinsurer's perspectives. On a funds-transferred basis, the insurer has a counterparty default risk toward the reinsurer, which is mitigated by the custodial account. The reinsurer has a legal title on the assets. Because the reinsurer is managing its own assets, this provides more flexibility and independence within the scope of the investment guidelines.

For the reinsurer, the funds-withheld structure is operationally more burdensome. Because the cedent retains the legal title of the assets, it may require a separate third-party investment management agreement to ensure sufficient influence of the reinsurer over the withheld assets for which the reinsurer ultimately assumes all risks. In addition, because assets reside on the balance sheet of the insurer, the reinsurer has to apply the valuation approach of the insurer to the funds-withheld portfolio.

In a funds-withheld reinsurance, if the insurer goes into insolvency, the reinsurer remains liable for its QS of the liabilities. Because the reinsurance premium was not paid but withheld, the reinsurer becomes a regular creditor for the assets withheld, that is, any excess and residual assets in the funds-withheld account once all claims to policyholders have been settled.

The governance of investment policy is also different between the two reinsurance structures. With funds transferred, the reinsurer is fully responsible for making changes to the investments by adhering to the investment guidelines that form part of the reinsurance treaty. If the reinsurer is subject to Solvency II regulation and has a high credit quality, the insurer's involvement is limited to monitoring compliance with investment guidelines and collateral management agreements.

In a funds-withheld structure, changes in the investment of the assets are driven by the insurer. Although the reinsurance treaty predefines the investment guidelines, the insurer's governance structure will necessarily have to retain the right to contradict obligations under the reinsurance treaty driven by other and broader considerations, hence retaining the right to breach the treaty. In addition, the governance is more complex because the insurer needs to ensure that the valuation policy is the same for the reinsurer's and insurer's assets. Furthermore, the insurer's asset strategy, concentration limits and assumptions, and other elements of the investment policy also apply to the reinsurer. Effectively, the reinsurer needs to coordinate its own investment strategy with the insurer's investment strategy, which may create governance complexity.

Operationally, the difference is that, on day one, the funds-transferred assets need to be legally moved to the reinsurer, yet on a funds-withheld basis, no such transfer occurs. Instead, a funds-withheld reinsurance structure is a notional "carve out," that is, segregation, of the assets. On an ongoing basis, the reconciliation of claims and liabilities will be identical, but the reconciliation of assets (either done by the custodian or by the insurer) is different.

Local country GAAP accounting and regulations are diverse across EU jurisdictions. Hence, the implications of funded reinsurance vary from a local accounting perspective. However, funds-transferred reinsurance generally decreases the size of the local country GAAP balance sheet of the insurer, while on a funds-withheld basis, the local country GAAP balance sheet of the insurer increases. The reason for the latter is that the legal ownership of the assets is not transferred to the reinsurer. Therefore, although the original values of assets and liabilities remain on the insurer's balance sheet, funded reinsurance results in two new items. On the asset side, a new asset is "reinsurance recoverables" equal to the reinsured liabilities. On the liability side, a new item is "reinsurance premium payable," which corresponds to the assets for which the reinsurer is responsible. The exact treatment and accounting representation of these items may differ between jurisdictions.

It may seem that funds withheld reinsurance structure is preferred to a funds-transferred structure from a regulatory perspective because the assets do not leave the insurer's legal ownership. A perceived reason for this is that a funds-withheld structure eliminates the risk that the regulator has no control in the case of distress if the assets are transferred to another jurisdiction. However, the same recourse can be constructed for funds-withheld and funds-transferred structures. For a funds-transferred structure, since assets remain in a custodial account in the local jurisdiction, it is the terms of the collateral management agreement that would be crucial for the management of counterparty risk. Further, as the value is often created by implementing an alternative investment strategy, the funds-withheld structure imposes additional constraints and costs on reinsurer investment policy. This can reduce returns and the joint economic benefits of the funded reinsurance for the insurer and reinsurer while diminishing the profits passed on to policyholders through profit sharing.

Funded reinsurance allows insurers to divest or manage the risks of the existing capital-intensive, in-force portfolios, as well as for new business initiatives where the insurer/cedent would like to continue selling life insurance products to customers but would like capital and risk-bearing support. The former is similar to LPT treaties in the European non-life market, while the latter is comparable to standard quota share arrangements. In either structure, the risks and rewards of the reserves and claims under the original contracts and assets backing the reserves could be transferred to the reinsurer in a collateralized arrangement to ensure the reserves are appropriately covered.

Funded reinsurance compared with other divestment strategies

All divestment strategies, that is, company sale, portfolio sale, or funded reinsurance, enable insurers to reduce their exposure to legacy portfolios and help to refocus their business. Ultimately, the best divestment strategy depends on the business circumstances of the seller and type of expertise that can be offered by potential acquirers. There are several features that distinguish funded reinsurance from other options to divest.

In contrast to other divestment strategies, that is, portfolio transfer and entity sales, the insurer remains the counterpart to policyholders and the ultimate obligor when it uses funded reinsurance to divest. In particular, the insurer/cedent transfers to reinsurers the underwriting risks (longevity, mortality, and disability), minimum guarantee combined with lapse and behavioral risks, market risks (e.g., interest rates or equity risks), asset credit risk, and liquidity risk. At the same time, no administrative processes related to the portfolio of policies are anticipated to be transferred as part of the transaction. Hence, the insurer retains the legal risks, expenses risks, and operational risks. Furthermore, since the transfer of assets and liabilities occurs on the original basis, the insurer and reinsurer must ensure that there is no detrimental impact on policyholder rights and benefits. Finally, as with any other reinsurance transaction, funded reinsurance changes the counterparty risks of the insurer, which are mitigated by the collateral agreement.

Funded reinsurance allows the primary insurer to maintain a relationship with policyholders, as the insurer remains the ultimate counterparty to policyholders. This feature is particularly relevant for composite insurers and bancassurers, where the customer relationship is much broader in terms of products than only the legacy savings policy. In this case, funded reinsurance prevents sending a letter to a core customer with a life, term life, non-life, and banking product explaining that the customer's life product has been sold to a third party, which can be undesirable. Often, there will also be customer solicitation clauses that may or may not implicate future upselling. Funded reinsurance preserves the distribution relationship of the insurer. Core and multiproduct distributors might be collecting commissions on the transferred portfolio, so there is then also a similar impact on distribution partners, who now see the relationships trans-

ferred to third parties. In contrast, under portfolio transfer and company sale, the relationship with policyholders is transferred to the buyer, which may create reputation risk for the insurer.

The security and reliability of benefit payments to policyholders, that is, “no policyholder should be worse off,” is the guiding principle of the regulatory approval process. These are also essential factors for mitigating the reputation risk for highly rated insurers considering divesting their legacy portfolios. To distinguish between divestment strategies from this perspective, one needs to evaluate the acquires’ financial strength and resilience, that is, the ability to pay policyholders’ claims over the term of their contract, leverage/exposure to market shocks, and the long-term business strategy. A divestment deal satisfies these criteria only for those acquirers who have a solid level of credit quality. Here, the collateralization of the exposure to the reinsurer that is part of the funded reinsurance treaty provides an additional layer of protection to policyholders and regulators.

The execution of the divestment strategy using portfolio transfer or company sale generally can be more complex, lengthy, and operationally risky compared with funded reinsurance. Under portfolio transfer, the operational migration from the seller to the acquirer can range from transferring the existing administration system to full migration to a new acquirer’s policyholder system. In the latter case, the migration process can take several years. The transfer of the relationship with policyholders and the IT infrastructure of managing payments and claims brings operational risks, with several cases being discussed in the media, where the customers have not received their pension from a new provider.[12] However, in some instances, divesting legacy operating systems, administration platforms, decommissioning legacy systems with resulting operational simplification, and cost savings are the very motivation of the seller. Hence, share and asset deals might be the only appropriate solution to achieve this objective, and funded reinsurance is not a viable option.

The deal approval and execution process also varies between divestment strategies. In the case of an entity sale or portfolio transfer, signing the sales agreement only represents the intention to go to the regulatory authorities. The parties need to engage with the regulators for approvals that may extend to 12–18 months before the deal is closed. In the case of portfolio transfer, there is also a period of operational transition from the seller to buyer. In the case of funded reinsurance, generally, the transaction does not require approval or non-objection, and the engagement with the regulator occurs prior to signing and closing, which can be done simultaneously, hence simplifying the execution.

In sum, in many situations, funded reinsurance can represent a credible and more robust strategy compared with entity and portfolio sale if the aggregate security package and risk mitigation measures, including counterparty credit profile and collateral arrangements, are comparable to those of the cedent and are consistent with cedent’s overall strategy. The main reasons for this are the ability of the insurer to maintain the customer relationship and mitigate the reputation risks, the collateralization of the insurer’s claim on the reinsurer, and a lower operational burden in terms of deal execution and business transition. Also, the regulatory authorities might prefer having the insurer retain ultimate liability to policyholders to maintain comparable policyholder protection.

As with any reinsurance, funded reinsurance implies that the insurer faces counterparty risk that the reinsurer becomes insolvent. The provisions on the credit quality of the reinsurer, e.g., compliance with regulatory capital requirements and a credit rating, and collateral arrangements can be used to manage counterparty risk. Notably, for other divestment strategies, the entity sale, and the portfolio transfer, the insolvency of the buyer of the legacy book may still impose reputation damage on the insurer and its regulator, even though the insurer does not have a direct counterparty exposure to the buyer.

Reinsurance in the context of the European life insurance market

Reinsurance is a valuable and recognized risk management tool in the European insurance market. In the European Economic Area (EEA) in 2021, reinsurance gross premiums written comprised 15% of the total gross premiums written in the insurance and reinsurance sector, coming in at €204 billion, where non-life reinsurance represented €146 billion and life reinsurance accounts for €58 billion.[13] Although the non-life reinsurance accepted amounts to 32% of the non-life direct business, the life reinsurance obligations amount to only 9% of the life direct business. Most non-life insurers have extensive reinsurance programs that combine intragroup and external QS reinsurance, excess loss and catastrophe reinsurance, as well as, in some cases, LPT treaties, which are used to divest legacy portfolios. Intragroup reinsurance is also often used to manage Solvency II capital intensity and monetize diversification benefits.

As for the European life insurance market, reinsurance is primarily known as a risk management and transfer tool for biometric risks such as mortality and disability in France, Germany, Italy, and Spain and longevity in the UK. The Dutch market is now also developing, being driven by the continued development of the longevity market in the UK and interest in longevity risk from US (re)insurers.[14]

In Germany, Belgium, and Italy, there are examples of funds-withheld transactions that transfer all risks, except for the investment risk and risks related to assets backing the reserves. Reinsurance transactions have also been used as a financing tool for large upfront commissions to distributors on recurring premium businesses.

Capital management under Solvency II or the management of various local GAAP challenges, such as Zinzuzatzsreserve (ZZR) requirements in Germany, is another application of reinsurance.[15] However, the reserves and risks on investment assets that are backing reserves have typically not been transferred. In addition, reinsurance has been used to raise financing/liquidity against value of in-force (VIF) on profitable unit-linked (UL) or mortality risk portfolios, for example, life insurance policies linked to mortgages in France, Portugal, and Spain.[16] Also, there have been several large VIF monetization transactions on mortality/term life portfolios tied to mortgages in Portugal and Spain in 2010–2014, which have been used by banks to obtain capital/dividends from insurance subsidiaries. Some reinsurance transactions have been used for managing and mitigating Contract Boundaries under Solvency II. Currently, there has been demand and activity in the "mass lapse" risk transfer market, where reinsurers are taking on mass lapse tails that are capital intensive under Solvency II. The Netherlands has examples of significant longevity swaps on portfolios >€10 billion. Also, there are examples of smaller longevity reinsurance transactions, with some transfer of investment assets backing reserves.

Below, we provide some further jurisdiction-specific examples of funded reinsurance transactions.

Germany. Insurers have executed intragroup-funded reinsurance transactions of around €1–2 billion that transfer all biometric, behavioral, and investment-related risks; some of these transactions have been done on a funds-transferred basis.

Ireland. Since the early 2000s, QS reinsurance transactions have been used in pension scheme buyouts and individual annuities. These are reinsured by multiple counterparties on a funds-transferred basis to reinsurers domiciled in Ireland and Bermuda.

Belgium. Several QS reinsurance transactions of >€1bn on a funds-withheld and funds-transferred basis have taken place on classical life portfolios with reinsurance counterparties in Ireland and Bermuda.[17]

Spain. Some intragroup QS reinsurance transactions of >€1bn on a funds-withheld basis have taken place with reinsurance counterparties domiciled in the European Union.

Switzerland. One publicly announced CHF4bn QS reinsurance transaction on a funds-withheld basis has taken place with a reinsurance counterparty domiciled in Bermuda.[18]

Regulatory considerations for funded reinsurance

Under Solvency II, reinsurance has been recognized as one of the key tools used by the insurance industry for risk transfer and diversification. Consequently, the use of funded reinsurance is expected to impact the Standard Formula Solvency Capital Requirement (SF SCR). Recently, the growing number of funded reinsurance transactions initiated a dialogue between the insurance supervisors at the domestic and European level and the insurance industry regarding the impact of funded reinsurance on stakeholders, including insurers, policyholders, and reinsurers.[19]

In the context of this dialogue, the following concerns have been raised by the regulators:

- Are policyholders treated fairly, or are they negatively impacted in any manner? The main issue here is to ensure that the policyholders are not disadvantaged and that their expectations are maintained. Relatedly, it is important that the responsibility for policyholders' portfolios is transferred to a reinsurer with a high credit quality and a robust and resilient risk management framework.
- Does the cedent and reinsurer have the operational processes in place to manage the transaction? The key concern here is to ensure that the policyholders are paid the benefits, even in case the liquidity is not transferred from the reinsurer to the cedent.
- Does the cedent sufficiently understand and have the ability to monitor transactions? The concern is a default of the reinsurer and, therefore, the enforcement of collateral and recapture. In this case, the cedent needs to understand and be able to manage the collateral as its own assets so that the reinsurer's default does not prevent it from operating as usual.

The main themes of the discussion are the impact of the funded reinsurance transaction on the SF SCR of the divesting insurer, the security of collateral arrangements, the flexibility of investment guidelines, the impact on the policyholders of the in-scope and out-of-scope portfolios (i.e., those who are services by the insurer but are not covered by the reinsurance agreement), and the adequacy of the system of governance of the insurer to monitor and control the effectiveness of the reinsurance contract, both in an ongoing basis and under the scenario of reinsurer default. It is important to emphasize that these aspects are relevant for all divestment strategies, including

share and asset deals. Here, we briefly summarize the main considerations of these themes.

Impact on capital requirement and diversification

In 2021, EIOPA issued an opinion on the use of risk mitigation techniques by insurance undertaking.[20] Its objective was to raise awareness and ensure a convergent supervision of risk mitigation techniques in the solvency capital requirement calculation. The EIOPA's opinion paper discusses that the transfer of risk might create basis risk and introduce counterparty default risk and concentration risk. Thus, the guiding principle in the assessment of the impact of reinsurance on SCR should be the congruence between the net risk transferred and SCR relief. The EIOPA's opinion paper emphasizes that the elements of the standard formula and scenarios are a means to an end, and the supervisors and insurers should take a holistic approach to analyze and measure the risk transferred by the reinsurance. Also, the EIOPA recommendation is against highly structured transactions designed solely with the aim of releasing regulatory capital or reducing capital charges while having limited economic risk transfer.

As in a non-life reinsurance transaction, by transferring the risks to the reinsurer, funded reinsurance reduces underwriting and market-related risks for the cedent and, consequently, its SCR. However, as the cedent remains the ultimate obligor and owner of the customer relationship, the cedent also assumes some counterparty exposure to the reinsurer. In case of the reinsurer's default, the insurer becomes exposed to the obligations that were previously reinsured. Under this scenario, the reinsurance contract will no longer be recognized for the purpose of SCR calculation.

The security of collateral arrangements

Collateral has a significant effect on the recognition of the risk mitigation impact of the funded reinsurance transaction. According to Art. 1.26 of Solvency II, there are two possible structures of the collateral: transfer of full ownership of the collateral to the collateral taker and providing collateral by the way of security or in favor of the collateral taker, but the legal ownership remains with the collateral provider or a custodian. The possibility of using collateral depends on whether it satisfies the recognition requirement of Art. 124 of Solvency II. In particular, the insurer needs to have the right to liquidate or retain the collateral in the event of default, the collateral needs to have sufficient credit, liquidity, and stability of assets, which are not issued by the counterparty, and the value of the collateral should not be positively correlated with the credit quality of the counterparty.

Flexibility of investment guidelines

A strong ALM focus and strategic asset allocation are the key ingredients to enable the reinsurer to generate superior risk-adjusted returns. This can only be achieved if the reinsurer has the flexibility to adjust the asset allocation, here in accordance with the investment principles derived from the risk appetite of the insurer. One relevant consideration is that the flexibility of the reinsurer's investment guidelines needs to be aligned with those of the ceding insurer. Otherwise, if the reinsurer has materially less flexibility than the cedent operates with, this may jeopardize the reinsurer's ability to create more value than the ceding insurer.

The impact on the policyholders of the in-scope and out-of-scope portfolios

Reinsurance is another means of raising capital in the insurance industry but in a more specific and targeted manner. If the outcome of the reinsurance transaction is that the cedent is better capitalized, it could improve not only the position of the in-scope policyholders, but also that of the out-of-scope policyholders. Indeed, funded reinsurance may allow to obtain better value and profitability by improving insurer's solvency while freeing up capital to support other new business initiatives. However, in a scenario where the reinsurer is distressed, the solvency position of the insurer can deteriorate, which may also impact out-of-scope policyholders. This is particularly relevant in the context of funded reinsurance, where the insurer can have a large exposure to the reinsurer. The issues can be amplified if the reinsurer heavily relies on leverage. The potential negative impact on in-scope and out-of-scope policyholders needs to be minimized by ensuring the high credit quality of the reinsurer and robust collateral arrangements. In addition, it requires regulatory monitoring of the use of leverage by the reinsurer.

Adequacy of the system of governance of the insurer

The insurer needs to be able to monitor and control the effectiveness of the reinsurance contract, both on an ongoing basis and under the scenario of the reinsurer's default. For funds-transferred structures, this includes the reinsurer's compliance with the requirements of the collateral agreement and ensuring that collateral assets and valuations are consistent with the agreement. In addition, the investment guidelines are to be met by the reinsurer. For funds-transferred structures, the monitoring and governance process is even more involved since the assets remain on the insurer's balance sheet. Thus, the insurer needs to make certain that the reinsurance abides by the risk limits and investment strategies and that the valuation policy is applied consistently across all assets, including the curved-out funds-withheld portfolio.

Policy implications and conclusion

The structural changes in the European life insurance market clearly indicate the demand for divestment solutions. The growing market of life insurance legacy books shows that private market investors are ready to match the needs of the European life insurance industry to redesign their business strategies. The expertise in new capital, operational efficiencies, and alternative investment strategies that private investors bring to the life insurance market can increase the efficiency of the market, which ultimately would benefit policyholders. Divestment strategies, as discussed in the paper – that is, portfolio transfers, entity sale, and funded reinsurance – provide the mechanisms to create a secondary market for life insurance liabilities that are generally viewed as sticky and nontradable. Hence, they can improve capital allocation efficiency in the industry.

However, to ensure policyholder protection, legacy book divestment strategies need to be assessed from the perspective of the financial strength and resilience of the acquires, that is, their ability to pay policyholder claims for extended periods of time, leverage/exposure to market shocks, and their long-term business strategy. The current market seems to be composed of a variety of acquirers employing diverse strategies to generate value from legacy books, which may fair differently across these criteria. Although some acquires bring long-term capital to the life insurance industry, others are opportunistic, that is, have shorter-term holding horizons, and rely heavily on leverage to generate returns. Further empirical research can be useful in classifying and evaluating the strategies used by the acquires of legacy books.

In this paper, we have presented funded reinsurance as an emerging strategy for the divestment of legacy books, which has several attractive features compared with portfolio transfers and entity sales. This strategy maintains the primary insurer as a counterparty to policyholders while transferring the biometric, lapse, and financial risks of the legacy portfolio to the reinsurer. In addition, it is operationally simpler compared with the migration of a portfolio to a new buyer. Further, collateralization provides additional security to the insurer. Hence, in some circumstances, it can be a more suitable solution compared with portfolio transfers and entity sales. Realizing these potential benefits, however, requires several ingredients, including a robust framework for the composition and management of the collateral and solid creditworthiness and expertise of the reinsurer.

In the rapidly evolving market of life insurance legacy books, the following considerations are relevant for insurance supervisors. Supporting the development of an effective and reliable market requires ensuring policyholder protection on an ongoing basis, that is, in case of the portfolio or entity sale, and ensuring that the new buyers meet the policyholder expectations in terms of service, returns, and security (insurer's creditworthiness). Ultimately, the supervisors also face a reputation risk if the policyholders are disadvantaged because of divestment, particularly in the case of the acquirer's weak solvency.

For funded reinsurance, supervisors need to ensure that the insurer and reinsurer adhere to a consistent and robust framework for collateral management. Also, the insurer needs to have the appropriate processes in place to monitor the relevant elements of the reinsurance treaty on an ongoing basis. Collateral management frameworks in derivatives markets that were significantly revised following the GFC is a good basis to guide the design of the collateral arrangements for funded reinsurance. Though the size of the divestment market is small relative to the life insurance market, monitoring the concentration risk and interconnectedness in the market is relevant for financial stability.

Endnotes

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4 From 2011 till 2020, the EIOPA Financial Stability Reports have referenced low interest rates as a major risk impacting the profitability of the European life insurance sector. See EIOPA Financial reports, years 2011–2020.
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8 The author is grateful to Carolin Schmitt, who contributed to data collection as part of her master's thesis assignment at the University of St Gallen in 2022.
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12 See, e.g., Versicherungsmonitor, 13/01/2023, The run-off remains a reputational risk
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17 E.g., 2020-SFCR-Report.pdf (monumentregroup.com)
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19 See Q&A on recognition of risk mitigation techniques using reinsurance contracts in the Solvency II Standard Formula (dnb.nl); Opinion on the use of risk mitigation techniques by insurance undertakings | Eiopa (europa.eu); NOTA DGSFP – OPERACIONES TRANSFERENCIAS RIESGOS.pdf (mineco.es)
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