In-Force Fixed Annuity Block Reinsurance

A Strategy to Improve Return on Capital

Many insurers are experiencing low or negative returns on in-force fixed annuity blocks of business. In most cases this is driven by the current very low interest rate environment. Low rates reduce portfolio yields and lengthen liability duration driving low returns.

Reinsuring these blocks with an off-shore reinsurer is often a very effective capital management strategy. In these transactions, the insurer can utilize the structural advantages of a reinsurer in order to free up capital and redeploy it to higher returning businesses.

Let's examine the case for such a transaction.

The Problem

Low portfolio yields

Given the current very low interest rate environment, many carriers have in-force fixed annuity blocks with low and decreasing portfolio yields matched with relatively high minimum crediting rates. This drives low or negative returns on regulatory and rating agency capital.

Duration lengthening

These fixed annuity blocks are typically crediting a guaranteed minimum rate which is above the currently available market crediting rates. Accordingly, lapse rates on these policies are at very low levels, thereby lengthening the liability duration beyond the duration of the asset portfolio backing the liability. This mismatch between portfolio duration and liability duration has the effect of further reducing the portfolio yield as maturing assets are reinvested in significantly lower yielding assets.

Rising rates not a panacea

While rising interest rates can improve the portfolio yield backing these liabilities over time, it also may drive higher lapse rates as the crediting rates available in the market exceeds the in-force block's current and guaranteed minimum crediting rate. This can result in unrealized losses as assets are sold to provide liquidity. Additionally, if the investment portfolio duration is shortened in anticipation of higher lapses, there may be no improvement or a reduction in portfolio yield. Finally, if crediting rates are increased in step with the crediting rates available in the market, low returns will persist.

Other considerations

In addition to addressing low returns, reinsurance is an effective tool in accomplishing other objectives:

- Exiting non-core businesses.
- Re-balancing overall product mix.
- Avoiding higher capital requirements under Solvency II, Systematically Important Financial Institution ("SIFI"), and other regulatory considerations.

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The Solution - Reinsurance

Offshore reinsurers possess several significant structural advantages over primary insurers. These advantages can often drive a mutually beneficial reinsurance transaction. In fact, over the past five years, there have been over $120 billion in such transactions completed. Let's look at these structural advantages.

Better income tax profile

Offshore reinsurers generally do not pay US income taxes while US insurers generally have an effective tax rate above 25%.

Lower capital requirements

In today's post 2008 environment, insurers typically hold capital at levels above 400% RBC. This is driven by competitive, regulatory, and rating agency considerations. Offshore reinsurers do not benchmark against operating US insurance companies and do not face the same competitive capital requirements associated with writing business as a primary insurer. Offshore reinsurers typically hold capital which approximates 300% to 350% on an RBC equivalent basis. Capital at this level is prudent in a reinsurance transaction given the many other structural protections typically provided for in such transactions.

Investment flexibility

Offshore reinsurers typically leverage robust and experienced investment teams. Often these teams bring expertise in structured securities and other higher yielding fixed income asset classes. Offshore reinsurers typically operate in regulatory environments which afford greater flexibility for investment allocations. Accordingly, offshore reinsurers are often well positioned to invest in asset classes which better optimize risk adjusted returns.

Access to capital

Offshore reinsurers are typically non-public entities focused on long term returns and have demonstrated they can raise capital effectively from sophisticated investors.

Laser like focus on managing spread risk

US operating insurance companies have many competing stakeholders which include shareholders, regulators, rating agencies, employees, agents, etc. Conversely, offshore reinsurers operate lean organizations with few stakeholders and have a core focus on managing spread risk.

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The Transaction Structure and Considerations

Over the past several years the robust reinsurance market has driven a template for deal structure and terms for these reinsurance transactions which favorably address the factors important to insurers. Let's briefly examine the key terms in a typical fixed annuity reinsurance transaction.

Form of reinsurance

These reinsurance transactions are typically completed in the form of modified coinsurance, coinsurance with funds withheld, or coinsurance with assets in a trust. Each of these structures secures reserve credit for the ceding insurer. In the modified coinsurance and coinsurance funds withheld transaction structures, the assets remain on the cedant's balance sheet. In the coinsurance funds withheld structure, the assets are placed in a trust for the benefit of the cedant. These structures are very effective in essentially collateralizing the investment portfolio for the benefit of the cedant. This is an important consideration in these indemnity reinsurance structures where the cedant remains liable for the underlying insurance policy terms and obligations.

Overcollateralization

Typically reinsurers will overcollateralize the investment portfolio held against reserves. Specifically, the reinsurer will hold an amount in excess of the reserve amount for the benefit of the cedant. While the level varies by transaction, the amount is typically between three to seven percent of the ceded reserves.

Investment guidelines

Investment assets are managed by the reinsurer pursuant to an investment policy negotiated by the parties and set forth in the reinsurance agreement. These guidelines reflect constraints and risk management provisions generally consistent with those typically followed by insurers.

Impairments

The reinsurance agreement sets forth how asset impairments are defined and accounted for.

Crediting rate determination

The process to be followed for setting crediting rates for the reinsured policies is set forth in the reinsurance agreement in a manner consistent with the insurers market and regulatory responsibilities.

Reimbursement of expenses

The reinsurer reimburses the cedant insurer for all expenses associated with the reinsured policies to include administrative expenses, excise taxes, premium taxes, agent compensation and reinsurance brokerage fees.

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Hypothetical Example

An insurer has a $1 billion block of single premium fixed annuities in-force. The policies are mostly out of surrender and 80% of the block is crediting at 300 basis points ("bp"). Agent compensation and administrative expense adds another 50bp to the cost of liability, for a total cost of liability of 350bp.

The liability duration based on expected lapse rates is estimated to be 7 years. The insurer's investment portfolio consists of 60% investment grade corporate bonds with an average credit rating of A-, 20% Agency RMBS, 10% commercial mortgage loans, and 10% allocated to below investment grade and structured securities. The portfolio book yield is 390bp. The portfolio has an unrealized gain of 5%.

The net spread is 40bps, represented by the difference between the 390bp portfolio yield and the 350bp policy total cost of liability. This 40bps on the $1 billion reserve block is equal to $4 million in annual pre-tax profits. Assuming a 35% tax rate, the after tax annual profit is $2.6 million.

Depending on the capital model (RBC, S&P Capital, or BCAR), the total capital requirement for the block for an A rated and 450% RBC level insurance carrier would be between 5.0% and 7.5%, or $50M to $75M. The after-tax annual return on capital is therefore between 3.5% and 5.2%.

The insurer reinsures the block of business in a reinsurance transaction where the assets are transferred to the reinsurer at book value and there is no ceding commission beyond the $50M (unrealized) gain transferred. The transaction frees up the $50M to $75M of capital associated with the block.

If the insurer redeploys this capital into a 12% return business, both net income and return on capital would improve meaningfully.

The actual ceding commission in a transaction will depend upon, among other factors, the total cost of liability, the liability duration, the key terms of the transaction (e.g. investment policy, overcollateralization amount, etc.), and the prevailing fixed income asset yields at the time of the transaction.

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Montshire Advice and Experience

Montshire's principals have led several reinsurance transactions with an aggregate reserve value of over $10 billion.

Most recently in 2014, Montshire advised a large public life insurer in a transaction to cede an approximately $1 billion reserve block of fixed annuities. Over a several month period, Montshire worked as part of the client's deal team (CFO, finance staff, actuaries, tax professionals, investment professionals, and inside and outside counsel) to advise and assist the client with the transaction. Montshire's role included the following:

- **Provided the insurer an analysis of the expected outcome and benefits of a reinsurance transaction. The insurer considered this analysis and made the decision to move forward and engaged Montshire Advisors as its advisor and broker of record for this transaction.**
- **Assisted the insurer in considering the potential reinsurers in the marketplace and in selecting the reinsurers most aligned with the insurers needs and objectives.**
- **Assisted the insurer in developing a bid package to optimize the positioning of the block with reinsurers.**
- **Evaluated the bid proposals and made modifications with the reinsurers on an iterative process. This included negotiating on behalf of the insurer to improve the bid structurally and financially.**
- **Recommended one reinsurer with whom to move forward to complete the transaction.**
- **Advised the client in negotiating the quantitative and qualitative terms of the transaction including form of reinsurance, the overcollateralization amount, selection of assets to transfer, investment guidelines, the ceding commission amount, etc. This included advising our client in its negotiations with the reinsurer and representing our client as an intermediary in those negotiations.**

The transaction freed up approximately $65M of capital for our client to be re-deployed to higher returning businesses. Additionally, it assisted our client in achieving their stated goal with investors to improve return on capital. Finally, the transaction provides a template for the insurer to use in future reinsurance transactions.

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