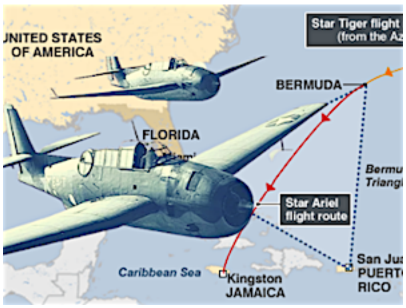
An Insider’s Take on the ‘Bermuda Triangle’ Strategy

By Kerry Pechter *Thu, Jul 1, 2021*

Willis Re, a reinsurance broker, has had an uptick in calls from life insurers hoping to execute what RIJ calls 'The Bermuda Triangle' strategy, thus removing a millstone and reaping a capital windfall. Willis Re executive Mike Kaster explains.



The Fed’s low-interest rate policy over the past decade has pinched the oxygen supply of US life/annuity companies, especially publicly held firms. Low bond yields have squeezed their profit margins and forced them out of old lines of business and into new ones.

Several companies have employed what RIJ calls the “Bermuda Triangle” strategy. The points of the triangle are, characteristically, a life/annuity company with large in-force, “blocks” of (usually) fixed annuities with guaranteed returns; a Bermuda-based or other offshore reinsurer, and a major buyout firm or money manager.

Generally, the life/annuity company will “cede” the annuity contracts to the reinsurer. The reinsurer typically pays the life/annuity company a “ceding commission” for the assets. The money manager, often affiliated with the reinsurer, then earns fees for investing the assets.

One industry participant called this a natural process of “value chain optimization” that puts money to its most efficient use: The life insurer gets fresh capital while turning a potentially money-losing business over to a specialty reinsurer who can handle the risks and an asset manager who can handle the investments at lower cost or more profitably than the insurer. “Specialization is part of the ecosystem,” he told *RIJ*.

Such deals are only sketchily described in the trade press, leaving many outsiders with questions. They wonder how much risk the asset managers might take with the annuity assets, whether policyholders will suffer when contracts change hands, and that divestitures hurt the annuity industry’s already fragile image.

The view from Willis Re

To get more insight into these triangular transactions, and to find out why they’ve become so popular, we talked to Mike Kaster, executive vice president at **Willis Re**, a reinsurance broker that's part of Willis Towers Watson. He helps life insurers find reinsurance partners and execute these types of deals.

RIJ: Hello, Mike. What role does Willis Re play in the transactions we've seen over the past 10 years in the annuity industry?

Mike Kaster

Kaster: We're a reinsurance adviser. We work with direct-writing companies—life insurers that issue life and annuity contracts, as opposed to reinsurers—and advise them on potential reinsurance solutions. We do a vast amount of work with them. They rely on us to know the markets.

RIJ: OK. Now let's get down in the weeds. When you say, 'reinsurance,' exactly what do you mean?

Kaster: When people hear 'reinsurance,' they think of *risk* reinsurance. The reinsurance of closed block transactions is more akin to a mergers and acquisition transaction. The life insurer is not buying the reinsurance to cover risk. It's selling a block of business. A large majority of these deals happen because the life/annuity company wants to improve its capital position.

Take for example a block of annuity business with a high interest rate guarantee, written in the late 2000s. Those annuities carried a 3% to 4% interest-rate guarantee. In [today's interest rate environment] that puts a strain on the issuing company. They have to back those liabilities not just with reserves but also with allocated capital.

There's a cost to that capital. But if they can sell those liabilities to another party and get full reserve credit and full capital credit, they end up with a benefit. That high-cost capital can then be applied to other things.

RIJ: So the life insurer 'cedes' a potentially expensive liability, and gets cash back at the same time. Sounds sweet.

Kaster: Depending on differences in the buyer's and seller's views of those liabilities, there could be a payment either way. If the reinsurer sees future value in them, it will pay a ceding commission, which is the equivalent of a purchase price. That commission would result in a direct improvement in the selling company's capital position.

RIJ: Why would anyone want to buy contracts that the life insurer wants to get rid of? I suppose it's to get the assets that are backing the liabilities.

Kaster: The buyer might feel that it can invest those assets a bit better than the ceding company's own investment department can. It might have access to CLOs [collateralized loan obligations] and other investment tranches that have enough strength and get a little higher yield, especially relative to the yields that a mid-sized, conservative life insurer might get. In other words, the reinsurer might be holding different assets. But the liability doesn't go away. There still has to be money backing those liabilities.

RIJ: There's another angle to this, right? The offshore angle.

Kaster: Then you bring in the whole Bermuda, Ireland, or Cayman Islands factor. The capital rules in those jurisdictions might be more favorable than the rules in the US. That's another piece of this. The original life insurer could have taken advantage of [offshore reinsurance] itself. But the offshore capital rules might not be sufficiently advantageous to justify the cost of setting something up.

Several US companies did look to set up their own offshore reinsurance vehicles several years ago. But the BEAT (Base Erosion and Anti-Abuse Tax), which was part of the Tax Cuts and Jobs Act of 2017, took away part of the tax advantage of doing that. So the frictional cost of [do-it-yourself] offshore reinsurance went up. A Bermuda-based reinsurer however can leverage that advantage over and over with different clients.

RIJ: So, if I own one of those annuities that moved offshore, who's looking after my interests?

Kaster: If for some reason the assets would fail altogether, the ceding company will still be liable to the consumer. They never relieve themselves fully of their liability. They get a credit, but they still hold the liability—the obligation to the customer—on their balance sheet. And they ultimately have to maintain their reputation with customers. That's why we say that this type of reinsurance is *like* an M&A transaction. If it were an actual M&A transaction, the ceding company would fully remove itself from liability to the customer. With reinsurance, the ceding company can't.

RIJ: What about the assets? I've heard from a forensic accountant that it's impossible to see what assets the reinsurer is using to back the liabilities.

Kaster: There's definitely some lack of transparency from the perspective of the outside world about how the reinsurer invests the assets. But when we're advising our clients, we would make sure they had transparency into the investments.

The assets must be in compliance with the pre-agreement. Here's where I and Willis Re get involved. We vet the reinsurance relationship. You have to set up pre-agreed-to [investment guidelines that are codified in the reinsurance agreement]. So that you [the ceding company] understand what the reinsurer will do.

RIJ: The forensic accountant also said that relatively weak assets—letters of credit, for instance—are sometimes used to back the contracts.

Kaster: For the reinsurance deals that we would work on, to be credible, letters of credit are not used. The parties may agree that additional capital will be put up as protection, and letters of credit or other facilities could be used to back the [primary] capital, but the liabilities are typically backed by real assets, like Treasury bonds, as opposed to letters of credit. Every adviser will have its own views and opinions on that issue. A lot of people have gotten comfortable with letters of credit. I'm not so sure I buy the model. The flexibility in the regulation is there for direct-writing companies to use them. But I'd rather see real assets held in a trust.

You can't generally or blindly let the buyer invest, for example, 30% [of the assets backing the book of business] in equities. But you must give them flexibility to get a higher yield so that they can back the liabilities. That's important. But, in all reinsurance transactions, the ceding company retains the consumer relationship. That doesn't go away. We may talk about it as 'ceding.' But life/annuity companies don't get rid of the ultimate obligation to the customer.

RIJ: Thanks, Mike.