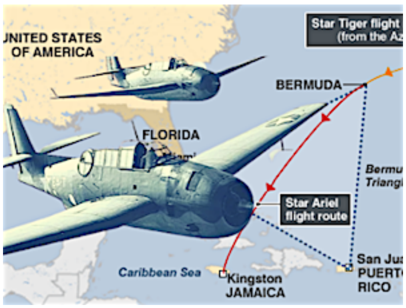
'Asset-intensive' annuity reinsurance has NAIC's attention

By Kerry Pechter *Mon, Nov 4, 2024*

At an Oct. 24 meeting, the NAIC's Life Actuarial Task Force (LATF) continued to hammer out a new guideline for 'asset adequacy testing' of offshore reinsurance reserves. Starting in 2025, it could raise the cost of 'asset-intensive business' for U.S. annuity issuers.



In the six years from 2018 through 2023, U.S. life/annuity companies ceded over $600 billion in reinsurance—essentially reducing their liabilities by a similar amount and potentially reducing their capital requirements by billions of dollars, according to AM Best.

An unknown amount of those liabilities are now covered by reinsurers in Bermuda, where U.S. regulators can't necessarily see all the assets backing them. What does that mean? Does the reinsurance make a life/annuity issuer stronger or weaker? How should insurance regulators respond?

Since last winter, the Life Actuarial Task Force (LATF) of the National Association of Insurance Commissioners (NAIC) has been working on a response. It has produced a draft for a new "guideline" that "establishes additional safeguards… to ensure that the assets supporting reserves continue to be adequate."

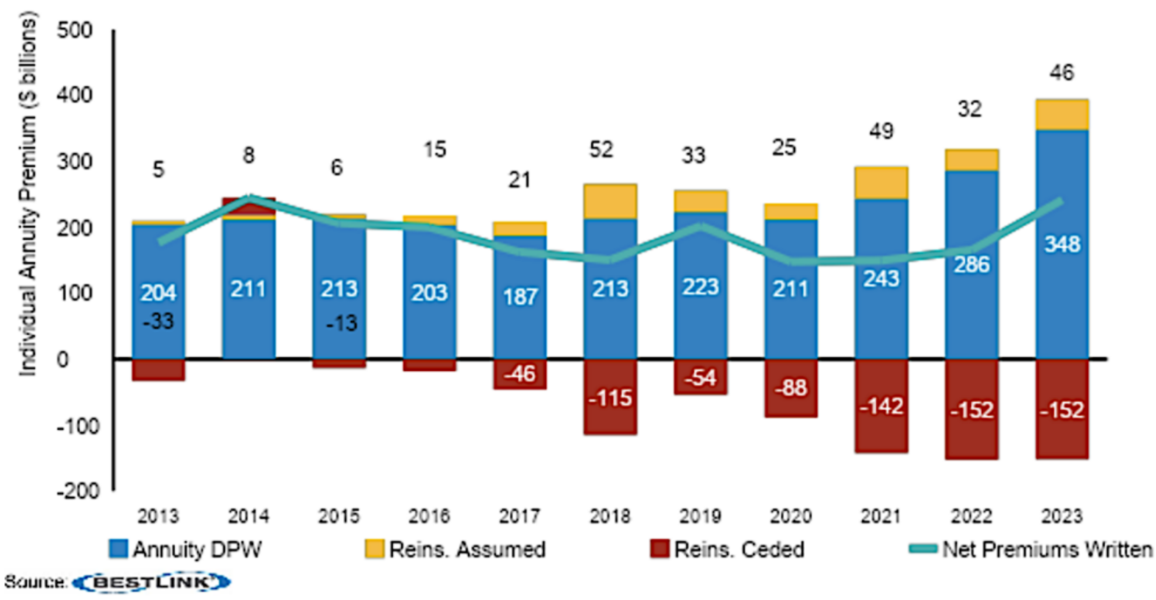
On October 24, the LATF met again to talk about the guideline, hosting a public Zoom meeting. Interest was high: 239 people were on the call. No conclusions were reached, but the task force expects to have a guideline in hand in 2025.

The LATF produced a detailed, 56-page **backgrounder** for the call, including input from the American Council of Life Insurers, the American Academy of Actuaries, and members of the public.

Many reinsurance transactions are unremarkable. Life/annuity and property/casualty insurers routinely use it to share or off-load risks to specialized reinsurers in order to re-deploy scarce capital to different ventures—or to underwrite more annuity business.

But reinsurance—in the view of economists at the **Bank for International Settlements**, the Federal Reserve, and others with financial fragility concerns —has been increasingly manipulated since 2013 to reduce the cost of writing annuity business—in ways that were once frowned upon. Large asset managers have bought life insurers, gathered revenue through the sale of fixed deferred annuities, set up their own reinsurers in Bermuda or the Cayman Islands, and moved liabilities to them, freeing up capital.

It's not clear how much of the $600 billion in reinsurance (see below) was involved in this "Bermuda Triangle" strategy, as *RIJ* has dubbed it.



Source: AM Best.

When reinsurers are offshore, however, U.S. regulators have a harder time seeing, analyzing, and evaluating the assets. When the annuities are "asset-intensive"—more like investments than insurance—ensuring the safety and performance of the underlying assets becomes more urgent for regulators.

Here's how the LATF laid out the issue in preparation for its October 24, 2024 meeting:

"State insurance regulators have identified the need to better understand the amount of reserves and type of assets supporting long duration insurance business that relies substantially on asset returns. In particular, there is risk that domestic life insurers may enter into reinsurance transactions that materially lower the amount of reserves and thereby facilitate releases of reserves that prejudice the interests of their policyholders."

The LATF has been enhancing its regulations to detect under-reserving with weak assets by offshore affiliated reinsurers. The task force is considering:

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"Enhancements to reserve adequacy requirements for life insurance companies by requiring that asset adequacy testing use a cash flow testing methodology that evaluates ceded reinsurance as an integral component of *asset-intensive business* (emphasis added; see sidebar)."

Morgan Stanley, whose equity analyst, Bob Jian Huang, covers publicly-traded life/annuity companies, issued a **research brief** on offshore reinsurance on October 23. "Regulators likely want to have better line of sight into the reinsurance agreements for offshore entities. Further ability to have comfort around these reinsurance relationships is also critical," the brief said.

According to Morgan Stanley, "The use of reinsurance to derisk and free up capital has become increasingly popular in recent years. Reserve credits taken at an industry level are up 65% over the last five years, and modified coinsurance reserves are up 76% for the same period. Specifically, credits ceded to non-US reinsurers have more than tripled since 2018, while credits taken to US-based reinsurers are up 31%, comparatively. Favorable reserve requirements, investment flexibility and tax efficiencies are among a few reasons driving this trend towards offshore reinsurance."

"Regulators hope to have a guideline by the end of 2025, and the Life Actuarial (A) Task Force, the task force which put forth this proposal, is on the preliminary agenda for the National NAIC Fall meeting, taking place on November 16-19," Morgan Stanley said.