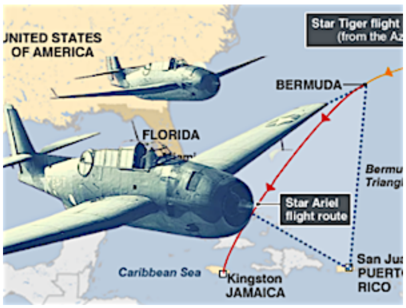
Bermuda Triangle Part IV: The Reinsurance Angle

By Kerry Pechter *Thu, Dec 10, 2020*

Publicly-held life insurers are using reinsurance to improve their balance sheets. But at what cost? 'I believe that many of these [reinsured] blocks of business are only being funded in part with real assets,' a forensic accountant told RIJ.



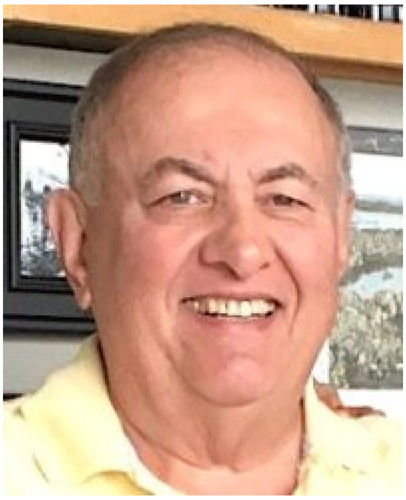
When a life insurer "cedes" a block of fixed indexed annuity (FIA) contracts to a reinsurer and the deal releases hundreds of millions of dollars in reserves that had previously supported the liabilities in that block, are the contracts blocks less safe than they were before?

And should the adviser who sold the contract or the client who bought the contract be at all concerned about the future administration or the safety of the contract?

We tossed these questions out to people who follow the life/annuity reinsurance space and they gave us three definitive answers: "No," "Maybe," and "Yes." It all depends, evidently, on the type of reinsurance deal under discussion.

In the case of a plain-vanilla transfer of risk from one life insurer to a second, unaffiliated life insurer, then the adviser and client needn't give it any thought. "Reinsurance is not an event. It's part of the process and seamless," said an Ameriprise adviser who has sold many fixed indexed annuities over the past decade.

But if a life insurer transfers a block of annuities to a captive reinsurer—that is, to itself—then there might be cause for concern. Those transactions tend to be opaque and at less than "arm's length." And if the reinsurer is domiciled in a regulatory or tax haven like Vermont, South Carolina, Bermuda or the Cayman Islands, it's another potential red flag. Those jurisdictions might be less fussy about the amount or type of assets they require as reserves.



Mike Gilotti

"The original issuers could probably still own riskier assets on their own balance sheets, but not in the same amounts as the offshore reinsurer can," Mike Gilotti, a retired insurance industry consultant, told *RIJ*. "Or, if they did, they would have to reserve more or see it reflected in their average credit ratings." The ultimate purpose for these maneuvers, he added, is to issue products that have higher crediting rates. "They're trying to remain in a competitive position. That's what's going on here."

RIJ began reporting on the "Bermuda Triangle" strategy last August. We have focused on partnerships between annuity issuers and asset management companies. The asset managers seek higher returns by investing part of the annuity assets in securitized bundles of debt.

An equally important corner of the triangle involves the use of reinsurance to move life insurance and annuity liabilities off of the life insurers' balance sheets to release reserves and/or invest in riskier assets. Earlier this year, three Federal Reserve economists published a paper on all three corners of the triangle. Academics at Princeton and the London Business School began studying this world of "shadow insurance" in 2013. They wrote:

> "Liabilities ceded to shadow reinsurers grew significantly from $11 billion in 2002 to $364 billion in 2012. This activity now exceeds total unaffiliated reinsurance in the life insurance industry, which was $270 billion in 2012. Life insurers using shadow insurance tend to be larger and capture 48% of the market share for both life insurance and annuities. These companies ceded 25 cents of every dollar insured to shadow reinsurers in 2012, up from two cents in 2002."

Pittsburgh-area advisor Matt Zagula, founder of Smart Retirement Advisors, has grown so concerned about this phenomenon that he created his own benchmarking system to measure the exposure of various FIA issuers to offshore reinsurers with hard-to-evaluate assets.

Matt Zagula

"If the life insurer created a captive offshore reinsurer and transferred a block of business to it, we have to ask, 'Why did they put it in there?' If we can't say with any degree of certainty that the reinsurer is as solvent as the ceding company, where we could see the assets, then we would suspect that there's a reason for the lack of transparency. If they didn't get an advantage from the reinsurance transaction, why did they do it?"

Ultimately, this is all about the sustained low interest rate environment and the way it has reshaped the life insurance industry since the Great Financial Crisis (GFC) of 2008-2009. The GFC and the interest rate drought drove life insurers out of the annuity business, created a slew of divestitures, mergers and acquisitions, and reinsurance deals, and—along with certain regulatory changes—inspired life insurers to do captive reinsurance deals.

The GFC (and subsequent regulatory changes) also opened opportunities for private equity artists (starting with Apollo's acquisition of Aviva and most recently involving KKR's acquisition of Global Atlantic) to enter the annuity business and acquire control of the money supporting long-term annuity contracts and deploy part of those assets into securitized investments. The process has elevated a product once scorned by all but "Wild West" insurance agents—the FIA—into the annuity industry's flagship product.

Tom Gober is a forensic accountant in Richmond, VA, who has followed this trend for years. "Over the past decade, virtually all for-profit life insurance companies have engaged in these special purpose captive reinsurance deals," he told *RIJ*. He described two types of problems that can crop up after a reinsurance deal.

The first is a potential administrative problem that would affect individual policyholders. "Any time a transaction puts distance and time between the annuity owner and whoever is collecting premiums or sending money—anytime a gap is created—you increase the odds of bad things happening," he said. For instance, the reinsurer might outsource policyholder communications to a third-party company, which then fails to keep policyholders informed about actions they must take or benefits due to them.

The second type of problem is more troubling. It involves the reinsurance deals we're discussing here, where a life insurer uses a wholly owned or affiliated captive reinsurer (owned by the same holding company) in a tax or regulatory haven to create a paper transaction that frees up reserves—without reducing the original insurer's liabilities. Multiple life insurers have done this many times since the GFC, creating what some believe is a potential buildup of systemic risk for the life insurance industry.

One document Gober shared with *RIJ* showed evidence of this. The document was filed with the National Association of Insurance Commissioners (NAIC) for 2019 by a major life insurer. It listed the assets and liabilities ceded to the insurer's wholly owned reinsurer. In this case, the parent company took a reserve credit of more than $1.5 billion, and transferred half a billion to the captive reinsurer. The parent declared more than a $1 billion in unspecified “letter of credit-like” assets to cover the difference in reserves.

“I believe that many of these blocks of business are only being funded in part with real assets; the rest are being backed by contingent items that do not qualify as assets. Every transaction with a captive which funds any amount less than real liabilities is in violation of the NAIC’s Model Holding Company Act,” Gober said.

Even when the reinsurer is not affiliated with the ceding life insurer, Gober believes, the profits anticipated by the reinsurer—made possible by the looser standards of the regulatory or tax haven—may be helping finance the reinsurance transaction and produce the desired gains for the ceding company.

As *RIJ* reported last August, Bermuda uses a different accounting standard (GAAP), which doesn’t require reinsurers to hold as much reserve capital as US (statutory) accounting rules do. A US life insurer can create its own reinsurance company in Bermuda and then can move a block of annuity business (“reinsure” it) to that new company. This act alone frees up capital, which the life insurer can use for other purposes.

“By having a Bermuda-based reinsurer, some companies are doing indirectly what they couldn’t do if the assets and liabilities stayed with the original domestic issuer: Get a credit for having reinsurance and take hard assets out,” said Larry Rybka, CEO of Valmark Financial Group, which helps advisers monitor the products they sell, in an interview last summer.

Can we assume that because a company released reserves through reinsurance that the liabilities transferred to the reinsurer are not as well protected as they once were? These new structures are so complex and so varied, that even people who should be in a position to know where all the numbers are buried don't know the answer, said Mike Gilotti.

"The assumption you can truthfully make about the reinsured liabilities is that those contracts are backed differently from the way they would be backed in the US," he told *RIJ*. "You can't tell by looking at the amount of capital released in the transaction that the reinsured liabilities aren't supported as well. There are just too many variables involved. Even people in the business don't always have a handle on it."

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