Private credit holdings of US life/annuity firms reach $1.7 trillion: AM Best

By Editorial Staff *Thu, Aug 1, 2024*

Aside from providing new data, this article describes the 'Bermuda Triangle' strategy, and includes comments from an AM Best managing director.

Private credit holdings of US life/annuity insurers grew at the rate of 5.7% in 2023 to nearly $1.7 trillion, after increasing around 10% annually from 2019-2022, according to a recent AM Best Special Report, “Asset Manager Relationships Lead Insurers’ Shift to Private Credit.”

Collateralized loan obligations (CLOs) and other non-mortgage-backed structured securities were the main driver of growth, the report said, noting that “This shift has also coincided with more insurers having private equity/asset managers (PE/AMs) that hold controlling interests along with investment manager subsidiaries.”

Private credit now accounts for 44% of the bonds held within the insurance industry, compared with about 27% in 2013, the report said. Over 41% of U.S. L/A insurers outsourced more than 10% of their invested assets in 2023, up from just under one-third of companies in 2016.

Bank regulations tightened after the Great Financial Crisis, and bank lending to high-risk companies dropped. PE/AMs have stepped into the lending vacuum. Many PE/AM firms now specialize in designing high-yield customized “leveraged loans” for high-risk borrowers.

Private equity firms continue to enter the L/A market through outright acquisitions of insurance companies or through minority investments in insurers, or by managing life insurer assets to generate fee income, the report said.

The investment firms use life insurers as platforms to obtain new assets to manage. This includes “permanent capital” (from the sale of long-dated deferred annuity contracts) and blocks of annuity or life insurance business (purchased from other insurers). PE/AMs also earn fee income from managing all or part of an insurance company’s investment portfolio.

Many PE/Ams practice what *RIJ* calls the “Bermuda Triangle” strategy. This business model involves transferring liabilities to offshore reinsurers through “modified coinsurance.” Such reinsurance can reduce the demand for new capital that typically follows rapid annuity sales growth.

RIJ asked AM Best to describe the purpose of this type of reinsurance, and how it plays into AM Best ratings reviews. “As part of AM Best’s analysis, we factor in a carrier’s reinsurance program, including its appropriateness, dependency and quality (i.e., counterparty credit),” AM Best managing director Ken Johnson said in an email.

“[Our] analysis attempts to factor in the entire consolidated balance sheet, including a stress of recapturing what may be considered riskier/less-liquid assets and ‘lower’ reserve levels. Additionally, reinsurance to unauthorized companies requires collateral to be posted, usually 105% of reserves, thereby limiting potential profitability.”

Johnson acknowledged the “capital efficiency” that PE/AM insurers obtain when using reinsurers in Bermuda or the Cayman Islands, where the accounting standards are more flexible than in the US.

“Many constituents believe that other non-US jurisdictions are somewhat less restrictive in the choice of asset allocation,” he wrote. “This is coupled with the potential to value liabilities somewhat less conservatively than in the United States. For example, by using a Best Estimate actuarial approach.

“One can debate whether the U.S. is too conservative and maybe a Best Estimate approach (lower reserves) is more in line with the actual exposure. But for now, the effect is a form of capital efficiency.”

Vacant buildings, overdue mortgages

In other news from AM Best, U.S. life/annuity (L/A) insurers continued to increase allocations to commercial mortgage loan portfolios in 2023, but problem loans, including those 90 days delinquent, again rose sharply.

According to *Best’s Special Report*, “Mortgages 90 Days Overdue Double,” L/A insurers expanded their allocations to mortgage loans last year by more than 6% to $734.2 billion, with mortgages now accounting for 13.5% of the segment’s investment portfolios.

New acquisitions were fueled largely by multi-unit (28%), residential (26%), and industrial property loans (18%), accounting for over 70% of new acquisitions in 2023.

“Although yields rose in 2023, so did the number of problem loans, which have been climbing steadily since 2020, and were up by nearly 44% in 2023," said Jason Hopper, associate director, AM Best, in a release. "The total amount of mortgages 90 days delinquent doubled, while those in the process of foreclosure were 63% higher than in 2022."

According to the report, office properties account for more than a quarter of overdue loans and those in foreclosure. Almost half of those that have been restructured but constitute just 17% of total mortgage portfolios. Office loans have recently faced headwinds due mainly to the impact of the pandemic and an increase in remote work.

The report also noted that the quality of mortgages in good standing continued to deteriorate in 2023, as economic conditions impacted debt service coverage and loan-to-value ratios. "This had resulted in a 'fallen angels' scenario that happens when loans migrate down the credit scale," Hopper said. "This trend is likely to continue until the market becomes more stable as a result of interest rates and loan maturity."