Private Equity Confidential

By Editor Test *Thu, Jan 3, 2013*

What are insurance people saying privately about private equity's invasion of the life industry? Five people who are close to the recent acquisitions spoke to RIJ on the condition of anonymity.

Now that private equity firms have decided to get into the annuity business by actually owning and running life insurance companies, retirement industry mavens have been speculating about their short- and long-term impact.

Are they white knights bearing saddlebags of cash and options expertise? Or Trojan horses full of opportunistic Achaeans in pin-stripes? Here are unfettered comments from five insiders who asked not to be identified because they do business with the companies involved in the deals.

"A buying opportunity"

"I see a convergence of two forces: underpriced companies and a belief in the buyer's ability to invest more productively. The purchasers see a buying opportunity as parents are trying to divest themselves of fixed annuity companies. This is certainly the case with Old Mutual and Aviva and may have been the case with EquiTrust and Liberty Life. Profit squeeze in the low-interest environment also makes it easier for insurers to part with fixed annuity businesses.

"The three purchasers all have a history of successfully investing in more complex asset classes and feel they can safely bring that expertise and higher investment yields into the insurance arena. The higher returns can be split in some fashion between more competitive products and higher profitability. The question is whether they are right and have a sustainable competitive advantage that does not bring extra risk or whether the advantage erodes over time and/or brings extra risk to the policyholders.

"The trader/investor attitude of the purchasers certainly must include the possibility of selling the companies if an attractive opportunity arises; however, this does not seem to have been a major objective in the purchases. I mainly see an attitude of 'we can run the insurance business better, particularly the investments.'"

"More imagination, more money, more risk tolerance"

"They think they're buying cheap and they think they're smarter than the insurance companies," he said. "Some will be short-term players but others won't; they will try to stick with this. Here's the thing: If we get a two percentage point increase in rates over the next three to five years, this all works. They will get out in six years and everybody's happy.

"There's the interest rate play, and the fact that demographics guarantee that the industry will grow. There are 21 million more people in the U.S. between the ages of 50 and 74 than there were 10 years ago.

"There's another part of it: If Solvency II doesn't have the effect that Aviva plc thinks it will have, and it may not, then it will be possible to recycle these companies back to Europe. The private equity firms could go back to the same people down the road and say, 'Do you want to buy it back?'

"What do they bring to the industry? More imagination, more money, more risk tolerance. In the case of Guggenheim, for instance, its insurer can say, 'I need extra million' and it's not a problem. The amount of money you play with in the annuity industry is so much less than in the capital markets. They also think they're better with derivatives than the insurance companies.

"The big fear is that if they will screw up—or if rates don't go up—and they walk away from this business rather than keep it. You'd have a long-lasting stain on the industry. That wouldn't be a good thing. They don't seem to be as scared as they should be on the mortality risk. Behaviorally, they shouldn't have the same problems that you see on the variable annuity side. Contract owners won't exercise all the riders at the worst possible time and the [underlying] assets should always be worth something. I am optimistic. I believe that we'll have an economic recovery. But I'm nervous about a screw-up."

"The sexiest part of the insurance business"

"You'll see more and more [acquisitions of insurance companies by private equity firms]. As interest rates remain low there are real challenges, from an ALM [asset-liability management] point of view on various blocks of business that insurers have. Fixed annuity, immediate annuity, and even fixed indexed annuity blocks to some extent, create extraordinary asset management challenges to support the liabilities.

"You have a slew of them. There are seven or eight—Apollo, Aquiline Capital Partners, Guggenheim, Harbinger, Stone Point Capital [which merged with Alterra last month in a $3.13 billion transaction], and they're starting to collaborate. Harbinger collaborated with Stone Point on the Old Mutual purchase.

"They're not just buying blocks of business anymore. Now they're buying whole companies. It all started pretty much with a run-off business. Wilton Reassurance [which acquired Texas Life from MetLife in 2009] is a good example. They were buying blocks of business with no intention of offering new products. Now you have Athene and Guggenheim forming insurance operations. You have Chris Grady [executive vice president, retail products, Athene Annuity & Life Assurance Co.], who used to head up Merrill Lynch distribution, running distribution for Athene. He's not interested in run-off.

"The private equity companies think they've figured out how to come up with more attractive yields to support the liabilities. In their perception they know how to invest. They have a better mousetrap. They think they're now the sexiest part of the insurance business. They get more aggressive on a portion of their portfolios to support the liabilities of the deal.

"Let's say they buy $2 billion of assets and $2 billion of liabilities. 'Now that we have this,' they say, 'we have to make it profitable.' So they'll take 10% to 50% of the assets and move them into other, more aggressive vehicles. They'll lengthen the duration or move down in credit quality on the bonds or simply come up with some asset classes that haven't been identified yet.

"At the same time, they need to be sure that they have enough for the surplus. The RBC [risk-based capital] that they have to put up is pretty high. They're going from a 5% capital charge in the investment world to a 30% capital charge in insurance. This business isn't for those who don't have lots of money. If they are well capitalized and do all the right things, this is a way for these products to continue to be sold, and for fixed annuity issuers to maintain a position in the business."

"Eventually it gets away from them"

"[Athene] seems to be interested in indexed annuities in New York, but the New York [insurance commission] has traditionally been very tough on carriers using that design. There are significant differences between a New York and non-New York design. There are more consumer advantages in a New York design and that makes it difficult to make the product more profitable.

"The private equity people think they are 'the smartest guys in the room.' They feel they have the expertise and the resources to ferret out better investments. But whenever people start reaching for yield it creates problems. And eventually it gets away from them. All the problems that we've seen in the recent past come from people trying to get above-market returns.

"I don't think these deals are dependent on interest rates going up. If there's a gradual rate increase, they can adjust. But if there's a spike and the 10-year Treasury goes to 3% in six months, then the industry could face a massive disintermediation problem. Another carrier could come along and offer new products with a better return. That would create losses and that would create management problems."

"FIAs tend to promise people the least"

"One fear that a lot of observers have is: Are the private equity firms buying these companies just to manage the assets, or will they run them as going concerns? So far, Athene has a pretty good track record in running Liberty Life. The CEO, Jim Belardi, came from AIG. We're encouraged by the fact that Athene hired someone who knows the insurance industry.

"Security Benefit has been offering competitive products—the rollup rate on their living benefit in particular is attractive. One of their competitors told me that they're offering terms even more competitive than they need to be to grab sales. A different company told me they saw Security Benefit coming down the pike and came up with their own new strategy to compete with them. New players tend to shake things up and that's not necessarily a bad thing.

"Another fear that people have is that the private equity firms will take too much risk and end up insolvent, and that they will have to sell the companies at a deep discount. In all the recent sales, the companies have already sold at a deep discount to book value. That's a big advantage that people who are frightened may not be considering. The question is how conservatively they'll invest.

"I think the ratings agencies are much more conservative than they were before the financial crisis, for obvious reasons. They're being very careful about ratings upgrades. If that's true, how can the private equity firms invest as aggressively as everyone seems to fear? It would jeopardize their ratings. A downgrade would hamper sales, especially in the broker-dealer and bank channels. So there will be a natural limit to how aggressive the private equity firms can be.

“They may not expect to make a killing. I’ve heard that they lowered their own expectations for how much money they can make. In fact, they may like the annuity industry because the profits, though not spectacular, are decent. And, in this rate environment, that’s not easy to find.

“Why are they interested in fixed indexed annuities? Possibly because that product tends to promise people the least. A fixed income or fixed deferred annuity promises a specific return. Most FIA products only promise that if you hold it for the entire surrender period you won’t lose anything.

“My main concern with indexed annuities is that they’re hard to understand. I have an MBA and I’ve been in the industry a long time, and FIAs still give me trouble. Even agents don’t understand them. When there’s more complexity, there’s more opportunity for unhappy owners.

“On the other hand, people can get a more generous guaranteed lifetime withdrawal benefit on an FIA than on a variable annuity, because the carrier doesn’t have to hedge against a drop in the account value. That’s why 61% of FIAs are purchased with IRA money, compared to 51% for all fixed annuities. Banks are slow adopters, but if they get comfortable with FIAs with GLWBs, sales could take off.”