‘Private equity’s insurance innovation needs a risk check’: Risk. net

By Kris Devasabai *Thu, Mar 17, 2022*

In this guest editorial, the editor-in-chief of Risk.net applauds the innovation that private equity firms bring to the annuity industry, but urges regulators to 'assess the private equity model, preferably before the next credit crisis hits.'

All innovations have their downsides. From the bicycle to social media, inventions that provide great benefits to their users can leave others behind. Private equity’s new brainwave for the insurance industry – reinsure everything in Bermuda, boost allocations to structured credit and discount liabilities – is no different. [This article appeared today at **Risk.net**.]

Private equity money is flowing into insurance, bringing with it new ideas and new risks. Last year saw a slew of deals, including the purchase of Global Atlantic by KKR, and the acquisition of Allstate’s life unit by Blackstone, which also took a 9.9% stake in AIG’s life and retirement business. A subsidiary of Ares Management acquired F&G Reinsurance at the end of 2020, renaming it Aspida Re.

These firms are following a path blazed by Apollo, which has turned Athene, the insurance platform it established in 2009, into a profit engine for its credit business. Apollo’s big idea was to allocate a larger share of fixed income investments to higher-yielding asset-backed securities (ABS), and away from corporate bonds, which account for the bulk of traditional insurers’ assets. Athene had 20% of its portfolio in ABS as of June 2021, with more than half of this in collateralised loan obligations (CLOs). The average insurer allocates 7% to ABS, with 2.6% in CLOs.

Athene’s assets are reinsured in Bermuda, where corporate bonds and CLOs with the same credit rating receive similar capital treatment. In the US, they receive the same capital treatment. But Bermuda also allows excess spread to be booked as up-front profit. This reduces an insurer’s liabilities and required reserves and boosts available capital.

The capital benefits can be substantial. In recent years, CLOs have generated 175 basis points of additional spread compared with similarly rated corporate bonds. Athene holds $17 billion of CLOs, which could translate to nearly $1.5 billion of excess yield over five years. One veteran insurance risk manager describes this as “manufacturing capital.”

That’s not all. Athene sources a large share of its private credit investments from Apollo and its affiliates, generating additional fees for its owner. CLOs are stuffed with levered loans originated by private equity sponsors, such as Apollo. Apollo’s strategy is, in many ways, brilliant. Rock-bottom rates hurt insurers and made them vulnerable to takeovers. Apollo gave the sector new life. But its emphasis on alternative assets and offshoring risk has also split the industry.

There are two ways of viewing the new entrants, according to the chief risk officer at a large US insurer: the private equity firms are doing something that is in some way unsustainable, or they are providing a useful jolt of competition into a sector that had run out of new ideas. “We should get on with it,” he says.

Others are more wary of piling into CLOs. Regulators have been sounding the alarm about leveraged loans for years. The National Association of Insurance Commissioners, which sets capital standards for US insurers, is now taking a closer look. Last month, it released a list of 13 “regulatory considerations” related to private equity-owned insurers.

These include “material increases in privately structured securities” and “potential conflicts of interest and excessive and/or hidden fees” in investment products – “for example, a CLO which is managed or structured by a related party.” The regulator is also reviewing “insurers’ use of offshore reinsurers (including captives) and complex affiliated sidecar vehicles to maximize capital efficiency, reduce reserves, increase investment risk, and introduce complexities into the group structure.”

Private equity-owned insurers now manage more than $500 billion of US life and retirement assets. There is little doubt they have brought innovation to a sector that was struggling to meet return goals in an era of low interest rates. But not every innovation is appropriate for financial institutions with long-term liabilities. Insurance regulators need to properly assess the private equity model, preferably before the next credit crisis hits.