The FIA ‘Loophole’

By Kerry Pechter *Wed, May 8, 2013*

At the Society of Actuaries Life & Annuity Symposium in Toronto this week, the invasion of the fixed indexed annuity market by private equity firms was of keen interest. Several presenters described how these firms get an edge over traditional issuers.

Here in Toronto, the odds of finding the perfect mango in Kensington Market are roughly one-to-one. The city’s Red Rocket streetcars, unlike investments, virtually never go off their rails. And the locals are born with lifelong health insurance. Let’s face it: there are riskier places on earth.

That may help explain why the risk-minded Society of Actuaries chose Toronto for this year’s Life & Annuity Symposium. Or perhaps it was simply Canada’s turn. In any case, some 500 actuaries showed up here this week to burnish their credentials and ponder the rate-starved state of the life insurance industry.

Fixed indexed annuities, along with deferred income annuities, are one of the few growth areas for annuities these days. The topic of the new private equity players in the FIA market arose several times. Long story short: The barbarians are at the gate. With their *how-do-they-do-that* pricing, they’re giving fits to traditional FIA issuers.

It’s not complicated, the panelists at one breakout session said. The private equity firms, particularly Guggenheim Partners and Athene Holding, are aggressive in their search for new pools of assets. They’re not bashful about using leverage, about buying reinsurance offshore and about getting extra yield from residential and commercial mortgage backed securities.

“This is all about grabbing more assets that are stickier, and generating slightly higher yields on those assets by investing more aggressively at the margins, especially in areas where they have a competitive advantage, like high-yield [bonds],” said John Nadel, a life insurance analyst at Sterne Agee & Leach Inc. in New York.

“Those higher yields are essentially profit margin, and it gives them great leveraged returns. They’re also using a lot of offshore captive [reinsurers] that have lower capital requirements. These are third-party investor-type players who may not care as much as you do about the long-term health of the insurance industry,” he said.

Howard Rosen of Standard & Poor’s ratings division affirmed that the private equity firms aren’t attracted to the insurance business per se. “They’re highlighting what they do best,” he said. “They look at life companies as groupings of business units, and they’re selectively taking them apart. They don’t look at the world the way [actuaries] do. Guggenheim is an asset manager. They acquired blocks of business and they acquired the people needed to do the insurance management part of it. But they want the assets.”

“There’s been a paradigm shift,” said David J. Weinsier, the U.S. life practice leader at Oliver Wyman. “The nontraditional insurers who have entered the market view the business differently. They’re running a net investment spread business, and earning the difference between the investment return on assets and the rate on their stable long-term fixed annuity funding sources."

In his presentation, Weinsier gave a rough example of how one of the new firms might achieve a 12% return on equity. For instance, they might expect a gross investment return of 5%—"No three percent assumptions for them," he said—and expenses of 0.5%, for a net investment return of about 4.5%. Their cost of funds might be about 3.75% (2.75% for premium and benefits and one percent for expenses).

The margin would then be 75 basis points. If the leverage ratio (of capital to reserves) is 10%, the margin expands into a return on investment of 7.5%. If you add the 4.5% expected return on invested capital, you get a total return on equity of 12%. Weinsier quoted the representative of a large U.S. annuity issuer as having described his returns in the following way at an A.M. Best conference last March:

> "[The] 6-7% net yield on assets less 3-4% liability cost of funds equals 2-4% net investment spread. Less 1-2% [for] G&A [general and administrative expenses] and taxes results in 1-3% operating income. Return on equity benefits from targeted leverage of 10-14x (capital/reserves ratio of 7-10%)."

"The private equity companies, the hedge funds and an increasing number of insurance companies are using the economic framework, where cash flow is king. Your company may not be thinking about its [FIA] business this way, but it should be," Weinsier added, "because this is how your competitors are thinking."

Asked if the private equity firms are playing by different rules than traditional FIA issuers, Weinsier said, "They're not playing by different rules. It's not like they've invented a 51st state.

"But a lot of the new entrants are taking advantage of a loophole created during the financial crisis that allows certain types of higher-yielding mortgage-backed securities to be categorized as NAIC 1 assets. And they're holding more of these mortgage-backed securities than you see elsewhere. How long the loophole will remain open, we don't know, but it's enabling them to increase leverage and pick up some extra yield. That's one distinction" between the new players and the older FIA issuers, he said.