Why RIJ Obsesses over the ‘Bermuda Triangle’

By Kerry Pechter *Thu, May 5, 2022*

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As an *RIJ* reader, you might have wondered why we spend so much editorial space on the ‘Bermuda Triangle’ phenomenon. There are three main reasons.

First, the obvious. The annuity business is our wheelhouse. Annuities (and life insurance, to a lesser extent) are an essential ingredient of the Bermuda Triangle strategy.

Second, if the insurance business is a black box, the Bermuda Triangle is a black box within a black box. Outsiders—competitors, regulators, investors—want to know what's happening inside of it.

Third, the Bermuda Triangle strategy contains echoes of the home mortgage crisis of 2008. It just may contain the seeds of another financial disaster.

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Let's unpack those points of interest one by one. [Newcomers can find a definition of the Bermuda Triangle strategy in the last section of this article.]

A problematic foundation

Yield-hungry individual investors bought some $63 billion worth of fixed indexed annuities (FIAs) and $53 billion worth of fixed-rate annuities in 2021. FIAs are complex and opaque products, but people typically buy them (often without understanding them) because they yield more than bonds—and because selling agents are highly incentivized and aggressive. But those factors are not new.

What's new is that there's more supply than ever: Life insurers that once ignored FIAs now sell them because they're less capital-intensive than other types of annuities. What's also new is the degree to which sales are driven by the requirements of the private equity companies that manage an increasing share of life insurer general account assets.

Private equity firms love FIA premiums because they’re a source of long-dated and illiquid deposits (“sticky”or “permanent” capital, in industry jargon) that the firms can lend at relatively high rates of interest to high-risk borrowers. They bundle the loans, securitize them, create tranches of varied risk levels, and sell the tranches to life insurers and other yield-starved investors worldwide.

Does this dynamic encourage suitable sales of commission-driven FIAs? Is the commission-driven FIA the right product on which to build the future of the life/annuity business? My impression is that buyers of long-dated FIAs are over-paying for the protection and/or upside potential they get—too much in terms of opportunity costs, if not in fees—without knowing it.

Too much privacy, too little transparency

Transparency is a sine qua non of trust, and not much about the Bermuda Triangle strategy is transparent. Private assets exist outside the public markets. The newest custom indexes that drive the returns of FIAs are hard to understand.

When one holding company controls all three partners in a Bermuda Triangle strategy—the annuity issuer, the reinsurer and the asset manager—no one can see whether or not transactions between affiliates are as fairly priced as they would be between unrelated counter-parties.

Ratings agencies say they can see the assets held by reinsurers in Bermuda, but the exact nature of those assets are not available for public review. The “modified coinsurance” and “funds withheld” forms of reinsurance that characterize most Bermuda Triangle reinsurance transactions are not widely understood, and have been described by academics as “shadow insurance.” Financial shadows call for sunlight.

Participants in the Bermuda Triangle strategy tell me that the current regulatory and legislative regimes governing their business are adequate. But regulators don’t necessarily agree. The NAIC has convened new task forces to address questions about the Bermuda Triangle strategy (without using that moniker).

The Senate Banking Committee chairman has asked for a formal briefing from the NAIC and the Federal Insurance Office on private equity involvement in the life/annuity business. There are many unanswered questions.

Seeds of crisis

Before the home mortgage crisis of 2008, houses were considered the safest of investments. Investors in mortgage-backed securities took comfort in the idea that there had never been a meltdown in housing prices. You hear the same about the life/annuity industry: It has a history of stability.

But in the housing crisis, banks lost their incentive not to lend to high-risk borrowers. They were writing mortgages and selling them to FannieMae and FreddieMac. Something similar may be happening in annuities. Issuers increasingly send the liabilities to reinsurers and the assets to asset managers. The asset managers repackage the investment risk and sell it to third-party investors. The issuers bear less risk and require less capital.

A so-called "capital light" fee-based business may be more profitable, but it also has less skin in the game. Is it even still an *insurance* company, let alone one that people will entrust with their retirement savings for periods of up to 30 years? Or has it become a mere storefront for annuity sales?

An annuity-fueled crisis wouldn't necessarily start with the large firms that pioneered the Bermuda Triangle strategy. It could start with the failure of small or hastily assembled copycats of the pioneers' business models. In classical fashion, it could start after the insurers and asset managers have accepted in-flows far in excess of the availability of worthwhile investment targets. We've seen that movie before.

A bit of background

What *RIJ* calls "the Bermuda Triangle" is a synergistic, much-varied business model involving a kind of triple accounting play between:

- A US domiciled life insurer that issues fixed-rate or fixed indexed annuities
- An asset manager with global reach and expertise in alternative assets and origination of high-yield loans
- A reinsurer in a jurisdiction (e.g., Bermuda, Cayman Islands, Vermont) that permits the valuation of annuity liabilities according to Generally Accepted Accounting Principles (GAAP) along with or instead of the more conservative Statutory Accounting Principles required of all US life insurers

In the Bermuda Triangle's purest form, all three players belong to the same holding company. They may also have some overlapping ownership, or may be strategic partners. Life insurers who employ all or part of the Bermuda Triangle strategy include leading FA and/or FIA sellers like Athene Annuity & Life, Global Atlantic, AIG, MassMutual, and others. Together, Bermuda Triangle companies accounted for about half of the $116.8 billion in 2021 fixed-rate/fixed indexed annuity sales **reported** by LIMRA's Secure Retirement Institute.