Article from

Reinsurance News

March 2019

Issue 116

Variable Annuity Blocks—Deal Activity

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HISTORY AND BACKGROUND OF INDIVIDUAL VARIABLE ANNUITIES

Individual variable annuities (VAs) have been around since the 1980s and were initially developed by insurance companies to provide middle-class individuals with tax-deferred investing and estate-wealth-transfer options via death benefit guarantees. With the tech boom and bust spanning the late '90s through the early part of the century, VA products became very popular as baby boomers watched the value of their retirement accounts gyrate and grew more concerned about their ability to support their guaranteed income needs in retirement. Insurers responded by developing and enhancing VA contract options, such as guaranteed minimum income benefits and guaranteed minimum withdrawal benefits. Advisers and their clients then bought in to the value of these guarantees, which allowed policyholders to remain invested in the equity markets while providing retirement income security through various guarantees.

With the increased popularity of variable annuity products in the early 2000s came more competitive pricing. Many insurers strove to differentiate their products and meet investor and analyst expectations for new sales. This resulted in new and more complex riders, which some insurance companies neither fully assessed nor appropriately hedged against the eventual downturn in the financial markets.

LEGACY BLOCKS

The decline in equity markets during the great financial crisis of 2008, coupled with the subsequent reduction in long-term interest rates stemming from the Federal Reserve's quantitative easing programs, caused many of these guarantees that insurance companies provided on their VA products to become "in the money." This change in market conditions, coupled with the variance between statutory and GAAP accounting for variable annuities, also exposed significant flaws in the risk management and hedging programs in place at some insurance companies. As a result of VA-driven earnings and capital volatility, many insurance companies stopped writing new VA business and put some or all their existing VA business in runoff. These runoff blocks were often designated as legacy businesses. Other carriers also revamped their VA product offerings to mitigate future exposure.

In the decade since the financial crisis, insurance companies have continued to manage their legacy VA blocks of business through more robust hedging strategies and capital management via VA captives—and in some instances, they have offered buyouts to policyholders to reduce exposure.

Until recently, there were very few announced deals involving variable annuity blocks. We believe this was the result of 1) unwillingness to address investor discounts on their equity valuations for their legacy VA blocks, and 2) other business priorities, including digitization and adapting business models to the low interest rate environment in the U.S.

WHY SELL NOW?

It appears that boards and C-suite executives at many insurance companies have recently been focusing more on legacy VA blocks and are giving serious consideration to divesting them. This is primarily the result of:

- **Market volatility.** While equity markets have performed well over the last several years, the last few months have seen considerable volatility. Rising interest rates and political uncertainty are likely to drive further market volatility over the next 12 to 24 months, which could adversely impact the performance of these blocks, even in the presence of hedging programs.

- **Diminished scale.** The dual regulatory status of VA products as securities and insurance products results in significant regulatory compliance, training, licensing and operational costs. Many companies stopped selling VA products several years ago, while others have scaled back on their sales. As these blocks continue to shrink, the operating costs on a per-policy basis increase, thus impacting the profitability of the business.

- **Evolving accounting standards.** Evolving US GAAP accounting standards for variable annuity guarantees are likely to require fair valuation of all contract guarantees and thus move away from the hybrid insurance/derivative model in place today. IFRS 17 standards (applicable to foreign domiciled insurers with U.S. operations) become effective in 2021 and also will require a fair valuation measurement model for VAs. These changes may translate to additional income volatility and could require that companies bring the liability values of VA guarantees under the insurance accounting model more in line with values that

reflect analyst discounts on valuations of VA carriers with legacy blocks.

IMPACT ON DEAL ACTIVITY?

In the last few months, we have already seen several large insurance companies divest their VA blocks and expect this trend to continue through 2019 and beyond. The 2018 block sales by the Hartford and Voya, along with MetLife's spinoff of the Brighthouse business, and AXA US's IPO are just the beginning of what we see as a trend that is similar to the fixed annuities divestitures that took place between 2011 and 2015. In most of these divestitures, the announcements were well received and sellers were rewarded via significant increases in their market capitalization. These events have not gone unnoticed by industry executives.

Investors now perceive an opportunity to acquire these legacy blocks and transition them out of publicly traded, short-term-earnings-focused entities and run them off as privately held entities away from the scrutiny of public shareholders and the analyst community. Furthermore, investors see an opportunity to consolidate these legacy blocks in order to reduce the per-policy costs of administering these regulated products. This could lead to an increase in the overall profitability of these runoff businesses as a whole.

WHAT ARE KEY BUYER CONSIDERATIONS?

While VA business could represent an attractive investment opportunity with sellers that are currently open to divestitures, potential buyers should not underestimate the complexity of both this business and the associated transactions. Furthermore, regulatory considerations and the complex structure of many insurance organizations make it very difficult to complete deals in this space. Considerations include:

- **Transaction structuring.** Legal entity sales and reinsurance are two likely structuring approaches. Legal entity sales likely require pre-close entity restructuring, as most companies did not use separate insurance entities to underwrite VA business. On the other hand, reinsurance transactions—while avoiding some of the complexity associated with a legal entity sale—also can be quite complex and often require multiple reinsurance transactions with varying structures (coinsurance, modified coinsurance and funds withheld arrangements) to transact in a manner that is efficient and also optimizes the capital and tax considerations of both parties. Other specific-tax considerations include the optimal harvesting of net operating losses from existing hedge programs and the impact of onshore or offshore affiliate captives on taxable income.

- **Asset management optimization.** Legacy blocks offer varying possibilities to improve returns on liability funding. For example, VA guarantees that are in the money or have been exercised provide more stable funding requirements for which an attractive variety of less liquid or alternative investment options would be suitable. Well-hedged blocks of business (net of any hedge collateral requirements) could also provide less volatile funding sources for these investment opportunities.

- **Post-transaction liability optimization strategies.** Variable annuity contracts may contain levers that allow for buyers to increase ultimate deal value while making good on policyholder obligations and meeting product compliance standards. Such levers include the ability to increase fees, rationalize fund offerings and institute buyout programs, but they vary by block of business.

- **Complex accounting.** The accounting for VA business and, in particular, reinsurance of VA riders is complex and needs careful analysis. Additionally, the reserving and the related hedge programs are unique and add to the complexity of the accounting and the related valuation of the business. For example, hedges of interest rate risk can have counterintuitive impacts on current statutory reserving and capital requirements. This requires that buyers understand the tradeoffs in hedging interest rate risk and mitigate accordingly.

- **Data quality and financial model integrity.** VA guarantee liabilities are highly dependent on the quality of policyholder data and the integrity of models underlying their valuations. Data issues may have developed over time with the upgrade or consolidation of policy administration systems, and complex VA insurer models may have unnoticed errors or may deviate from prescribed valuation standards. The importance of pre-assessing both data and models cannot be overstated.

- **Separate accounts and brokerage operations.** As we noted earlier, VA products are both insurance products and securities. As a result, insurance regulatory filings need to be supplemented by SEC registration and annual filings. Nonpublic companies may not be familiar with these filing requirements. Furthermore, both public and private insurers have to maintain a licensed broker dealer to administer the business. ■

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