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Annuity Reinsurance: Trends & Solutions

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The global demand for reinsurance solutions in annuity markets has skyrocketed over the past decade, and the industry expects this growth trajectory to be sustained for the foreseeable future. In this article, we examine the top thematic trends driving this growth as well as explore the top reinsurance solutions being developed to address this trillion-dollar opportunity.

TOP TRENDS

Macroeconomic Environment

The past decade has proven to be a challenging interest rate environment amid various quantitative easing programs pursued by central banks globally in response to the financial crisis. Several players in the annuity reinsurance market were established during this period of low interest rates and credit spread compression, primarily in order to provide yield enhancement solutions to annuity writers. With strong capabilities in asset-liability management and asset sourcing, these reinsurers have helped cedants manage legacy portfolios and offer attractive pricing on new business despite suppressed investment yields.

Over the same period, equity markets have rebounded to all-time highs, leading to strong performance for traditionally equity-backed liabilities, such as pensions and structured settlements.

Turning to the current economic environment, and looking ahead to the future, we note that the quantitative easing era has ended and rates have been steadily rising in recent years. This has been particularly pronounced in the last two years. As a consequence, we can expect credit spreads to revert closer to historical norms. In this new environment, the same reinsurance capabilities will be required to respond to higher crediting rates on new annuity business and help de-risk equity-heavy portfolios as credit opportunities become more attractive.

Consumer Shift

In the past, guaranteed withdrawal benefit features were added to annuities in order to compensate for the low crediting and/or participation rates being offered. Given the increase in interest rates and market returns, we have seen a shift from income-driven products to accumulation products. This, in combination with the increased need for retirement solutions, will entice life insurers to enter the annuity market, if they haven't already, and those already in the market will need to keep up with higher crediting rates.

Through a combination of annuity writers de-risking variable annuity product features coming out of the financial crisis and fierce competition pushing up crediting rates on fixed annuity products, fixed annuity sales have increased substantially over the last few years, surpassing variable annuity sales.

Fixed annuity sales in the U.S. have approached and exceeded $100 billion annually for the last five years, according to LIMRA statistics. Through the third quarter of 2018, year-over-year sales have grown by more than 10 percent, with deferred annuities and indexed annuities leading the charge. As of this writing, many industry observers expect 2018 to be a record sales year, with the fourth quarter being among the largest of all time. Indeed, this trend is expected to continue into 2019, during which many observers predict yet another record sales year.

Turning again to long-dated bulk annuities, we have observed impressive growth in the demand for pension risk transfer (PRT) solutions globally. The value proposition for pursuing a PRT transaction continues to become more attractive in the rising rate environment, particularly as plans' funding statuses are restored to healthy levels coming out of a bull equity market. PRT in the U.S. has the potential to be a $3 trillion market, and we are only scratching the surface, with a little more than $300 billion transacted to date.

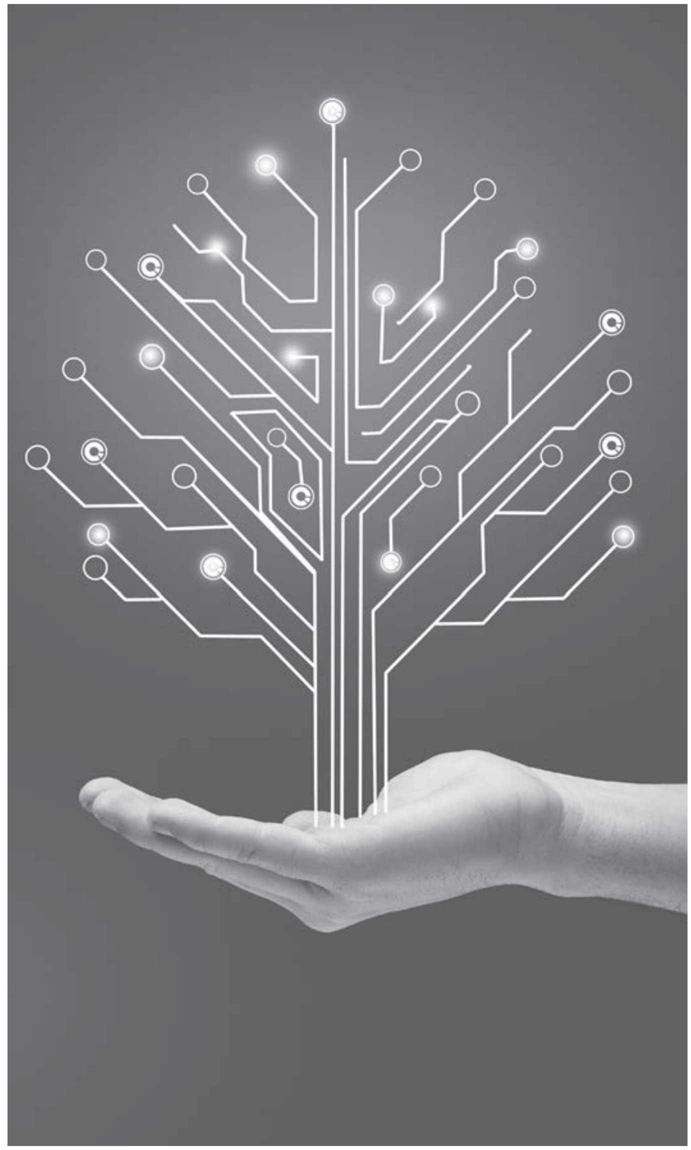
Supply of Capital

In response to this growing demand, we have observed an influx of capital sources seeking to provide capacity in this market. As we discussed, several specialist reinsurers with strong capabilities in asset-liability management and yield enhancement have emerged in the past decade to provide much-needed solutions during the quantitative easing era. Now, with rising interest rates and the prospect for increasing investment yields, traditional onshore reinsurers have become more active in the annuity reinsurance market as well.

The market also continues to attract interest from nontraditional capital sources, including hedge funds and other private equity. For these investors, the asset-intensive insurance space represents a cheap and sticky source of leverage, enabling them to deploy their asset management capabilities at scale. We have also observed interest from property and casualty reinsurers in diversifying into the life and annuity markets, due in part to saturation in their core markets and a prolonged soft underwriting environment.

This new environment has led to a very competitive process for reinsurance quotes and thus an upward trend in ceding commission, ultimately benefiting the cedants.

A combination of these trends brings us to the current trillion-dollar opportunity. Interest rates are rising, credit spreads are widening, and equity markets may have reached the peak of the current cycle. Demand for annuity products is at an all-time high. The reinsurance market is awash with capital. How is the market evolving to address this new environment? Let's find out in the next section.



TOP SOLUTIONS

Block Reinsurance

Annuity reserves held by U.S. life insurers are estimated to be $1 trillion. A substantial proportion of those annuities were written more than 10 years ago with much higher guaranteed rates than would otherwise be credited in the current market. Given the extended period of low returns on assets backing the legacy annuity blocks, insurers have encountered spread compression and an increased pressure on their ability to achieve original return targets. This has resulted in direct writers seeking reinsurance solutions to assist in meeting profit objectives and alleviating capital strain. Insurers can use annuity reinsurance to exit legacy blocks, releasing capital and allowing for redeployment to newer and more profitable lines of business. Legacy annuity blocks that were not put out to reinsurers in the past are now emerging due to the competitive pricing available in the current market.

Reinsuring annuity reserves can help manage risk-based capital and a company's risk appetite. For a company that already has a high C3 component, ceding the reserves under coinsurance will reduce retained C3 reserves and thus the overall required capital. This can also help a company exit existing business if new opportunities better align with its risk appetite and/or strategic goals.

Product Development

We have seen an increase in the number of cedants looking for product development support for their new business initiatives (more commonly referred to as flow business). Direct writers look to utilize the expertise of the reinsurance companies so that their new products are competitive, profitable and ultimately sustainable. This solution is unique in that the direct writer and reinsurer have aligned partnership interests during both the development stage and the full life cycle of the product.

On the liability side, the direct writer and reinsurer work closely to design and price a competitive product, while the reinsurer also provides support in the preparation and review of contracts and marketing materials. On the asset side, a model portfolio is developed based on projected volume, duration and risk profile characteristics of the underlying reserves. Analyzing both sides of the balance sheet ensures that the annuity product meets return objectives and risk constraints for both the cedant and the reinsurer.

Reinsuring flow business can limit strain and committed capital associated with increased sales volume. Direct writers can continue sales without the concern of reaching a maximum concentration or allocating too much capital to one project. The reinsurer typically pays the cedant an upfront allowance that can help offset first-year strain.

The efficiency of the direct writer's administrative resources can be maximized by reinsuring flow business, as the cedant is typically responsible for the administration of the new business. Distribution channels can also be retained even though the risk is reduced.

Innovative Structuring

Coinsurance is the most common and straightforward type of reinsurance structure used for annuity reinsurance. Under this approach, the assets are transferred from the cedant to the reinsurer. The reinsurer establishes its quota share of the reserves, and the cedant takes reserve credit for the same amount. For the credit to be recognized by the domiciliary regulator, the reinsurer must be authorized by the state. Many offshore reinsurance companies are classified by the National Association of Insurance Commissioners (NAIC) as unauthorized reinsurers, with reinsurers from certain NAIC-qualified jurisdictions able to apply for certified reinsurer status on a state-by-state basis.

When a reinsurer is unauthorized, the reserve credit must be fully collateralized by either letters of credit or assets in trust (all of which must meet regulatory requirements laid out by the NAIC). The trust structure guarantees the cedant access to the supporting assets for reimbursement of amounts due or in the event of reinsurer insolvency. The offshore reinsurer typically must fully collateralize its obligations on a market value basis (which is not required or commonly offered by authorized domestic reinsurers). This can and should be seen as a positive differentiating aspect of a transaction with an offshore reinsurance company. As an additional safeguard to the cedant, it is common for the reinsurance agreement to define a negotiated level of overcollateralization in excess of the market value of the assets supporting the reserves.

When choosing a reinsurance partner, it is important for cedants to perform adequate due diligence and understand the reinsurer's yield enhancement strategies. This is particularly relevant if a recapture event were ever to occur. In this scenario, the cedant would need to take control and potentially trade out of supporting assets. Cedants do not want to be faced with assets that have limited liquidity and lower-than-expected credit quality. The cedant should also be comfortable with the negotiated investment guidelines as they relate to permitted assets, limits by asset class and issuer, and duration limits relative to the liabilities.

Under variants of coinsurance, such as funds withheld coinsurance or modified coinsurance, the cedant retains ownership of the assets (recognized on the cedant's balance sheet). Some prefer this approach, as it can provide greater visibility to the underlying investments. The assets are typically retained in a segregated custody account and managed by an investment adviser agreed upon by both the reinsurer and the cedant. There is generally more transparency on investment strategies and the underwriting process performed by the investment manager. We are seeing a renewed emphasis on credit quality and collateral liquidity, as well as pushing for greater levels of overcollateralization.

The cedant should review all methods described and evaluate the structure that will best meet its needs.

CONCLUSIONS

There is good reason to be excited about the current annuity reinsurance market and what we can expect in the future. As annuity writers ramp up production on new business offerings to keep up with the growing demand, reinsurance solutions will continue to be essential for providing balance sheet capacity, product expertise and yield enhancement.

Block reinsurance of legacy portfolios, as well as capacity for bulk annuity transactions, will continue to be an essential tool for balance sheet optimization as cedants seek de-risking opportunities on noncore lines and solutions to redeploy capital and resources toward new business.

The turn in the economic cycle will have positive effects on new business sales as well as an opportunity to review asset allocations. We expect cedants to benefit as their existing and potential reinsurance partners leverage their capabilities to source attractive credit opportunities in this changing investment environment.

Despite the unprecedented success of annuity reinsurance over the past decade, the untapped potential remains impressive, with underserved liabilities totaling in the trillions of dollars. As the market continues to innovate and provide cedants with a variety of solutions, we believe the best is yet to come. ■

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