RGA

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Global Financial Solutions Insights

Welcome to the second issue of *Global Financial Solutions U.S. Market Insights*. In this issue we feature articles about what we believe to be the first longevity-only reinsurance transaction in the U.S., a high-level review of changes in the Insurance Business Transfer and Corporate Division rules, a discussion of the impact of targeted improvements on long-duration contracts, and an interview with Mitchell Schepps of Aon, in which he shares his observations regarding the annuity reinsurance market.

Our aim is to provide topical and practical updates on aspects of the industry that are relevant to our friends and partners. We strive to offer a balance between technical information and topics of strategic interest to managers and leaders. Please drop us a line to let us know if we are achieving this balance.

We know that you, like all of us, receive more email than you have time to review and that your time is valuable. Thank you for taking the time to read our newsletter, and please pass it on to any colleagues who might find it of interest. We welcome any feedback you would like to provide as well as suggestions for topics for future editions. ■

U.S. Market for Pension Risk Transfer Reinsurance Transactions Opens Up

The pension risk transfer (PRT) market has been well established outside the U.S. for many years. More recently the U.S. market has seen a steady growth in transactional volume, but to date no insurer assuming these liabilities has reinsured any of the business. In 2018 RGA completed what we believe to be the first longevity-only reinsurance transaction executed in the United States. The transaction, which transferred the longevity risk in a client's in-force PRT book, with a present value of benefits of just under $1 billion was transformational because it proved that there is a market for longevity-only reinsurance.

The reinsurance transaction took the form of a swap (although not a derivative) where the cedant pays the reinsurer a negotiated "fixed leg" (expected benefit payments plus a load) that is netted against RGA's payment of actual reinsured benefits. The net payment, which can go in either direction, is typically modest.

As we prepared to enter this business, we were consistently warned by players in the PRT industry about the poor quality of PRT data coming from plan sponsors. Our client engaged in a rigorous exercise to sanitize its data, such that as a reinsurer we were using a cleaner data set than the cedant had initially bid on. This data cleansing enabled RGA to reduce the required PAD for information deficiencies, and as the market evolves, this is suggestive of the benefits that improved information can bring to the broader market.

There is no asset transfer per se associated with a longevity only transaction. It is conceivable that assets could be transferred in the future if the obligations of one side to the other become material and seemingly irreversible. An explicit collateral provision was implemented to codify this.

In developing this pioneering transaction in the U.S., we relied heavily on the experience of our associates in the UK, who have been completing longevity-only reinsurance transactions regularly since 2007. There were no significant differences between this transaction and a comparable deal executed in the UK.

One notable element of risk in the U.S., aside from the quality of data, is the absence of statutory guidance in determining an appropriate reserve credit. Neither is such a transaction contemplated by risk-based capital as yet. Given the groundbreaking aspects of the transaction, it was key that the cedant cleared its proposed reporting of the transaction with its domiciliary regulator.

Among the key benefits for the cedant were a reduction in longevity exposure and to demonstrate market confidence in longevity pricing.

RGA anticipates that this will be the first of many longevity reinsurance transactions in the U.S. market. The underlying business is growing, and whereas much of the direct market demand is motivated by a desire to manage assets, the emergence of a robust longevity reinsurance market should enable competitive growth in the PRT space. RGA is also eager to discuss coinsurance of PRT business, either in force or flow. RGA has extensive experience as an asset-intensive reinsurer ($27 billion of account value at risk and growing). Such a transaction would decrease an insurer's concentration in PRT in force, and may enable an insurer to compete for larger cases. ■

Insurance Business Transfer and Corporate Division Laws: An Overview for the Non-Lawyer

The following article is intended to provide high-level background information and does not represent a legal opinion. While the source material was prepared by counsel, this synopsis has been prepared by a non-lawyer and should be read accordingly.

In the past, if an insurer wanted to transfer its liabilities to another entity it had few choices, none of which required policyholder consent. A merger or a consolidation did not require consent, but the business stayed with the writing entity. Assumption reinsurance, on the other hand, required policyholder approval. The recent passage of "insurance business transfer" and/or "corporate division" laws by a number of states has changed the playing field. These laws allow an insurance company to "transfer" insurance liabilities to another insurer. These transactions are different from a traditional merger or consolidation, and are considered to be more efficient in separating companies and blocks of business. Unlike assumption reinsurance, policyholder consent is not required and policyholders generally are not permitted to opt out. To date these transactions have been limited to commercial property and casualty (P&C) transactions, but that is likely changing.

Kimberly Welsh
VP & Assistant General Counsel, Global Legal Services

Insurance business transfer (IBT): IBT laws allow an insurer to transfer policies to another insurer. The transferred contracts will be novated and in most cases policyholder consent is not required. The assuming insurer becomes directly liable to the policyholders, and the transferring insurer's obligations under the contracts are extinguished. The transferring and assuming insurers may or may not be related.

IBT legislation has been enacted in Oklahoma, Vermont, Rhode Island, and Arizona (with various individual state restrictions on business covered). Not all the states listed have adopted regulations as of this writing. There are no additional IBT bills pending in any states. ▶

Corporate division: Corporate division laws permit an insurer to divide into two or more entities upon the approval of the domestic state regulator. There is no transfer or novation of any policies. Rather, the assets and liabilities, including insurance policies, are allocated to the resulting companies, either by legal succession (with the dividing company no longer surviving) or direct transfer (with the dividing company surviving). Policyholder consent is not required. The resulting insurer is liable only to the policyholders that are allocated to that insurer. The insurers involved – the dividing and resulting insurers – may or may not be related.

Corporate division legislation has been enacted in Arizona, Pennsylvania, Connecticut, Illinois, Michigan, Iowa, and Georgia. These statutes apply to all lines of business, including life insurance.

Procedural requirements: The IBT and corporate division statutes vary with respect to procedural requirements such as active or closed blocks, levels of regulatory approval, and notice to policyholders, to name a few.

- Many of the laws provide that certain conditions relating to the impact on policyholder interests and on company solvency and financial condition (e.g., regulator must find that both companies will be solvent after a division) must be met before a commissioner may approve a plan of transfer or division. The requirements vary among the states.
- There is some uncertainty as to whether policyholders that had guaranty fund protection prior to an IBT or corporate division would always continue to have it after the transfer or division, as the laws typically do not require the assuming or resulting insurer to be licensed in other states.

IBT and corporate division laws should include protections for policyholders and the industry, including independent expert review, court approval, and rigorous regulatory review of financial condition.

Impact on reinsurers: Many of the enacted laws explicitly require notice to reinsurers. Third parties, including reinsurers, typically have no ability to challenge the division or transfer except to raise concerns in the hearing. Reinsurer consent is not required, and reinsurers may not have a right to object to changes to their offset rights, solvency, and claims handling.

Industry concerns: Additional concerns could arise if a division is used to dispose of problem blocks of businesses, such as in some long-term care insurance or structured settlements.

To address these concerns, IBT and corporate division laws should include protections for policyholders and the industry, including independent expert review, court approval, and rigorous regulatory review of financial condition such that the transfer or division will result in solvent entities with sufficient assets. Regulatory review should encompass financials, operations, and ownership and management qualifications before approval of a transfer or division is granted.

National Association of Insurance Commissioners (NAIC): The NAIC is drafting a white paper to address the perceived need for restructuring statutes and the issues the statutes are designed to remedy, as well as the alternatives insurers are currently using to achieve similar results. It is possible that paper will also provide guidance on necessary protections and requirements.

This article touches the surface of an important and emerging issue that could impact insurers, policyholders, guaranty funds, and the industry as a whole. Please consult with your in-house counsel to get the complete picture. ■

Financial Reporting Changes Coming Soon

The cornerstone of U.S. GAAP accounting for insurance contracts is Financial Accounting Standard 60 (FAS60), which was released June 1982. In 2009, as part of the Financial Accounting Standards Board's codification project, the requirements of FAS 60 were incorporated into "Financial Services – Insurance (Topic 944)," usually referred to as Accounting Standards Codification 944 (ASC 944).

The approach prescribed by FAS60 was designed to provide a reasonable profit emergence for insurance products written at the time, but taking into account the companies' IT capability at the time the standard was developed. A notable outcome of the approach is that valuation assumptions for long-duration contracts are set at policy inception and are not updated over time unless blocks of business are expected to become loss-making.

For a few years, the FASB worked with the International Accounting Standards Board (IASB) in an attempt to establish a global insurance accounting standard, but later concluded that U.S. GAAP accounting for insurance did not need a fundamental rewrite. Instead they determined that many of the FASB's goals could be met by making a series of targeted improvements.

In August 2018, the FASB released Accounting Standards Update 2018-12 titled "Targeted Improvements to the Accounting for Long-Duration Contracts" (LDTI). In this article, we detail these accounting rules changes, how they might impact your company's operations and business, and how you can prepare for them.

Tim Bishop
VP, Global Business Liason –
IFRS/GAAP Targeted Improvements
South Africa

Q: What is LDTI changing?

A: The updated standard makes changes to reporting in four areas:

(1) Benefit Reserve:

- Benefit Reserve is calculated as present value of expected claims less Net Premium Ratio multiplied by the present value of expected premiums. Net Premium Ratio is set so that reserve equals zero at contract inception.
- Net Premium Ratio at contract inception is recalculated at each valuation date, with actual cash flows replacing expected cash flows where available.
- Cash flow assumptions should be reviewed on an annual basis or more frequently if evidence suggests that cash flow assumptions should be revised. Impact from changes in cash flow assumptions would be reflected in net income.
- Provision for risk of adverse deviation and premium deficiency tests will be eliminated. Instead, net premium ratio will be capped at 100%. Loss recognition testing is retained for universal life-type contracts.
- Discount Rate is prescribed as upper medium grade fixed income instrument yield. This is being interpreted as consistent with the 'A' credit curve. Changes in the value of the liabilities due to changes in the discount rate are shown as accumulated other comprehensive income (AOCI).

(2) Deferred Acquisition Costs (DAC):

- DAC for all contracts sold by insurance companies (including universal life and investment contracts) will be amortized on a constant basis over the expected life of the contract. In practice, there is a policy choice of using a straight line amortization over the expected life, calculated at a contract level, or a grouped approach that provides a reasonable approximation of the individual contract approach. ▶

(3) Market Risk Benefits (MRBs)

- While there are other examples, MRBs generally refer to riders on variable and fixed index annuity contracts.
- New standard requires that MRBs are all measured at fair value, with changes due to own credit risk shown in AOCI.

(4) Disclosures:

Insurance companies must now provide more detailed disclosures in financial statements. In particular, a roll forward of the present value of net premiums and future benefit payments must be provided in the disclosures.

Q: How will LDTI impact my business?

A: The LDTI will have financial and operational repercussions. Financially, profit can emerge very differently under the updated standard, particularly if experience deviates from that initially expected. Generally, actual experience is significantly offset by reserve changes, whereas a large portion of the impact from changing assumptions emerges in the period when the assumption change is made. Changes in the balance sheet at transition could also be significant for some product lines at some companies. For example, contracts currently valued based on the 8% interest rate available at issue many years ago could switch to use a rate of less than 4% now.

Operationally, valuation and data management will become much more complex because of the new disclosures. Multiple projections of future contract cash flows will be needed, along with grouping and tracking of cohorts of policies. Financial statements will become larger with new balance roll-forward disclosures. Because periodic valuation assumption reviews will become relevant to financial performance, assumption management processes will receive much more scrutiny. As additional valuation runs will be needed, many companies may have to push their existing systems beyond their current capacity, so increasing or outsourcing their computing power may be required.

Another aspect of the operational impact relates to staffing. Companies need to look at the current capacity and skill sets of their valuation and financial reporting teams. The work and skills needed for financial reporting will only increase. While many companies are expecting to build efficiencies or implement automation, they will need to perform more work during a financial reporting window that generally is not getting larger. Training, staff capacity, and operational models will need to be reexamined.

Q: When will it go into effect?

A: While the industry has some concerns about how to properly apply parts of the updated standard, most of the concern centers on the short implementation period, which has recently changed. On July 17, 2019, the FASB tentatively deferred the effective date for large listed companies by one year, now effective for reporting periods beginning on or after January 2022. Smaller listed companies will have a two-year deferral and other companies will have a three-year deferral in effective date.

It should be noted that to meet the requirements for a January 2022 effective date, two prior years of comparative financials must be provided at transition. From that perspective, LDTI reporting will be required for 2020 and 2021 as well.

Contracts currently valued based on the 8% interest rate available at issue many years ago could switch to use a rate of less than 4% now

Q: The new standards for U.S. GAAP were released in 2018. I heard that these standards are open to interpretation, and that there has just been a tentative delay to the effective date. How can we hit a moving target?

A: Not every detail is explicit on how these new standards should be interpreted or implemented. There are also a number of strategic decisions that a company must make in consideration toward the broader impacts of the new requirements. While you should anticipate shifts to interpretations and other developments along the way, the core of what is to be done and why is explicitly understood. Many of the strategic decisions to be made will require testing the impact of alternatives. This work is best started early.

Q: What strategies can I adopt to best handle it?

A: Like many things, what is needed to get somewhere new depends on where you are starting from. A gap analysis is a critical initial step to understand what capabilities you have now and compare these to what will soon be needed. One approach is to start from the end financial statements and work back through all processes to administration systems that provide the initial data.

Q: What resources do I need?

A: The new standard will affect the whole company, but in most cases, the largest impact will be on the finance, valuation, and IT teams. The first step is estimating and then getting agreement with management on the size of the project, but overall implementing the changes is likely to be an expensive undertaking for most companies because of the additional resources that will be required, stemming from having to reprioritize other work (which is difficult given other important initiatives such as principle-based reserving), adding permanent or short-term staff, or temporarily moving staff from other teams.

Q: What are other companies doing? What are the best practices?

A: Many larger companies are outsourcing computing capacity. By moving actuarial systems to cloud-based providers, companies can purchase computing power that scales up and down with the cyclical demand inherent in financial reporting.

Many companies are using external advisors for initial gap analysis and implementation strategy work as well. This can also be a way to gain more information on what others in the market are doing. Industry groups are also up and running to help companies share their opinions and learnings.

Given the potential level of disruption and change needed for implementation, most companies are taking a “compliance plus” approach, whereby they are looking to enhance overall systems and processes while making any changes necessary for compliance. The only issue is whether their projections for how much time all of this change will take are realistic.

Project and change management are also key areas of focus. The effects of these changes can reach far beyond finance and valuation functions into areas such as investor relations, human resources, risk management, product development, and pricing. Adequate communication, education, and understanding how the necessary changes will interact with and affect different areas of the business are needed to prevent surprises and avoid unnecessary scrambling after the fact.

Q: How is RGA getting ready?

A: RGA began its project to implement LDTI changes of in the latter half of 2018. While we have made significant progress, there is still much work to complete so that we can produce high-quality accounts under the new standard in the required timeframe.

Q: Can RGA provide solutions I can use?

A: Companies with blocks of long-term business that are no longer considered core or relatively small for that company could consider selling that block to simply avoid these implementation challenges. More broadly, RGA would be happy to discuss your unique challenges, share implementation advice, and consider any reinsurance solutions that could be of benefit before or after the changes in accounting rules. ■

A Conversation with Mitchell Schepps of Aon

Recently RGA's David Addison, Senior Vice President, Business Development for Global Financial Solutions, and Mitchell Schepps, Senior Managing Director at Aon, had a discussion about the U.S. annuity reinsurance market. Mitchell is a Senior Managing Director within Aon's Reinsurance Solutions business. He provides accident, health and life clients with risk transfer solutions, data and analytic services, and capital management strategies to improve clients' performance and reduce volatility. Mitchell has over 30 years of reinsurance experience collaborating with life insurance clients to structure and place efficient reinsurance transactions. Prior to joining Aon in 1999, Mitchell served as the Regional Vice President at Cologne Life Re for 14 years. He assists life and health insurance companies in using reinsurance as an effective financial management tool.

What follows is a condensed and edited version of their conversation, focusing on Mitchell's insights and observations about the current annuity environment from a broker's perspective.

As you look at recent activity in the annuity reinsurance market, what trends have you noticed?

Recently we have seen more companies interested in legacy in-force transactions as well as new business reinsurance transactions. As a firm we are bullish on the legacy in-force market and anticipate more transactions to be completed in 2019.

On legacy in-force transactions, we are seeing some of the smaller to medium-sized cedants reaching out to firms like ours to try to reduce execution risk and achieve better treaty terms. On new business, we are seeing more interest from clients looking to reinsure their fixed annuity and multi-year guarantee annuity (MYGA) products rather than indexed annuity products, with the goal of increasing their minimum guaranteed rate on the products. The good news is that these products seem to be simpler and faster to market so there will be continued appetite.

How much does the current interest rate environment enter into conversations with clients who are considering transacting on their legacy in-force blocks?

Interest rates enter into the conversation quite frequently with our clients who are looking to cede their blocks of business. In the past few years, many companies held the view that interest rates were on the rise and that they could wait until interest rates reached a level where they could achieve the spreads they were looking for on their product. However, because higher interest rates have not materialized, and many companies no longer expect interest rates to rise anytime soon, there is increased pressure to find an annuity reinsurance solution for those products.

However, one tail wind is that because interest rates have actually fallen, the negative ceding commission – that is, the amount in excess of the policy reserves that would need to be transferred from the cedant to the reinsurer – required to sell a block to the market has actually increased. Some companies that a year ago could have done a break-even trade (no ceding commission) would now need to pay a negative ceding commission. For some companies, that is an obstacle to completing a transaction. We have looked at a lot of blocks which will not trade in the market because the ceding company will not accept a negative ceding commission.

What other considerations do companies typically take into account when contemplating a transaction?

Companies will typically consider their current excess capital position; if they have a lot of excess capital with no direct use for the capital to be freed up from a transaction, they may hold off on bringing a legacy block to market. Companies will also consider the impact on their regulators and rating agencies. For example, if a company is viewed as overweight on interest rate or another risk class, it may believe a transaction to realign their balance sheet would be viewed positively by regulators and rating agencies regardless of their current capital position.

What do you see as the advantages to your clients of working with a full-service broker such as Aon?

At Aon, we deliver reinsurance intermediary services and beyond. We do a lot of work up front to help companies understand what their legacy blocks of business look like and what the current market might accept. We typically assist clients in comparing the benefits of full divesture versus reinsurance and assist with rating agency discussions, pro-forma financial statement analysis, and consult on accounting treatment. We can also assist with treaty review and treaty negotiations with the reinsurer. We view providing a broad range of services as part of our job in meeting our clients' needs.

> Because higher interest rates have not materialized, and many companies no longer expect interest rates to rise anytime soon, there is increased pressure to find an annuity reinsurance solution for those products.

The market for legacy in-force business, especially where the reinsurer has the ability to direct or manage the asset portfolio, appears to be increasingly competitive, particularly with offshore reinsurers. Where have you seen these new entrants looking to compete, and what has the reaction been from your clients?

We see the number of counterparties continuing to increase, and we frequently hear of new companies trying to raise between $100 million and $1 billion of capital. Most of these companies seem to be chasing fixed deferred annuities and fixed indexed annuities, given the large supply of those products in the market. Although not much has been done in the market to date, we also hear continued interest in long term care transactions. Most of the new entrants have different asset strategies, with the pitch that 80% of the investment portfolio will look similar to the cedant's strategy while the remaining 20% is allocated to their specific strategy. Their pitch is to let them do what they do best and pass some of the economics on to the cedant.

We've seen limited success with these strategies because our clients are typically conservative and value assets in trust, a strong reinsurer balance sheet, and execution certainty. There are a lot of counterparties in the market but only a few that can meet those three requirements.

At RGA we view our counterparty strength as one of our key differentiators. How do your clients think about the value of a strong counterparty compared to trust provisions? Do you see any willingness from your clients to look at less than 100% of assets held in trust for a reinsurer that is a strong counterparty?

In my experience cedants still appreciate the value of a reinsurer posting assets in a comfort trust but have gotten more sophisticated in their views on counterparties. If given the option to trade with a new entrant with assets in trust, or trade with a firm like RGA with a rating and a strong balance sheet, I think many cedants would choose the stronger counterparty. We have not seen many trades in the market with new entrants.

We do see some willingness and interest from our clients in reducing the amount of collateral for a strong counterparty. That discussion is largely driven by how the improved economics on the ceding commission compares to the reduction in collateral provided by the reinsurer. To date, we have seen most companies opt for worse economics and stronger collateral.

One situation where companies may be interested in the reinsurer holding less than 100% of assets in trust is where doing so would result in a positive or break-even ceding commission. With interest rates now dropping, this option may be attractive to cedants that wish to avoid the optics of having a negative ceding commission.

Lastly, how important is deal execution certainty to your clients?

Aon's view is that this is an extremely underrated risk and one where Aon spends a lot of time with our clients. We provide a great deal of advice to our clients on the degree of execution risk for a transaction given the nature of each counterparty the client is involving in the sales process. ■

If you have any questions or would like to discuss these articles in further detail, please reach out to your GFS business development contact or any of the following:

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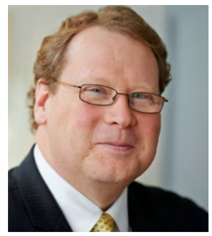

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