RGA

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Global Financial Solutions Insights

Welcome to the first edition of Global Financial Solutions U.S. Market Insights. We aim to provide topical and useful updates on aspects of the industry of interest to our friends and partners.

In this issue we feature a discussion on timing block disposition to coincide with favorable investment market conditions, observations on the impact of the BEAT, suggestions on how to achieve a successful in-force sales process, our perspective on managing regulatory relations, as well as a 2018 market review of large U.S. block annuity transactions and commentary on potential industry developments in the coming year.

Our articles for this inaugural newsletter derive from a few key observations:

- Market pricing allows companies to move legacy blocks of asset intensive business at positive or minimally negative ceding allowances, releasing trapped capital.
- There is a plethora of interested parties with significant deployable capital – both new entrants and established players – looking to buy blocks, allowing ceding companies flexibility in choosing their counterparties.
- With the current uncertainty in the financial market, it is unclear how much longer the current asset intensive reinsurance market will last.

Our plan is to publish this newsletter twice a year, focusing on topical articles related to industry developments, as well as periodic recurring feature updates related to other issues. In the next issue we expect to provide a review of the U.S. Longevity Reinsurance marketplace with a focus on the Pension Risk Transfer market. We welcome your feedback, as well as your suggestions for topics of interest. ■

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2018 and looking ahead to 2019

From our perspective 2018 was a very active year for in-force block annuity transactions. The table below summarizes some of the larger market transactions that occurred this past year. The seven transactions, representing roughly $25 billion of statutory reserves, demonstrate that several insurers seized the opportunity to rationalize their product portfolio mix and free up capital. At one point, predictions were that ▶

2018 was going to be a banner year for structured settlement ("SSA") block sales. While SSA blocks attracted reasonable bidder interest, in general, the sale of longer duration underwritten annuities continues to be challenging.

Many of these legacy deferred and payout blocks had been in run-off for several years. So why were these blocks successfully traded during 2018? While there may be idiosyncratic motivators specific to each seller, our experience has shown that the two most important factors were: (1) high demand from buyers of such legacy blocks, and (2) a relatively favorable yield environment.

During 2018 it was not uncommon for large sales processes to attract 10 or more bidders. We understand from discussions with our clients, as well as our banking and brokerage partners, that in some cases there were another handful of interested bidders that did not have sufficient credibility to be invited into such sales processes. One investment bank estimates that since early 2017 there has been at least $25 billion of capital, from long established buyers and desirous new entrants, pursuing in-force blocks and/or new business platforms. The plentitude of market capacity, sufficient to absorb several typical years of block annuity transactions, appears to have increased bidder willingness to pursue more challenging blocks in the hopes of a less competitive environment.

2018 Large In-Force U.S. Asset Intensive Transactions[1]

	Client	Acquiror	Approximate Reserves	Date
Closed Transactions	Lincoln	Athene	$7.7 billion	12/18
	Confidential	RGA	$1.1 billion	11/18
	John Hancock	RGA	~$3 billion	9/18
	Confidential	RGA	$400 million	9/18
	Symetra	Resolution	$5.7 billion	9/18
	Confidential	RGA	$600 million	1/18
	Lincoln/Liberty	Protective	~$6.2 billion[2]	1/18
	Closed Transactions Total: ~$24.7 billion			
Other Activity	Confidential	Still active	$2.5 billion	N/A
	Confidential	Still active	~$10.6 billion	N/A
	Confidential	Still active	~$2 billion	N/A
	Confidential	Withdrawn	~$10 billion	N/A
	Other Activity: ~$23.1 billion			
	Total Activity: ~$47.8 billion			

With a large and diverse pool of buyers also comes a wide range of investment strategies and risk appetites. Some bidders believe they have unique asset origination and risk management capabilities that permit them to offer superior purchase prices. Others may be willing to take duration bets and ascribe significant option value to reinvesting in what they anticipate will be a rising interest rate environment. There are still others who value the long duration and illiquid nature of many of these liabilities, ▶

[1] Excludes transactions primarily involving ordinary life, group, health, long-term care, variable annuity and pension risk transfer business. Based on public and non-public information available to RGA and is not intended to be comprehensive.

[2] As related to individual annuity business.

and seek to capture alpha by investing in private, less liquid, and potentially more complex structured securities. As bidders have proposed unconventional asset strategies, sellers have responded by asking for enhanced counterparty protections (e.g.: restrictive investment guidelines, over-collateralization and termination rights), which can erode much of the desired value creation.

Our outlook for 2019 is that in-force block deal activity will be as robust as during 2018. We believe this will be driven by two slightly different key factors: (1) concern that the current level of buyer demand may attenuate; and (2) emerging macroeconomic factors including elevated uncertainty about a recession, increased market volatility, or a potential downturn in the credit cycle, all of which may encourage insurers to sell non-core blocks sooner and avoid asset related losses.

While 2018 saw a strong level of large deal announcements, many eager suitors were again disappointed with nothing to show for their efforts. Intense competition also generally brings lower expected returns and weaker protections for the successful buyer. At some point, some of these pools of capital may pivot to pursue acquisitions outside the insurance industry. The depth and quality of the buyer universe have fluctuated significantly over the past decade. Emerging economic and political events could result in significant reductions in the demand for in-force legacy blocks of life and annuity business. One needs only to look at the situation during the global financial crisis when several insurers were eager to bolster their capital position by shedding business, but faced a dearth of willing investors. We have seen a few private equity backed asset accumulators abandon their pursuit in recent years. Some we believe were deterred in part by what they perceived as increasingly onerous regulatory hurdles, while others came to realize that high-teen returns were less likely.

Historically the need for a seller to recognize a loss by transferring assets to the buyer in excess of their reserves (commonly referred to as a "negative ceding commission") has been the biggest single impediment to transactions. Expectations of moderately rising interest rates should positively impact block activity by reducing the size of such negative ceding commissions. Credit spreads, illiquidity, and complexity premiums, while near historic lows, could expand should trade tensions heighten recession concerns. Recent pullbacks and increased volatility in the equity markets may pose headwinds in pricing the longest duration liabilities, which some insurers have chosen to back with large allocations to equities.

We see signs that insurance company investor sentiment may be shifting from pressure to deploy or return excess capital towards the retention and enhancement of capital to increase resiliency to weather a potential market downturn. While we are not so bold to predict the economic environment we will encounter during 2019, we do believe that increased uncertainty could be perceived as narrowing the window of opportunity for prospective sellers.

The favorable window of opportunity to sell blocks is expected to remain open during 2019.

We anticipate that several large sales processes commenced in the latter part of 2018 will result in announced transactions during 2019. Recently, a number of states have adopted insurance business transfer and division laws to provide new ways for insurers to dispose of or isolate a subset of their in-force business. Some regulators, insurers, and industry observers are currently debating the merits, constitutionality, and consumer protection considerations raised by these new legislations. If the experience with Part VII transfers in the UK is a good predictor, these U.S. legal developments could spur increased in-force block sales activity. We further understand that insurers, having seen some of the more challenging blocks transact on reasonable economic terms, are preparing some of their non-core blocks for sale. The favorable window of opportunity to sell blocks has been open for the past few years and, absent unexpected global economic shocks, it is expected to remain open during 2019. All that is needed is a well-planned sales process and careful selection of the buyer. ■

China trade war, U.S. government shutdown, AAPL's drop in stock price: Is this a good time to sell?

Many clients seized the opportunity to shed underperforming business over the past few years. Others have it on their "to do" list, anticipating that the perfect time to sell is yet to come. Some hope for a 200 bps rise in the 10-year treasury rate, stable spreads and low default cost expectations. There is no clear consensus amongst investment professionals as to what constitutes the best time to sell the investment portfolio supporting legacy liabilities.

In GFS's experience, the ability to hit the "top tick" on any trade is difficult, especially given the lead time to complete a large in-force reinsurance transaction. Considering you have to form an internal view of the business, gather the information, generate an appraisal, engage any external advisors, evaluate bids from prospective buyers, obtain approvals, negotiate documents, and to agree on the specific assets to transfer, it is not uncommon for it to take six to nine months before closing with the selected buyer. Clearly much could have happened in the yield environment over such a period of time.

Predicting where interest rates will be in six to nine months is very difficult. Therefore it is important for prospective sellers to gain an early understanding of how yield fluctuations could impact sale price. This may start by valuing the business under various interest rate assumptions. It is then important to understand the reinsurer' strategy for the business.

For instance, buyers often seek to bring value by repositioning the assets backing the portfolio. Such repositioning can entail going down the credit curve, introducing more private or alternative assets, and adopting an opportunistic ALM strategy. A few non-traditional bidders may have a contrarian investment mentality, which thrives during periods of financial market dislocation, but lose their edge during extended periods of stability. Sellers should understand the bidders' intent and determine how the investment market environment might impact those plans.

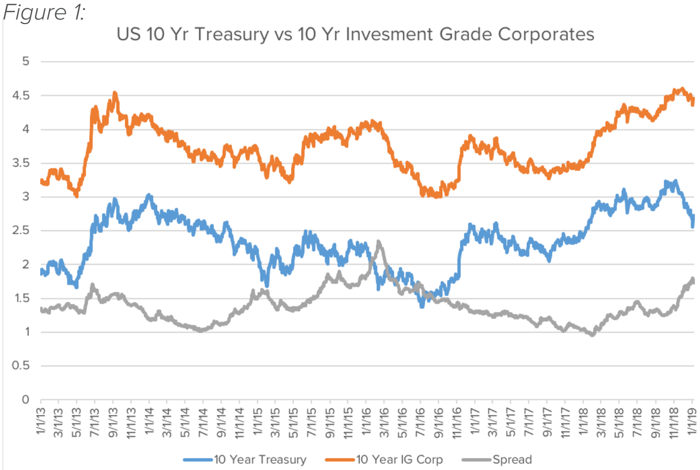
Purchase price adjustments

Should the risk of market movements between bid and closing dates be borne by the buyer? Such a one-sided allocation of risk may not lead to the best overall economics for the seller. In our experience, a two-sided purchase price adjustment (“PPA”) allows the buyer to offer more of the value expected to be realized from repositioning the investment portfolio. PPAs can be designed to consider yield movements in the transferred assets that will be sold by the buyer and/or movement in indices reflective of where the buyer intends to increase the portfolio allocation.

For example, should yields become richer during the PPA’s measurement period for the asset classes targeted for an increased allocation, then the buyer benefits from an improved purchase price. Conversely, decreased market values for transferred assets targeted for disposition have a negative impact on the purchase price. A seller may be able to hedge the PPA externally at a significantly lower cost than the incremental value the seller will add by including a PPA. A collaborative approach between seller and buyer frequently yields better outcomes than a rigid auction process.

Anecdotally, over the past three years our group has observed an increasing level of interest in selling in-force annuity blocks. We attribute this partly to steadily rising interest rates, which in turn increases the likelihood that the buyer can offer a zero or positive ceding commission. Figure 1, summarizes 10-year treasury and investment grade corporate bond yields for the past six years. One observes a general trend of improving total yields and tightening credit spreads over the latter period. We feel these are useful benchmarks as our experience has been that most sellers require the majority of the collateral package be comprised of investment grade corporate debt.

Figure 1:



Source: U.S. Treasury[1]

The role of credit spreads

As in the sale of any asset, the buyer and seller need to agree on the transaction value. This includes both the value of the liabilities and the value of the assets to be transferred. Setting aside complexities associated with certain illiquid or esoteric assets, the relative level of credit spreads can have differing impacts on the psychology of the parties.

For instance, significant spread widening may cause a seller to be reluctant to recognize losses when transferring securities. Many block buyers have a “risk up” asset repositioning strategy and may be willing to offer a better price for the block if they are confident about capturing such wider spreads. In practice, however, one often finds it difficult to source sufficient securities in the market to increase portfolio allocations quickly. When spreads are widening significantly, some block buyers may also be reluctant to accept certain assets out of concern that values will continue to decline.

Where to from here?

The next time your CEO or a board member asks why the company has yet to dispose of that legacy annuity block, given that we are in tenth year of the longest bull market in history, how should you respond? You could explain why you believe the spread environment is likely to improve and therefore the company should continue to wait and monitor spreads before bringing legacy blocks to market. Given the length of the sales process, the alternative solutions available to mitigate the risk of market movements between bid and closing dates, and the difficulty in timing legacy block dispositions with favorable credit spreads, might it be better to describe the preparations for sale that have been completed and your anticipated execution timeline? ■

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[1] Source: https://research.stlouisfed.org/ (January 10, 2019)

Best Practices for Asset Intensive Transactions

As an established player in the in-force reinsurance market, RGA has seen the majority of U.S. asset intensive blocks brought to market in the last several years. We've won some of these, lost some, and seen other blocks withdrawn from the market. Based on our experience, we offer the following general principles common to the most successful transactions, with success being measured as "achieving a favorable outcome for the seller with minimal surprises during the sales process." If you are considering bringing your asset intensive blocks to market in 2019, we hope these best practices provide you with valuable insights leading to a successful divestiture process.

1. Set realistic expectations for the block upfront

Understand the likely price range you will receive for your block. While it may seem to an outside observer that the sale process begins when materials are distributed to potential bidders, successful auctions are those where management puts the time in upfront establishing realistic expectations and agreeing internally to trade on those terms, if achieved. It can take nine months or more from the time you consider selling a block until the time you receive regulatory approval to transfer the block to a buyer, so it is important to understand the impact intervening movements in interest rates can have on the valuation of your block.

Additionally, the difference between the crediting rate on your annuity contracts and the prevailing treasury rates also impact whether you receive, or must pay, a ceding commission to the acquirer. For example, if you are crediting 5% with unlimited additional deposits, and the ten-year treasury rate is at 2%, you should expect to provide additional assets to the seller to assume these obligations. Giving ample consideration to the price range you anticipate receiving from bidders can minimize surprises late in process.

Review the models and third party appraisals you are providing to potential acquirers to ensure your own data supports the assumptions used. Typically a reinsurer will use your ▶

projections to provide the first round quote, but will dig into the supporting details as part of the second round process. If your own internal experience studies do not support the assumptions used in the model or appraisal, their bid is likely to deteriorate once that information is made available. While a rosy appraisal may lead to higher valuations in a first round quote, having a bidder's quote fall apart late in the process once the underlying assumptions and supporting data have been provided only leads to delays and surprise drops in valuation late in the process. You also risk eliminating a solid bidder into the later stage of the process because their early price indication was constructed using what will ultimately prove to be market-clearing assumptions.

Consider any sensitivities your regulators may have, and understand that these sensitivities may differ depending upon the counterparty profile of the eventual buyer. The most successful transactions are those where the seller has had good ongoing communication with the impacted regulators throughout the process. Discussing the transaction with the regulator early in your decision making process builds trust with the regulator and reduces the potential for last minute regulator requests after you have signed definitive transaction documents. Having an issue arise during the regulatory review process not only delays the transaction timeline but also forces you back to the negotiating table with the buyer, this time with much less leverage.

2. Set goals to ensure you get what you want… but be open to value enhancing solutions by the buyer

Establish a process upfront to plan for the auction and to vet potential bidders rigorously. Sale processes take a lot of time and divert significant internal resources from your company as you respond to due diligence questions from multiple bidders. While inviting many bidders into a process may seem like the best way to get the highest valuation for your block, remember that getting 1-2 great offers is better than 4-5 good offers. It takes a lot of time to respond to multiple bidders which can mean providing incomplete information to potentially the best bidders, resulting in a less attractive offer. Bidders are also most likely to invest more time in a process when they feel there are a small number of qualified and pre-vetted bidders invited to participate.

Consider the underlying objectives of the transaction and ensure you care about the treaty provisions you are pushing for.

Consider the underlying objectives of the transaction and ensure you care about the treaty provisions you are pushing for. Often external law firms will push for treaty terms (on both sides!) that may not be critical to their clients. Setting clear priorities and upfront goals helps expedite the treaty negotiations process and may better position you to obtain the long term protections you need from your counterparty. Pushing for preferable legal terms — especially in areas where there is an asymmetry of information or control between buyer and seller — may seem beneficial on its surface but may come at a cost in terms of the overall value offered, as often the buyer compensates with conservatism in their pricing.

Set goals and expectations for the process, but remain flexible to value enhancement by the reinsurer. Necessity breeds innovation, and we have seen multiple examples where a buyer was able to provide a more competitive valuation for the block by deviating slightly from the seller's preferred structure while still achieving the seller's objectives. Examples include working with the buyer to transfer specific assets to the reinsurer to achieve the seller's broader asset management objectives, utilizing coinsurance with assets held in trust instead of a modified coinsurance structure, or combining blocks of business to realize diversification synergies across multiple blocks. Often the most successful negotiations are those where both parties are able to collaborate to find win-win opportunities.

3. Perhaps most important: it's not a sale, it's a long-term relationship

In the U.S. regulatory environment, you are never fully selling or divesting a block of business via reinsurance; rather, you are entering into a long term contract with a counterparty for the duration of the underlying liabilities. While contractual protections and comfort trusts help provide some protection if your counterparty is unable to perform under the contract, you cannot ensure a successful long term transaction through these measures alone. While price is an important consideration in choosing a reinsurer, given the long duration of the liabilities and the nature of the reinsurance transaction, make sure to consider the long term relationship and trust you need to place in the buyer. Some items that are important to consider:

- Do I anticipate having an ongoing business relationship with this reinsurer? If not, how easy will it be to work with the reinsurer as issues arise over the life of the business or as treaty amendments are required?
- What does the reinsurer look like in a downside scenario where I need to rely on the negotiated contractual provisions? Are they a monoline heavily exposed to interest rates or credit losses, or do they have a diversified risk profile? What sources of additional funding are available to the reinsurer to meet their obligations in such a scenario?
- If the reinsurer was overly generous on risk assessment or protective legal language in my transaction, how sound is the rest of their book of business?

While 2019 is shaping up to be a good year to bring asset intensive blocks to market in the U.S., increasing uncertainty in financial markets makes it ever more important to set realistic expectations for your block upfront. Focusing in on your key objectives and likely valuation range upfront, and setting clear goals for the process and treaty negotiations, will help set you on the course to a successful sale process. Perhaps most importantly, remember that the end of your sale process is just the beginning of your long relationship with your reinsurer, so give ample consideration to the long term financial strength and working relationship with your counterparty. ■

Trust, and the Importance of Good Relations with Your Regulator

Good regulatory relationships are not only helpful to an insurer or reinsurer, they can be essential to the long-term competitive position of the company. The level of respect and trust between regulator and insurer can be the difference between achieving goals and falling short of the target. Attaining a good relationship with regulators does not happen overnight. It is not a sprint, but rather a marathon, with the relationship and trust being achieved over a long period of time.

Dana Wiele
SVP
Associate General Counsel

What is the nature of a good relationship with regulators? It is not one where the regulator is a "rubber stamp" on the filings for which the insurer shares as little as possible about its business. A good regulatory relationship is one that is quite contrary to this. Today solid relationships between an insurer and its regulators are built on transparency, shared information and most important, earned trust. Trust is grounded in respect for both the competence and character of the company and is furthered by the knowledge and diligence of the regulator itself. ▶

It does little good, over the long-term, for the regulator to deliver a quick approval to the insurer if the regulator does not understand the transactions or plans that it is approving. Uninformed decisions on the part of the regulator, based upon minimal information, pose a real risk of being reversed later during the course of a transaction. This aspect of regulatory relations has changed the most over the past twenty years. While it continues to be appropriate and advisable not to ask for approvals where no approval is required by law or regulation, it is appropriate that an insurer's regulators understand the products being sold, the character and experience of the insurer's management, and the strategy of the insurer.

There are several actions that an insurer can take to build good regulatory relationships. These, if done on a methodical and consistent basis, help to build a more solid working relationship with regulators.

- First, the insurer must consistently make sound management decisions, demonstrating its character and competence. This requires prudence in the type of transactions proposed for participation.
- Second, the insurer should find opportunities to meet with the regulator at least once a year to give a general update of its strategic plan, progress and objectives. While this is not possible by custom in all jurisdictions of the world, discussions during a supervisory college can be a way to reach even the most reclusive regulators.
- Third, the insurer must be proactive in sharing its ideas with the regulator as to why the insurer's programs are appropriate and how these promote proper objectives of both the insurer and the industry. This is about education and exchanging ideas.
- Fourth, the insurer should try to participate in presentations during events regulators are likely to attend. This can include special presentations on topics of interest to the regulator, and articles written by the officers and employees of the insurer.
- Fifth, the insurer should also be proactive in discussing common industry problems with regulators, offering solutions showing how the insurer, and its resources or products, might provide answers.

Where possible, messages to the regulator should be delivered at the local level, but supported and managed globally to fit into an overall corporate strategy.

Above all, it should be recognized that while it takes years to establish a strong relationship with a regulator, the relationship and accompanying trust can be lost in minutes. The insurer should always consider that even a strong relationship is nevertheless delicate and must be protected and considered with every filing, statement and action it takes. ■

The BEAT Goes On…

The Tax Cuts and Jobs Act (TCJA), which went into effect on January 1, 2018, was the largest piece of tax reform legislation to be passed since 1986. The legislation, and subsequent Department of the Treasury and IRS proposed regulations, have significant implications for the U.S. life insurance industry. In this inaugural issue of the GFS Newsletter, we offer some commentary as to how insurers reacted to the introduction of the base-erosion and anti-abuse tax, commonly referred to as the BEAT, based on industry conferences and client meetings held throughout 2018.

One of the most significant pieces of the TCJA to impact U.S. life insurers is the introduction of the BEAT. At a high level, the legislation imposes a minimum tax (5% in 2018, 10% in 2019, increasing to 12.5% in 2025) on deductible related-party payments from U.S. companies to foreign affiliates. As a result, we have heard that in 2018 U.S. insurers began to re-examine affiliated transactions between U.S.-tax-paying and non-U.S.-tax-paying entities in the new tax environment. We expect this to continue into 2019 and beyond. Insurers have also been in discussions with Treasury and IRS to obtain clarifications as to the TCJA as the law itself leaves many open questions. Treasury and IRS released proposed regulations in December 2018. These proposed regulations answered very few of the insurance industries concerns but did request comments from the industry. Final regulations are anticipated by the end of June 2019.

In response to the BEAT, many ideas have been floated including the use of IRC §953(d) companies, modified coinsurance, non-proportional reinsurance, new forms of financial derivatives, and other ways to minimize the new tax. Given the newness of the BEAT and the uncertainty around final regulations, some of these strategies can attract significant uncertainty. Our sense is that in general the industry has, to date, tended towards caution with some insurers questioning the value of affiliated transactions.

Looking forward to the rest of 2019, we anticipate that business re-optimization for the new tax environment will continue. For large acquisitions of in force blocks of annuity business, we expect to see an increase in the number of sellers transacting directly with the offshore arm of an acquirer in place of the current potentially less economically effective model which uses an onshore arm of the acquiror as a conduit.

Given the magnitude of TCJA, and the divided 116th United States Congress that took office on January 3rd, it is unlikely that we will see significant tax legislation passed in the next two years as few proposed tax reforms appear likely to receive bipartisan support.

Although we might see some tax legislation as part of broader legislative compromise package, we expect much of the activity in 2019 to be continue to be around proposed regulations by Treasury and IRS. ■

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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