A Leading Global Investment Management Firm

Insurance Insights

February 2020

CONNING®

INSURANCE RESEARCH | WHITE PAPER

Liability Platforms Trends:
Focused on Annuities and Reinsurance

By Scott Hawkins
Director, Insurance Research

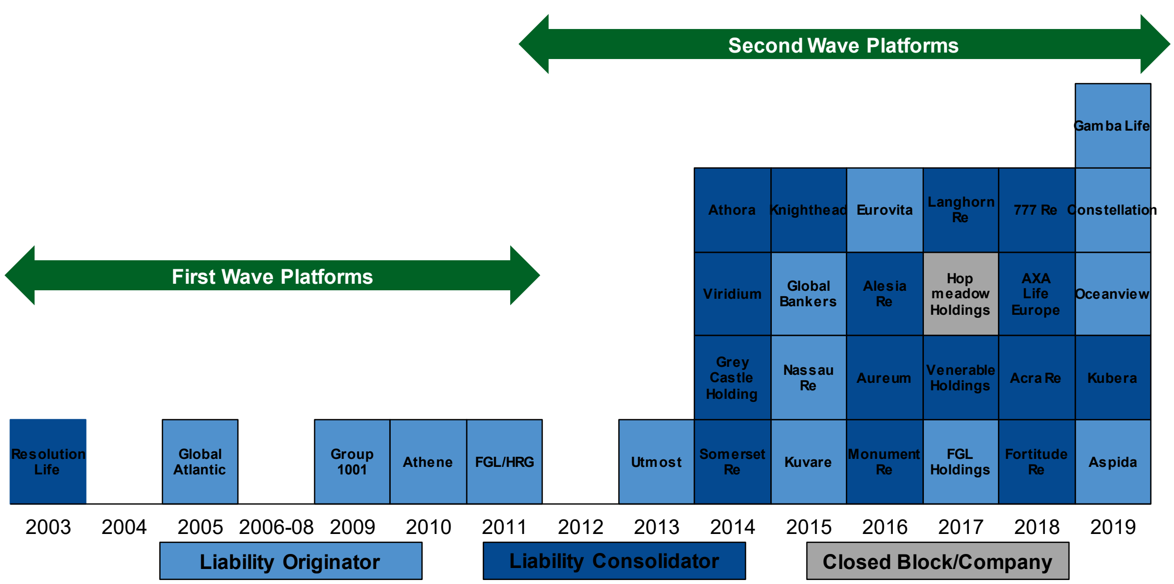
Key Takeaways

- New liability platforms – life-annuity re/insurers focused on acquiring and managing insurance liabilities – continue to be formed, funded by firms seeking sources of permanent capital.
- While their business model has evolved, reinsurance remains a crucial component of the liability platform business model.
- Because of their newness, only time will tell how a more difficult investment environment, combined with potentially higher RBC charges, will test liability platform profitability.

The Liability Platform Evolving Landscape

Since their emergence in the early 2000s, specialist insurers and reinsurers have been formed that focus on acquiring and managing insurance liabilities. By the end of 2019, there were 32 liability platforms domiciled in Bermuda, the Cayman Islands, the EU, and the United States, with the majority of the formations occurring in 2014 and later.

Figure 1 - Liability Platform Development



Prepared by Conning, Inc. Source: Company press releases, public filings, and news articles.

That growth has been accompanied by an evolution in business models, domicile, and geographic focus.

The business models used by these platforms are falling into two broad categories. Liability consolidation platforms, such as Monument Re, Somerset Re, or Viridium, acquire closed blocks of business from insurers who offloaded these liabilities as they focus on their core business. These acquisitions can be through reinsurance, traditional M&A, or Part VII transfers.

Liability origination platforms, such as Athene and F&G, go beyond liability consolidation and create new liabilities by selling new business. Creating these new liabilities, however, requires the origination platform to also invest in building a primary re/insurance operation.

In terms of domicile and geographic focus, these liability platforms' domiciles reflect their geographic focus. We find both types operating in the EU and the U.S., and most have an offshore capability including Bermuda, the Caymans, and Ireland.

Seeking a Permanent Capital Advantage

What is driving the growth in liability platforms? In some cases, such as AIG and its formation of Fortitude Re, it was the desire to spin out closed blocks of business that led to the creation of a liability platform. For others, Athene being the most noticeable, the ability to have access to permanent capital led to its development of many new liability platforms.

A liability platform creates a source of permanent capital because of its need to match long-term life and annuity liabilities with longer-term investments.

The access to sources of permanent capital offers a solution to a set of challenges facing some investment managers. Without permanent capital, asset managers are exposed to investors redeeming their money. This can limit the ability of investment managers to generate higher returns through longer-term, less liquid investments. The combination of shorter-term investing periods with redemptions can produce higher management fee volatility.

A liability platform creates a source of permanent capital because of the platform's need to match its long-term life and annuity liabilities with longer-term investments. With a longer-term investment horizon and lower redemption risk, liability platforms can support the development by their owners of more robust investment strategies and allocations. Of course, those strategies and allocations must be balanced against the need of their liability platform to hold capital against investment risk.

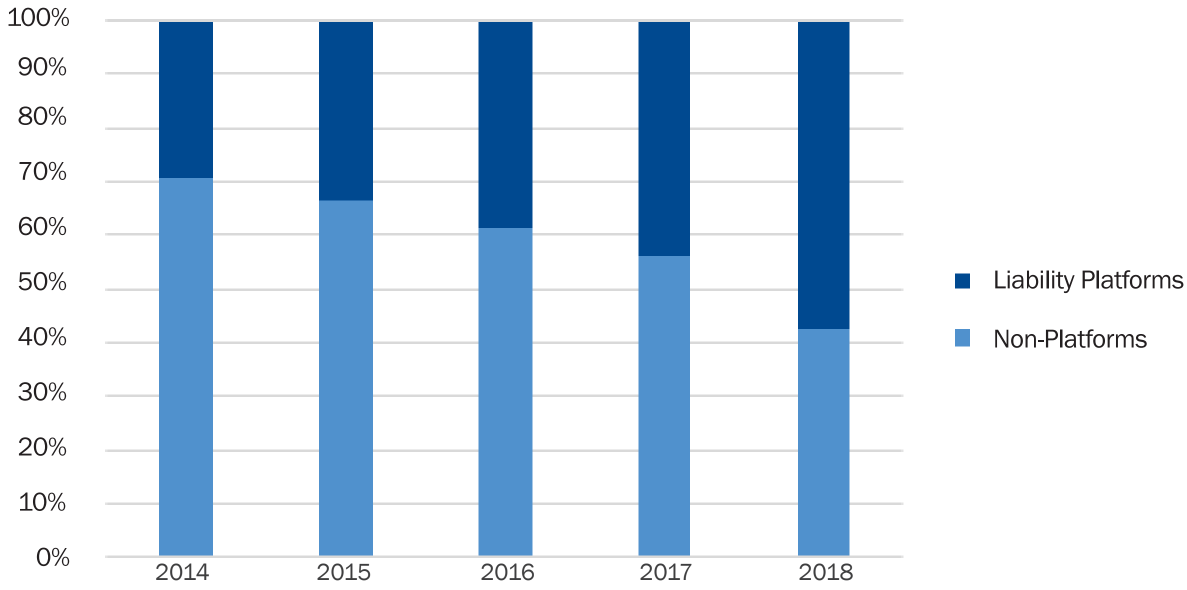
Reinsurance, the Liability Platform's Heart

While traditional M&A and Part VII Transfers are used to acquire liabilities, the use of reinsurance lies at the heart of the liability platform. Reinsurance is an attractive solution for many companies looking to dispose of unwanted liabilities. Unlike M&A, which involves the selling of an entire operating company, reinsurance allows the cedent to select specific blocks of business or lines of insurance for disposal. Reinsurance can also be easier for the cedent to execute than M&A because regulatory approval is not required.

While there are various types of reinsurance, our analysis found that they primarily use coinsurance and modco reinsurance. In addition, the use of funds withheld reinsurance is prevalent.

As described earlier, many of the liability platforms are located offshore in Bermuda or the Cayman Islands. These

Figure 2 - Annuity Reserve Credit and Modco Reserve for U.S. Annuities: Bermudian Resinsurers



Prepared by Conning, Inc. Source: © 2019 A.M. Best Company - used by permission.

liability platforms now account for a significant percentage of the annuity reserve credits generated in both domiciles. The issuance by the IRS and U.S. Treasury of the final regulations concerning the BEAT (Base Erosion Anti-Abuse Tax) in December 2019 could significantly impact the tax liability of those platforms with U.S.-domiciled affiliates. In response, those offshore platforms may develop tax mitigation strategies to reduce the impact of BEAT on their companies.

From 2014 through 2018, liability platforms in Bermuda saw their percentage of annuity reserve credits and modco reserve credits increase from 29% of all annuity reserve credits to 57%. In the Cayman Islands, in 2014 and 2015 liability platforms represented none of the reserve credits; in 2018, 49% of reserve credits were from liability platforms.

Liability Platform Profitability Yet to be Tested

Understanding liability platform profitability is crucial to understanding potential future developments. One recurring theme among these consolidation platforms is that they may have lower costs, due to more modern technology or greater scale, than the cost assumptions used when the closed block was originally priced. The lower costs can translate into higher profitability for a closed block than it would have generated for the cedent. For liability consolidation platforms whose owners are also asset managers, the liability platform represents a source of "permanent capital" that increases the parent company's pool of assets on which it can generate asset management fees.

Given the important role reinsurance plays in the liability platform business model, platform profitability can also be the result of lower capital and reserve charges because of jurisdictional differences between the cedent and the reinsurer.

The relative newness of these liability platforms, however, carries with it some degree of risk. Their business model has yet to be tested under adverse investment or regulatory conditions. For those liability platforms that are looking to their asset management skills to generate robust investment returns, recent fixed income markets have been relatively benign. It has yet to be seen how those returns would hold up if market conditions harden.

In addition to generating profits through investment management, liability platforms have focused on annuities because they have lower costs of capital than life insurance. Lower capital requirements enable investors to support more liabilities, potentially generating higher profits as a result. While annuities currently have lower RBC charges than life insurance, that may not be the case over the coming decade.

The NAIC has formed a working group to examine and develop a longevity C-2 charge. Should the NAIC adopt a longevity RBC charge, the capital charges for annuities would increase. This could make it more expensive for liability platforms to hold annuity liabilities. Solvency II introduced a similar longevity charge which caused insurers to reconsider the types of annuities they offered.

Given the start-up nature of many of these young, offshore reinsurance companies, Conning was not surprised to see significant variation in year-over-year performance metrics. What was surprising, however, was the impact that realized and unrealized derivative losses had on financial performance. The use of modco and funds withheld reinsurance creates embedded derivatives under GAAP and IFRS. These losses significantly reduced 2018 revenue for several of the companies, leading to net income losses.

Liability Platforms, Both Opportunity and Risk Lie Ahead

Liability platforms are providing the capacity to absorb liabilities no longer wanted by the insurers that originated them. To the extent these platforms also use their capital to support the origination of new policies, they help the life-annuity industry fulfill its role in providing retirement and protection coverage to consumers.

The use of reinsurance will remain crucial to the success and profitability of these liability platforms. As investors continue to seek access to permanent capital, there is likely to be continued liability platform formation. However, as with any group of new businesses, it would not be surprising that some retrenchment will occur. Whether that is due to changing economic conditions, regulatory changes, or some combination is unknown.

Looking ahead, liability platforms will continue to play a crucial role for primary insurers. It will be up to those primary insurers' due diligence to identify and select those platforms they want to partner with.

For More Information

This Conning report is an extract from Conning's 2020 strategic study: "Life-Annuity Liabilities: growing interest in a new asset class." That study builds out the themes and issues discussed here. In addition, it provides an in-depth analysis of individual liability platforms, as well as market sizes and the amount of unwanted U.S. life-annuity liabilities. Contact Conning Insurance Research to learn more about this study, and how Conning can help you and your firm better understand the opportunities and challenges in this new asset class.

Scott Hawkins is a Director in Conning's Insurance Research group responsible for research related to the life and retirement insurance industry. Prior to joining Conning in 2006, he was senior research fellow for Networks Financial Institute. Previously he held research roles with Skandia in the U.S. and Sweden, advising on emerging strategic issues in financial services and managing the firm's research projects with the European Commission. Mr. Hawkins earned a degree in history from Yale University and has a certificate in Information Management Systems from Columbia University.

ABOUT CONNING

Conning (www.conning.com) is a leading investment management firm with a long history of serving the insurance industry. Conning supports institutional investors, including pension plans, with investment solutions and asset management offerings, risk modeling software, and industry research. Founded in 1912, Conning has investment centers in Asia, Europe and North America.

C# 9557643