Asset-Intensive Buyers' Guide

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Introduction

Hearing the term “asset-intensive” may cause cold sweats and weakness in the knees for actuaries and other insurance professionals who have spent much of their careers focused on the liability side of the balance sheet! This is because insurance products under the asset-intensive label, such as savings products like annuities, are exposed to more asset risk than they are traditional biometric risk. But as with so many other complex subjects, we can get through the mystique of an asset-intensive transaction by breaking it into its component parts and gaining an understanding of each to then build a complete understanding of the whole. Reinsurance of in-force blocks of business involves many technical aspects that are not often encountered in everyday actuarial and accounting work. The purpose of this guide is to introduce many of these technical aspects, especially from a U.S. statutory perspective, to help the reader begin to put the pieces together.

Why is this understanding important? In the United States, there is currently a strong supply and demand for asset-intensive solutions for in-force blocks of business, especially with all types of annuities. Ceding companies have many motivations to consider reinsuring their in-force asset-intensive business, including capital redeployment opportunities, improving earnings metrics, and managing spread compression. For reinsurers, the motivations include diversifying against biometric risks and/or using reinsurance as a source of funding to pursue investment opportunities. Even in today’s low interest rate environment, the market for in-force asset-intensive solutions remains active.

RGA has a long history of providing asset-intensive solutions to our clients, dating back to our first such transaction in 1997. Through the years, we have worked with a variety of clients who start out at different points on the path to successful execution. This extensive experience has given us a depth of expertise in all aspects of asset-intensive solutions. We hope that this guide will help introduce our clients to how these transactions work and give them an advantage in understanding how reinsurance could help achieve their company’s goals.

Forms of Reinsurance

Coinsurance, sometimes referred to as “original terms” reinsurance, is the most straightforward form of an asset-intensive solution. With coinsurance, the ceding company transfers the liability reserves it wishes to reinsure, as well as the assets supporting the reserves, off of its U.S. statutory balance sheet and onto the reinsurer’s balance sheet. The difference of the value of the reserves transferred, less the value of the assets transferred, is known as the “ceding commission,” which can be positive (value of reserves transferred exceeds value of assets transferred) or negative (value of assets transferred exceeds value of reserves transferred).

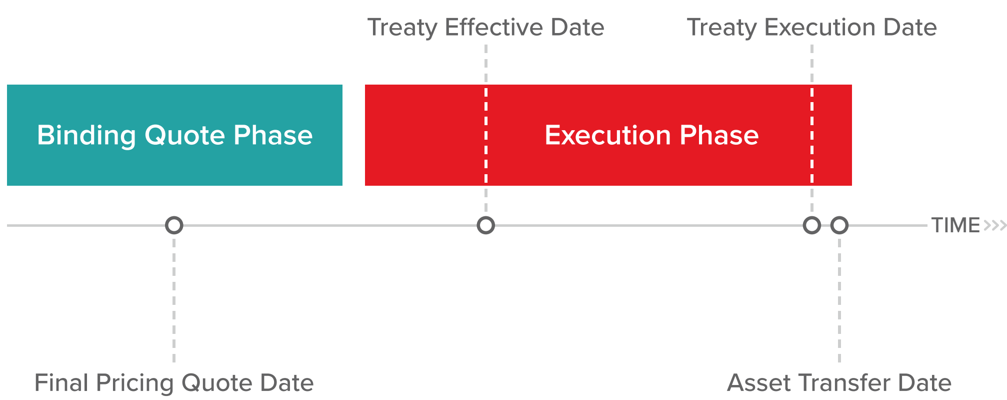
After the assets are transferred, the reinsurer is fully responsible for the management and performance of the asset portfolio. If the reinsurer is an unauthorized reinsurer in the ceding company’s state of domicile, the reinsurer will have to place those assets in a reserve credit trust or provide another suitable form of collateral (such as a letter of credit) in order for the ceding company to recognize a reinsurance reserve credit.[1] However, even licensed or accredited reinsurers may place some portion of the assets in a less restrictive “comfort” trust and agree to follow a set of investment guidelines to provide visibility to the ceding company on how the portfolio will be managed.

Other forms of reinsurance introduce additional complexities. Coinsurance with funds withheld (co-fwh), for example, transfers the reserves but not the assets. Instead, the ceding company continues to hold the assets on its balance sheet in a segregated account to back a new payable account called a "funds withheld liability" and will periodically pay the investment income from those assets to the reinsurer.

Modified coinsurance (mod-co) keeps both the assets and statutory reserves on the ceding company's balance sheet. In both cases, the reinsurer will typically want some control of the assets– for example, by assigning an asset manager to the portfolio. Thus, the ceding company may lose control of these assets on its balance sheet. Since assets are not transferred to the reinsurer with co-fwh and mod-co, the ceding commission represents cash that the reinsurer will pay to (or get paid from, in the case of a negative ceding commission) the ceding company from its surplus.

Timeline and Key Dates

A typical quoting process for reinsurance of asset-intensive business will have multiple rounds, from indicative to binding. Since the focus of this guide is on technical aspects of a transaction, it is helpful to define some of the important dates that will occur. Following is a simplified timeline of these key dates:



Here is more detail on the terms used in the illustration above:

- **Final Pricing Quote Date** – the reinsurers use the market conditions and liability information as of this date when offering their binding price to the ceding company
- **Treaty Effective Date** – the date that the ceding company wants the reinsurer to formally be "on-risk" for the reinsured liabilities
- **Treaty Execution Date** – the date when the ceding company and the reinsurer sign the reinsurance treaty documents, also known as the "closing date"
- **Asset Transfer Date** – the date the ceding company delivers assets to the reinsurer (or assigns the assets to the mod-co account or co-fwh account), and the reinsurer delivers the ceding commission to the ceding company; ideally assets will transfer (or be assigned) on the Treaty Execution Date

There is always variability in the timing between these dates, and some dates may overlap. However, the treaty will need to be executed, or a binding letter of intent signed, for the ceding company to reflect the reinsurance transaction in its statutory financials as of any quarter-end statutory filing date.[2]

Asset-Intensive Solutions Key Concepts

Assets

As the name suggests, an asset-intensive solution is just as much, if not more so, about the underlying assets as it is about the reinsured liability. In fact, in order for the ceding company to claim statutory reserve credit in the U.S. on reinsured liabilities exposed to significant credit quality, reinvestment, or disintermediation risk, the ceding company must either transfer the underlying assets to the reinsurer or otherwise legally segregate the assets backing the reinsured liability.[3] If it has not already done so in prior rounds of the quote process, the ceding company will need to identify a portfolio of assets in the execution phase that it will transfer to the reinsurer, the "Transfer Asset Portfolio." This portfolio would ideally:

1. Contain assets whose investment income has historically been allocated to the reinsured business
2. Be composed of highly liquid public assets with easily discernible market values
3. Have a duration similar to the duration of the liability

On the Asset Transfer Date of a coinsurance transaction, the statutory book value of the transferred assets will be marked-to-market when they are transferred to the reinsurer. This marking-to-market can be a source of misunderstanding in interpreting a coinsurance quote, especially as it relates to the interest maintenance reserve (IMR). We explore this concept further in the "Initial Settlement" section below.

For mod-co or co-fwh transactions, the assets are not marked-to-market on the ceding company's statutory balance sheet, as they are assigned to the mod-co reserve account or the co-fwh liability account. However, the reinsurer will still realize the benefit of any unrealized gains (or cost of unrealized losses) over time as it becomes entitled to investment income on the assets. Therefore, it is important for the ceding company to consider the full value of what it is allocating to the mod-co reserve account or co-fwh liability account.

Reserves

A coinsurance transaction on asset-intensive business typically transfers policy reserves and IMR to the reinsurer. Some types of business might also transfer claim reserves. Historically, statutory policy reserves and claim reserves have been calculated from prescribed formulas and assumptions, so the identification of the reserves transferred is often straightforward. In contrast, the identification of the IMR transferred can sometimes involve a few additional steps.

As a first step, the ceding company will need to identify "Historical IMR," which is the IMR that has accumulated on assets allocated to the reinsured business from its inception up to the Treaty Effective Date. Depending on the sophistication of historical reporting, this value could be as simple as a pro-rata share of the company's overall IMR, or as precise as the unamortized IMR from sold assets that were specifically assigned to back the policy reserves to be reinsured.

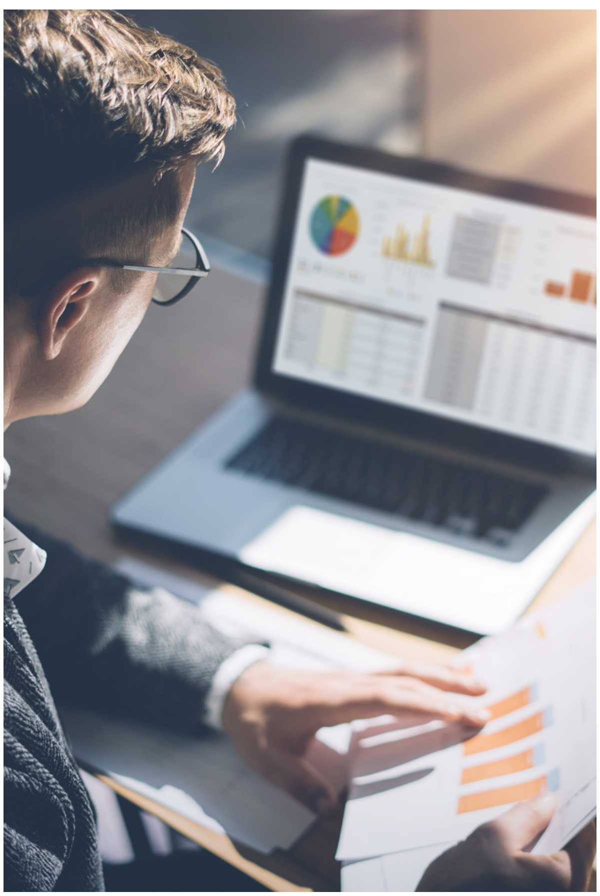
Second, for a coinsurance transaction, the transfer of assets will generate a "Transactional IMR." In the most straightforward case, the Transactional IMR is based directly on the difference between the market value of the transferred assets and the book value of the assets on the ceding company's balance sheet immediately prior to the reinsurance. Some additional complexities can exist in the calculation depending on the historical reporting of the assets supporting the reinsured liabilities. The ceding company and the reinsurer should work together to identify the appropriate amount of Transaction IMR and ensure the amount complies with applicable statutory accounting rules for reinsurance.

Mod-co and co-fwh superficially appear simpler at the Treaty Effective Date as the second step above is not necessary. However, both of these forms of reinsurance have ongoing investment income and reserve adjustment settlements between the parties. The election of how realized gains/losses are shared, as well as who will capitalize and amortize any new IMR, requires careful consideration.

Transactional Tax

All reinsurance transactions involving U.S. taxpayers have federal income tax implications at the Treaty Effective Date. This one-time tax effect is known as the “Transactional Tax Impact.” Because tax positions vary by company, many appraisals of proposed reinsurance transactions ignore the Transactional Tax Impact. However, it can be a source of value – or expense – for the ceding company and the reinsurer.

Critically, transactions that have very similar pre-tax economics can have drastically different tax implications depending on their form and other details of the transaction. In addition, ceding business to a non-U.S. taxpayer may also attract a federal excise tax that needs to be considered in the overall valuation of a transaction. An in-depth look at the various tax laws affecting reinsurance is beyond the scope of this guide. Suffice it to say, both the ceding company and the reinsurer should seek the assistance of experienced life insurance tax professionals when evaluating potential transactions.



Price Rollforward

Very few, if any, reinsurance transactions between unaffiliated companies will ever have the Final Pricing Quote Date, Treaty Effective Date, and Asset Transfer Date all occur on the same day. And yet, market conditions that affect the value of the reinsurance transaction change every day. To equitably share in the potential risks and rewards of market movements, the ceding company and the reinsurer will often agree on a mechanism – a “Purchase Price Adjustment” – to roll the reinsurer’s price at the Final Pricing Quote Date forward to an equitable price at the Asset Transfer Date. This mechanism can take many forms depending on the needs and risk appetites of the ceding company and the reinsurer.

A Purchase Price Adjustment should conceptually:

1. Account for changes in the liability from the Final Pricing Quote Date to the Treaty Effective Date
2. Track investment income accrued by the ceding company during the time between the Treaty Effective Date and the Asset Transfer Date
3. Equitably share in duration and/or convexity mismatch risk between the Transfer Asset Portfolio and the reinsured liability from the Final Pricing Quote Date to the Asset Transfer Date

Some companies may prefer the simplicity of not having a Purchase Price Adjustment mechanism over the risk protections it can afford. This can be achievable when asset duration and convexity are well aligned with liability duration and convexity, which can make the closing process easier, assuming no large market movements occur. However, it also raises the risk that one party may back out of the transaction if they suddenly find they are no longer meeting their target returns due to adverse market movements. This is never a desirable outcome.

Initial Settlement

The initial settlement is a key part of the treaty execution process, but for reinsurance of asset-intensive business, the initial settlement is complicated by the large transfer of invested assets. The typical approach to coinsurance of an in-force block of business is to define the initial reinsurance premium as the statutory reserves transferred. The statutory reserves include not just the policy reserves and any Historical IMR allocated to the reinsured business, but also the Transactional IMR. The inclusion of the Transactional IMR makes it difficult to predict what the initial reinsurance premium will be, since the mark-to-market on the Transfer Asset Portfolio changes daily. There are a couple of approaches companies can use to remove this uncertainty. Experienced reinsurers will have preferred strategies and can walk the ceding company through illustrations of various examples.

Trust/Collateral Provisions

Trusts and other forms of collateral (including mod-co and co-fwh accounts) are a very common feature of asset-intensive solutions. In coinsurance transactions, comfort trusts typically contain assets backing a significant portion, or all, of the reinsured statutory reserve. These trusts can also exist in an "over-collateralized" form (i.e., covering more than just the reinsured statutory reserves) on all types of asset-intensive solutions. Since investment risk is a key risk of these transactions, collateral provisions give ceding companies visibility into how the reinsurer is managing the assets, including following agreed-upon investment guidelines and following sound asset-liability management (ALM) practices. They also provide protection to the ceding company in an instance where it needs to recapture. However, it should also be recognized that overcollateralization or tight restrictions on management of the assets typically will be limited or come at a cost as it may require the reinsurer to encumber additional assets beyond those economically priced into the transaction.

Despite the extra protections afforded by comfort trusts, they do add some complexity at the time of closing. The terms of the trust will need to be negotiated and the parties will need to determine a trustee. Details on all the terms of a trust are beyond the scope of this guide.

In many cases, the actual funding of the trust will come in two stages. The first stage is the funding by the ceding company with all or some portion of the initial reinsurance premium for the transaction. The next stage often involves the reinsurer topping up the trust to meet the required trust amount – especially in cases where the reinsurer has agreed to over-collateralization. These stages can include many technical challenges for both the ceding company and the reinsurer, as these transactions do not occur with regular frequency and each one is unique. Here is where it can be advantageous to work with an experienced partner.

Finally, if the reinsurer is not authorized in the ceding company's state of domicile, the reinsurer in a coinsurance transaction will need to provide the stronger and stricter reserve credit trust for the ceding company to get statutory reserve credit. Due to the extra restrictions on this form of trust, most companies prefer to use co-fwh or mod-co with unauthorized reinsurers instead of setting up a reserve credit trust.

Capital Considerations

One of the key motivators of seeking an asset-intensive solution is for the ceding company to release required capital that it needed to hold to support the business. While any discussion of U.S.-based reinsurance should incorporate risk-based capital (RBC), depending on their ownership structure, companies in the U.S. may be bound by other global capital regimes such as the Canadian Life Insurance Capital Adequacy Test (LICAT) or Solvency II. Further, many companies target capital levels sufficient to maintain their ratings from agencies such as S&P and A.M. Best. This large variety of capital regimes all but ensures each company will have its own unique considerations.

However, in all cases, it is important for ceding companies to have a good understanding of how an asset-intensive solution can benefit their capital position under whatever metrics they target. Of course, this analysis is not complete without consideration of counterparty capital for the exposure to the reinsurer. This counterparty capital is largely driven by the creditworthiness of the reinsurer but can also be influenced by other factors such as the collateral provisions.

Conclusion

Asset-intensive solutions may be a complex subject, but with the right tools and the right partnerships companies can persevere through these transactions to achieve their goals. While the information provided in this Buyers' Guide is a good start, there is much more to discover about how these transactions can benefit ceding companies' balance sheets, reduce their exposures to investment and credit risk, and improve their financial metrics. The best next step along the way is to reach out to the experts at RGA to find out how our asset-intensive solutions can meet your particular needs.

References

1. NAIC Credit for Reinsurance Model Regulation, Section 7.
2. NAIC Life and Health Reinsurance Agreements Model Regulation, Section 5.
3. NAIC Life and Health Reinsurance Agreements Regulation, Section 4.A(7)(a).

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