Life and Annuity Transaction Hot Topics

Prepared for:
Southeastern Actuaries Conference & Actuaries' Club of the Southwest

Justin Li, ASA, MAAA
Eric Wagner, FSA, MAAA

NOVEMBER 2022

Milliman

Agenda

- **Overview of the Merger and Acquisition (M&A) and Transaction Environment**
  - Introduction to M&A / Transactions
  - Blocks of Interest for Sale: Fixed Annuities / ULSG
  - Packaging Blocks & Observed Expected Returns
  - 2023 Outlook

- **Life & Annuity Sidecars**
  - Introduction & Sample Structure
  - Key Considerations for Insurers and Investment/Asset Managers
  - Potential Next Steps

Milliman

U.S. Life Mergers & Acquisitions and Transaction Environment

Introduction to M&A / Transactions

- The "M&A Space" refers to the environment of buying/selling specifics blocks of business
  - Also includes reinsurance transactions (e.g., captive financing, surplus relief)
- Each 'transaction' commonly includes the development of an actuarial appraisal report, which includes some basis of 'actuarial appraisal value'
  - The actuarial appraisal value is NOT the price paid for the business (*think starting point*)
  - The appraisal is grounded in actuarial concepts (assets and liabilities are projected in actuarial software, based on cash flows calculated using actuarial principles (e.g., life contingencies)
- The business being considered is often complex insurance/annuity products that require subject matter expertise to appropriately analyze and understand risks
- The potential transaction needs to be viewed from a "risk management" perspective by actuaries
- In recent years, there has been a heavy focus on transactions involving fixed (deferred/indexed) annuities and/or universal life with secondary guarantees

Blocks of Interest for Sale: Fixed (Deferred/Indexed) Annuities

- Rationale Behind Sale: To ‘stop the bleed’ on the investment spread; blocks with guarantees of 3%+ are in focus (*still relevant even with interest rates rising in recent months*)
- **Key Considerations for Buyers**
  - Gives access to the insurance space to buyers who are strong asset managers or have access to bespoke investment opportunities
  - Allows buyers to leverage use of affiliate offshore reinsurers (*primarily Bermuda domiciled*), granting:
    - Reserve efficiency, especially when combining across a variety of risks
    - Capital enhancement for select classes of assets (BMA BSCR vs. NAIC RBC)
    - Harvest mark-to-market gain on assets supporting block (*if any*), given offshore reinsurers do not need to hold ‘IMR’
- **Key Considerations for Sellers**
  - Counterparty credit risk
  - Setting future crediting rates, in light of the buyer (reinsurer) employing a different investment strategy than that used by seller
- Note: While the focus has been fixed annuities, a recent variable annuity deal has spurred discussion/activity amongst owners of legacy VA blocks (*however, only a small pool of buyers have appetite for VA risks*)

Blocks of Interest for Sale: UL with Secondary Guarantees

- Rationale Behind Sale: Defease risk stemming primarily from ALM mis-match, low yields, and poor mortality experience
- More complex process/deal (*compared to, for example, fixed annuities*) due to variety of risks that need to be analyzed (investment, mortality, lapse, premium, etc.)
- As the market for annuity block sale processes become more competitive, buyers have turned their focus to ULSG as they offer exposure to asset intensive, (very) long-duration liabilities, but are materially more complex blocks
- **Key Considerations for Buyers**
  - Liability cash flows/duration and whether the buyer can structure an appropriate (high yielding) asset portfolio to support deal
  - Experience data – given the vintage of the block, there can be credible experience data (mortality, premium payments, etc.) which gives buyers more comfort as they consider pricing the transaction
  - Reserve financing: Grandfathered under AG48? What will be the reserve financing a buyer may get or enact?
  - YRT Repricing Risk: Does the block have significant 3rd party YRT reinsurance?
  - Exposure to STOLI/life settlements? Does seller know which policies are being 'optimized'?
- **Key Considerations for Sellers**
  - Should seller look to do indemnity reinsurance, consider surplus relief reinsurance, and/or AG48 captive financing?
  - Alternate to sale: Sub-contract asset management of ULSG block assets to a third-party with enhanced investment capabilities

“Packaging” Blocks

- **Concept**
  - Often, various challenged legacy blocks (e.g., VA, ULSG, LTC) that are being considered for sale are combined (or “packaged”) with other legacy blocks that are less challenged or at least easier to due diligence
  - From recent experience, the most common block to package with a ‘challenged block’ is fixed annuities (MYGA, FIA, or payouts)
- **Packaging Serves Multiple Purposes**
  - Increases size of deal, which can create an enhanced level of attraction and attention paid to deal by some buyers who are increasingly looking for scale
    - e.g., Allianz’s annuity deal with Sixth Street/Resolution was ~$35B in size | Principal ULSG/annuity deal with Sixth Street was ~$25B
  - Depending on block economics, packaging can reduce income volatility of the overall deal
  - Allows seller to divest a larger portion of its legacy book
  - Potentially reduces the size of a negative ceding commission

Outlook: 2023 (Buyers)

Expect continued strong transaction activity and interest in 2023 from buyer & sellers

- **Buyers** - Predominantly "**asset managers**'" (private equity firms, sovereign wealth funds, hedge funds, etc.)
  - Blackstone (Allstate Life, AIG stake), Sixth Street (Principal, Allianz deals), Brookfield (American National, AEL)
  - Offshore reinsurers (e.g., Somerset, Knighthead) remain active in their interest for US blocks, focusing on annuities
  - KKR x Global Atlantic (with Ivy sidecar) - *since KKR deal, GA has done deals for 6B annuity & 8B disability blocks*
  - Athene/Apollo created a ~$4 billion reinsurance sidecar 'ACRA' - *used for Jackson National reinsurance*
  - Carlyle took majority ownership of Fortitude Re and plans to continue growing it as a provider of run-off solutions
  - Regularly continue to see potential new entrants considering the US market
    - *Have seen recent official entry to US market by Centerbridge, Investcorp, Redbird Capital, etc.*

- **US Insurers**: mutual, mutual holding companies, etc.
  - We have recently seen an uptick in interest from large traditional US insurers, primarily mutuals/MHCs
  - Many of them are attractive buyers:
    - Have excess surplus ready to be deployed
    - Can better leverage a distribution platform being sold (e.g., investing or partnering with Insurtechs)
    - Have existing/strong relationship with regulators

Outlook: 2023 (Sellers)

- Low interest rates led many insurers to attempt to sell blocks with high interest guarantees, though the outlook seems to be changing
  - *There has been an increase in insurers considering options related to legacy annuity/ULSG blocks*
- AIG spin-off of its life & annuity business will be a seminal moment for the US insurance industry
  - Blackstone has announced acquiring 9.9% stake & right to manage assets (starting with $50B initially)
- Principal exit of retail fixed annuities & retail life
  - Leads to question: what will be reaction (if any) by other public US life/annuity insurers?
- Legacy Blocks: VA (*Brighthouse*) | ULSG (*John Hancock*) | LTC (*Genworth*, *John Hancock*)
  - *Recent deals have spurred owners of legacy VA blocks to (re)consider sale options*
- Rising interest rates creating new opportunities / challenges

Given the increased number of buyers along with pressure from stakeholders, sellers (*recently more mutuals*) have been encouraged to consider options related to their non-core blocks that can be better managed by another party (*largely focused on asset intensive blocks*), or entities that could command a premium above book value (e.g., preneed business)

Life and Annuity Sidecars

Life & Annuity Sidecars: Introduction

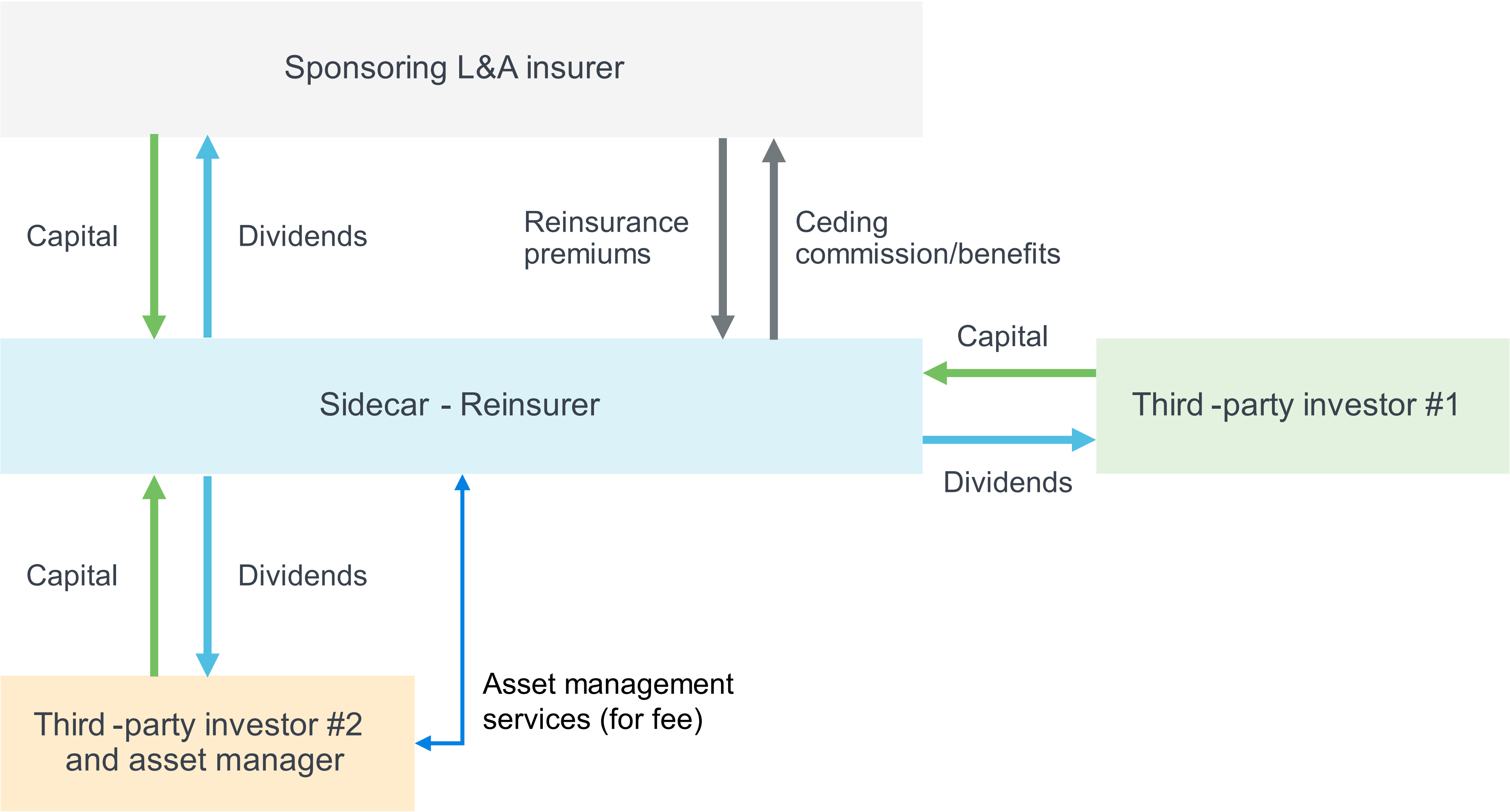
Background

- Sidecars have become a more prominent consideration for insurers as a form of partnering with a third-party(s) for capital as well as potentially leveraging a third-party's asset management expertise
- In the US, sidecar-like constructs have existed for decades as part of the business model (*e.g., Captives XXX/AXXX financing*)
- Recent sidecar examples:
  - *'ACRA': an Apollo/Athene created vehicle for 'on call capital' from third-party investors for Athene's reinsurance transactions*
  - *Bermuda based 'SkyRidge Re', a subsidiary of Security Benefit (owned by Eldridge)*

"Unbundling"

- Premise of sidecar advances the argument to "unbundle" an insurance block's core return drivers
- Allows different parties to focus on their individual core competencies
- Example: Sponsoring insurer is a leader in mortality risk underwriting, but leverage leading asset manager's investment capabilities and includes them as a sidecar investor, thus ensuring asset manager has 'skin in the game'

Life & Annuity Sidecars: Sample Structure



Key Considerations for Insurers

Does having a sidecar make an insurer’s product(s) more competitive and/or create more free surplus?

- Alternate Jurisdictions
  - For example, while Bermuda is often thought of as allowing for less total required assets (*“TAR”, reserve + capital*) for US fixed annuity blocks - rightfully so in many cases but that is not always guaranteed
- Asset management expertise
  - A core thesis of the recent offshore sidecars (*Bermuda or Cayman Islands*) has been the ability/expertise in asset management that takes advantage of the (offshore) regulatory framework
- Alignment of interest (economics and governance)
  - Critical to appreciate the ‘overall’ return afforded to the various sidecar investors, and sidecar governance (e.g., board representation)
- Sidecar reinsurer as a “call option”
  - Even if the immediate benefit of a sidecar reinsurer may be limited in making products more competitive or creating material free surplus, a consideration we have discussed with clients is that having a sidecar (especially with access to ‘on-call’ capital) creates an advantage for large M&A deals

Key Considerations for Investors/Asset Managers

- Clarity of investor/asset manager's competitive advantage
  - In some cases, an asset manager may be able to provide access to a private lending platform that is inaccessible to general portfolio managers, or a capital provider may have a different and/or a lower cost of capital (e.g., a sovereign wealth fund vs. PE firm)

- Underwriting proficiency at the direct insurer
  - For any investor committing capital, or looking to serve as an asset manager, understanding the quality of the direct insurer's liability underwriting (including underwriting for M&A or reinsurance deals) is of critical importance

- M&A or reinsurance track record of direct insurer
  - An attractive feature for investors serving as 'on-call capital' for Athene's ACRA or Global Atlantic's Ivy was that these insurers had track records of doing attractive deals, and doing them regularly such that the 'on-call capital' is needed

- Structure of the capital investment
  - Some sidecar opportunities assume the capital invested is perpetual in nature, whereas other structures allow for 'exits' at various different points for various different costs

Potential Next Steps

For Sponsoring Insurer

- **Strategy**: focus on in-force or new business (or both)? Legal structure/tax implications? Asset yield pick-up resulting from partnering benefitting product IRR?
- **Feasibility Study**: To be potentially used for a capital raise, a formal report highlighting actuarial assumptions, liability block economics, deal distributable earnings and structure (including details on fees)
- **Implementation**: Independent appointed actuary review, ALM, capital management, actuarial modeling assistance, etc.

For Sidecar Investor

A sidecar investor's due diligence efforts will depend on its prior exposure to the US L&A industry. The following are examples we have seen:

- Understanding sponsor's types of insurance products, embedded guarantees, key risks, etc.
- Reviewing implications of the US regulatory framework vs. sidecar's local regulatory framework for reserving/capital
- Considering/analyzing implication of alternate asset strategies (both on reserves/capital)
- Review of actuarial assumptions and supporting experience data provided by the sponsor
- Analyzing the sidecar deal model detailing the distributable earnings or dividend waterfall and the structure of any fees/expenses

Milliman is among the world's largest providers of actuarial and related products and services. Our mission is to help our clients protect the health and financial well-being of people everywhere. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe.
For further information, visit milliman.com.

Justin Li, ASA, MAAA | Associate Actuary | justin.li@milliman.com | +1 646 473 3115

Eric Wagner, FSA, MAAA | Consulting Actuary | eric.wagner@milliman.com | +1 973 569 5572