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Life/Annuity Industry Morphing into 'Hot' M&A Market: S&P Global Analyst

By Warren S. Hersch January 26, 2018

S&P panel, from left: Beth Campbell, Deep Banerjee and Peggy Poon.

With the dust not yet settled following the recent spike in M&A deals spearheaded by **The Hartford**, **Voya Financial** and **Lincoln Financial,** industry prognosticators are focusing on the potential long-term outlook. One distinct possibility: a bifurcation of the industry between carriers serving separate markets for individual and group protection products.

So suggested **Deep Banerjee**, an S&P global director and sector lead analyst during a panel discussion the credit ratings agency hosted on Wednesday to explore the 2018 outlook for life insurers. Banerjee and a colleague on the panel, S&P Global associate director **Peggy Poon**, covered a range of "insurance hot topics," including trends in product sales, the impact of the tax reform law, plus factors underpinning the industry's financial strength, which the panelists deemed "stable." But the implications of the recent M&A activity — and the increasing role of private equity in spearheading and funding the deals — was a highlight of the gathering.

"The life insurance sector has suddenly become a hot [M&A] market, said Banerjee. "This heightened activity will remain for the foreseeable future. What's most interesting to me is this new cohort of investor consortiums that are taking over blocks of business — and not just any blocks," added Banerjee. "They're acquiring blocks that no one else seems to have wanted."

Case in point: **Voya Financial**'s sale last month of a closed block of variable annuities that was valued at $35 billion, to an investor consortium led by **Apollo Global Management**. The same month, an investor group, including private equity firms **Cornell Capital** and **Atlas Merchant Capital**, purchased **The Hartford**'s individual life and annuity run-off businesses, as part of a $2.05 billion transaction.

Banerjee said he sees the growing role of "external capital" in the sector's M&A arena as a positive, noting acquisitions of run-off businesses that have "strained" insurers' balance sheets enhance carriers' financial flexibility and ability to focus on core competencies. For private equity firms, the buyouts also bring new assets under management, offering them (as in respect to Voya's VA closed block) the opportunity to generate additional fees.

But he cautioned that the buyouts have potential downsides. One among them: the fact that such investor groups don't have a long track record in the life-annuity space, thus making an analysis as to the groups' ability to profitably sustain the run-off businesses problematic. Private-equity ownership of the legacy blocks also entails new financial risks – both for the firms and for policyholders.

"Once these blocks are removed and isolated, they become higher in terms of concentration risk," said Banerjee, noting that the run-off businesses no longer benefit from the selling carrier's financial flexibility, product diversification and capital. "So, we're a little skeptical of the credit quality of these transactions."

Hence the credit downgrades for closed blocks disclosed after the run-off sales. In the Voya deal, for example, S&P Global lowered its financial strength rating for the closed block (to be managed by a new group, **Venerable Holdings**) to BBB-, S&P Global's lowest investment-grade rating.

S&P's Poon also sees as a growing trend the participation of third-parties in reinsuring divested blocks in the M&A deals. To illustrate, she pointed to **Protective Life**'s acquisition via reinsurance of $13 billion in individual annuity and life insurance liabilities, a component of a larger $3.3 billion deal that transitioned Liberty's Life's group business to **Lincoln Financial**. Similarly, **Global Atlantic** joined in the investor group buyout through reinsurance of a closed block of fixed annuities in The Hartford deal.

"We see a lot of groups — either alternative capital or traditional insurance companies — pairing up and chopping up blocks to get these deals done in an environment that's increasingly competitive and specialized," she said.

A potential outcome of the deal-making, added Banerjee, is an industry split, with carriers focusing either on individual or group protection products. Factors that might contribute to this fragmentation are the unique risk profiles and capital requirements of individual and group products; and carrier size, with the group space populated by larger players able to leverage the financial resources and footprint needed in the highly competitive worksite market.

"Risk in the retail sector is very different from risk in the group space," said Banerjee. "There could a greater separation in the future, where large carriers only focus on group benefits and middle-tier players pick up retail business. That's absolutely possible."

Product evolution

Turning to products, Poon noted that annuity sales may rebound in 2018, but will remain well below historic highs. Life insurance sales are also expected to grow in the single digits, though hybrid life-long-term care products will remain "stronger growth areas" for the carriers.

According to **LIMRA**, sales of variable and fixed annuities dipped an eye-popping 13% in the third quarter of 2017. U.S individual life sales over the same period increased by 6% — to $479 million from $452 million — compared to the year-ago period.

Poon attributed the precipitous drop in annuity sales in part to the negative regulatory impact of the **Department of Labor**'s fiduciary rule. She also cited the products' less generous living benefit guarantees, notably in respect to variable products, compared to prior years; as well as continuing low interest rates, which depress yields.

"Even [annuity] players that have stayed consistent in this space are struggling with net outflows," said Poon. "We thought at first that fixed annuities would take up the slack, but in the last year, fixed annuity sales declined as well."

In contrast to the dimmed prospects for individual life and annuity sales, she added, sales of group products are on the rise. The increase is especially noteworthy in respect to group annuity-funded pension buyouts, premiums for which rocketed by 47% between 2016 and 2017 (excluding December of last year), topping $11.9 billion. Players in the space include **Athene**, **OneAmerica**, **MetLife**, **Principal** and **Prudential**, among others.

Poon noted, however, that carriers are not doing "jumbo deals" of earlier years (e.g. Prudential's June 2016 buyout for $7.5 billion of **Verizon'**s pension plan, a deal that affected some 50,000 plan participants). Instead, they're doing smaller and "more conservative" transactions, focusing on pension liabilities primarily for current retirees, as opposed to future retirement benefits for individuals still in the workforce.

Tax Reform Pros, Cons

As with products, the outlook respecting the financial impact of the recently enacted tax reform law is mixed. On the negative ledger, Banerjee said the industry can expect a 4% "hit" to capital and reserves due to changes in the tax treatment of deferred tax asset balances of net operating losses (i.e., overpaid taxes that are returned to the insurer in the form of tax relief, and thus are recorded as an asset on the balance sheet).

S&P Global does foresee a longer-term benefit from reform, including enhanced after-tax earnings because of reduced corporate income tax rates. But Banerjee pointed to provisions that could offset the gains, including the requirement that insurers defer acquisitions costs over a longer period; a provision that reduces the dividends received deduction (DRD); as well as changes for calculating life insurers' reserves.

Banerjee described the industry's current outlook as "stable," with its capital and reserve levels "strong but limping along a bit." As a result, he doesn't anticipate S&P Global undertaking negative ratings actions "on mass scale" near-term. He added that actions being considered by the **National Association of Insurance Commissioners** (NAIC) this year should not significantly impact insurer's required capital.

Turning to earnings spread compression — the income from carriers' portfolio returns in excess of obligations owed to policyholders — he added that spreads are improving. He attributed this to two trends, including (in respect to annuities) reduced interest rate guarantees for new products; and better than average yields on carriers' investments.

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