GALLAGHER RE - GLOBAL LIFE & HEALTH NEWSLETTER

Asset Intensive Reinsurance
Issue 2

Considering various reinsurance solutions to transfer market risk, we published our first newsletter in January on the topic of asset intensive reinsurance (AIR), focusing on the rationales driving AIR transactions, common structures, and recent transactions in the market.

This second issue of the AIR newsletter highlights key themes based on our discussions with Steve Hales, CEO at Resolution Life Re and Cyrille Strugarek, Head of Business Development - Reinsurance at Athora. This newsletter brings the unique perspectives of the two reinsurers. In our subsequent AIR newsletters, we will bring to you the insights and views from other reinsurers as well as the ceding companies.

1

CUSTOMERS AT THE HEART OF AIR TRANSACTIONS

The centrepiece of any reinsurance is the protection of the ceding company and ultimately the policyholders. Putting customers at the heart of AIR transactions help to strengthen the trust with the ceding companies and their regulators. While regulators have different attitudes and levels of experience of AIR, they have inevitably placed great emphasis on the protection of policyholder interests.

This is especially relevant when the transaction involves policyholder profit sharing considerations. In many jurisdictions, local GAAP is the main driver for profit sharing arrangements for saving policyholders. Therefore, to ensure the transactions benefit the underlying customers, reinsurers would need to factor in the specific features of local accounting and law.

> The bread and butter of our business model in Europe is that we are both a direct business writer and a reinsurer. We leverage the knowledge and expertise of our local entities to structure our reinsurance transactions according to the local specificities." – **Athora**

> We maintain a very strong relationship with our counterparties in all markets. Within the Resolution Life group, in the U.S. we have an onshore platform, and we work closely with our New Markets team. As we build up business, we would also build up more local presence." – **Resolution Life**

There is also a significant regulatory focus on where physically and geographically the assets are invested, and, how they are invested. Constraints vary by local GAAP, AIR structure, underlying product, and specific views of the local regulator.

2

LIABILITIES DRIVE THE STRATEGIC ASSET ALLOCATION (SAA)

AIR reinsurers leverage their investment capabilities to offer attractive pricing to the market. Nevertheless, reinsurers' SAAs are always agreed with the cedant in the treaty and are not always materially different from the ceding companies. Reinsurers' SAA decisions are also anchored to the underlying characteristics of liabilities. Alongside with the usual benefits of diversification across jurisdictions, underlying portfolios, and risks, reinsurers would usually offer to keep the assets backing the liabilities in the cedant's jurisdiction. The upside is then driven by the ability to source illiquid (mostly private) assets under solid risk management principles. This approach is reflected both in the reinsurers' pricing and the ongoing profit distribution to policyholders under some AIR structures.

AIR reinsurers also value a robust asset liability matching principle when deciding their SAAs. They consider not only the pattern of cash flows, duration and liquidity requirements, but also the risks associated with the cash flows, for example, dynamic lapse, while adhering to the cedent's investment guidelines.

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> What we do is to focus on managing legacy portfolios, we can often bring additional value by matching the longer duration liabilities with illiquid assets. As legacy portfolios run off, they naturally generate excess capital, which allows us to take longer-term views on our asset management approach.” – **Resolution Life**

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> We use liquid and high-quality assets to match the interest rate profile of the liabilities we reinsure. Depending on the situation, it will often require 70%-80% of assets to be invested in highly liquid and high-quality assets. The remaining portion will be allocated to private and illiquid assets to generate better risk-adjusted returns ultimately benefitting the underlying policyholders.” – **Athora**

3

ECONOMIC HEADWINDS DO NOT IMPACT AIR REINSURERS' ASSET ORIGINATION

Globally, both reinsurers and the ceding companies are currently facing significant economic headwinds as stagflation or even recession is now grabbing the headlines. AIR reinsurers, however, have generally expressed confidence in terms of origination of assets, especially illiquid/private assets in the current climate.

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Our asset management approach is guided by risk management discipline. Our group asset manager insists on the principle that purchase price matters. We would not chase yield by taking on excessive risk, and have not done so during the last 5 years of persistent low yields. With interest rates going up now, our assets are yielding very well relative to the fundamental risk." – **Athora**

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From an origination of assets perspective, the market volatility may generate opportunities. The key is to be adequately capitalised to absorb the market volatility." – **Resolution Life**

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REINSURERS RELY ON THE ROBUSTNESS AND FLEXIBILITY OF THE BERMUDA REINSURANCE REGIME RATHER THAN TECHNICAL SPECIFICITIES

While there are some technical differences among the different capital regimes, for example, the scenario-based discounting approach under the Bermuda capital regime may have perceived benefits over Solvency II, AIR reinsurers' business strategy and operational model does not rely on these differences.

While acknowledging the benefits of having a reinsurer-focused regulatory regime in Bermuda that has Solvency II equivalent status and U.S. reciprocal status, reinsurers do not put significant weight on the technical differences between regulatory regimes in driving the business strategy.

"Technical specifics such as how the discount rate is defined will evolve over time and should be seen in the context of the total balance sheet management. The key difference is the reinsurance-driven regulatory approach that allows us to reinsure businesses from different jurisdictions to have a diversified portfolio." – **Resolution Life**

Reinsurers have a strong belief that the foundation of business is to have a diversified portfolio of liabilities and assets, originating illiquid assets that are well-matched to long-term liabilities, rather than relying on the technical differences between solvency regimes.

"Our strategy is driven by the economic risk profile of our transactions, and those are not specific to any solvency framework." – **Athora**

5

GROWTH OF AIR MARKET EXPECTED DESPITE UNCERTAINTIES

The AIR market is expected to continue its growth trajectory in the medium term. In addition to growth in the more established U.S. market, many reinsurers are now expanding their growth focus to include other regions such as Asia and Europe. The spread of U.S. assets over the rest of the world could drive significant growth of AIR transactions in Asia and Europe. The continued trend of global insurers shifting their exposures from market risk to non-life and biometric risks could also drive the growth in AIR transactions.

While the recent interest rate increases can generally benefit life insurers' balance sheets and solvency positions, how the demand for AIR will be impacted by interest rate increases is more nuanced.

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For large companies, there will be ongoing needs to de-risk from the legacy portfolios, so they can focus on their strategy going forward. It often is a publicly stated long-term strategy. The high interest rate environment makes it easier to find a price point for old legacy books with high interest rates, which requires lower write-offs from the cedent.” – **Resolution Life**

Insurers in certain jurisdictions previously faced challenges when selling assets to finance AIR because such sales realised the difference between book and market values of assets, leading to material profit-sharing implications in addition. This challenge is mitigated to some extent by the recent interest rate increases.

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Six months ago, many European insurers had material unrealised gains (URG) on their balance sheet. To sell assets to finance reinsurance premiums means significant one-off capital gains to be realised. In some markets, such capital gains are required to be reflected in the policyholders' profit sharing, which was constraining the ability of insurers to fund the reinsurance transactions. With higher interest rate, insurers' balance sheets have very little URG left, or are facing unrealised capital losses. Funding reinsurance transactions may thus prove easier than it was.” – **Athora**

GALLAGHER RE OFFERING ON AIR

Global reach and local expertise - Gallagher Re have extensive AIR experience across U.S., Asia and Europe, with local experts in different markets designing reinsurance structures that comply with local law and accounting principles and providing regulatory support during transactions.

Strong relationship and understanding - Gallagher Re have strong relationships with both insurers and AIR reinsurers. We apply our understanding of different AIR reinsurers' strategic focus and risk appetites for different AIR structures, helping insurers find the most suitable solution to match their needs.

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The reinsurance broker can definitely bring more structure to the transaction process and help the cedent understand how they can analyse and manage the transaction, especially for a new market.”
– **Resolution Life**

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It's vitally important to consider local specificities, and having a reinsurance broker helps in the process.” – **Athora**

Execution experience - Gallagher Re have experience negotiating and placing all manner of reinsurance arrangements with counterparties everywhere along the credit rating scale. This broad practical experience puts us in a strong position in negotiations and maximises value for the ceding companies.

Analytics and market insights - Gallagher Re have capabilities in performing cost benefit analysis on AIR solutions to help insurers understand the impact of different AIR structures on their solvency and accounting regimes. Gallagher Re also bring additional market insights to ensure any decision-making is well informed during the execution process of transactions.

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The Gallagher Re team would like to thank Steve Hales, CEO at Resolution Life Re and Cyrille Strugarek, Head of Business Development – Reinsurance at Athora for sharing their perspectives on AIR with us.

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