



Counterparty Risk and the effects of regulation in structuring transactions

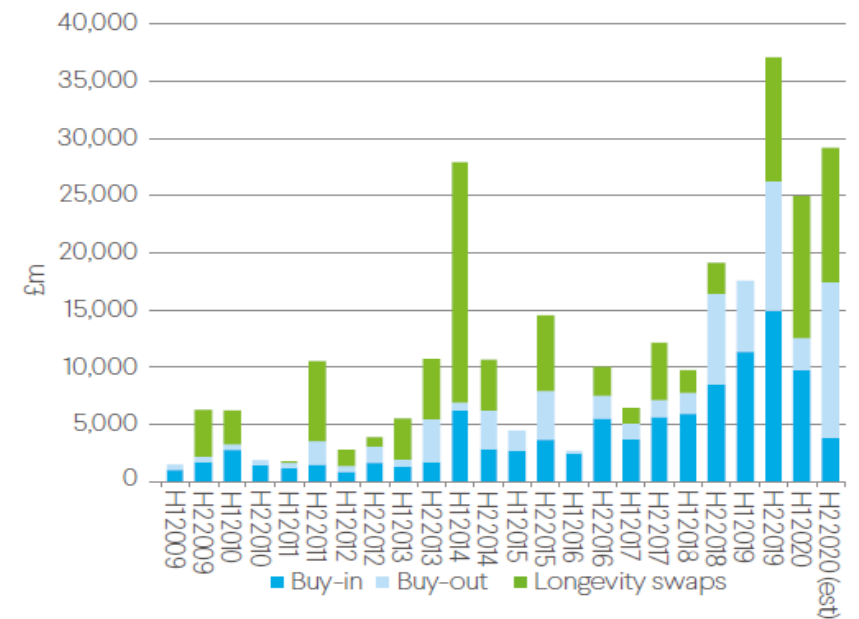
Author: Hamish Galloway
SVP Business Lines, RGA
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Longevity is a big market

Players are big, but deals are as well

- I will look internationally but there may be a UK bias
 - The UK is the most developed market
 - It is seeing these issues now
 - It is at the forefront of change due to the “opportunities” offered by Brexit
 - I live and work there
- In each market there are a limited number of companies
- Deals are big enough to cause significant counterparty risk
 - £3-10Billion not uncommon

Half-yearly risk transfers since 2009



Source – Hymans Robertson Risk Transfer Report 2021

Don't claim to have seen everything

But...

RGIA

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Omnilife

Reasons for Primary Market to Exist

Primary Market is Pension Fund De-risking

- Pension Funds' reasons are inter alia
 - Accounting Volatility
 - Risk Control
- Insurance Company's advantages are
 - Pooling Effect
 - Offsetting and Diversifying Risks
 - Risk appetite
- Insurance Market is backed by capital
 - But capital is expensive
- Further Primary Market is individual annuity sales by insurers

Reasons for Secondary Markets to Exist on Longevity

Secondary Markets are the Reinsurance and Retrocession markets

- Risk migrating to most capital efficient location
 - This is not Solvency II !
 - Risk Margin drives longevity risk out of Solvency II
 - Reinsurance is the conduit to this process
 - Reinsurers have similar offsetting and diversifying portfolios
 - US - no offset to capital requirements
 - Risk stays onshore
 - Little if any secondary market has emerged
 - Risk sharing and demographic pricing would be the drivers
 - In fact US insurers are significant buyers of longevity risk from elsewhere
 - Elsewhere in the world
 - Canada has a fledgling market
- RGAA** Many territories await enabling legislation

Reasons for Secondary Markets to Exist on Asset Risk

- Deals do exist
- Fewer regulatory advantages
- Reinsurers must work harder to get asset risk transferred
 - Illiquid and high yielding assets
 - Will have counterparty issues as we will see

Regulatory Framework

Solvency II type arrangements

- Insurer holds risk on (inter alia)
 - Investment
 - Demographics (augmented by risk margin)
 - Operational
 - Spreads
 - Counterparty

- Reinsurance swaps Demographic risk for Counterparty Risk
 - Counterparty risk is mild
 - Counterparties are generally well-rated and required capital generated is small
 - Counterparty Risk diversifies

Regulatory Response

Don't just think probability – think worst case

- Brings low probability, high impact events into regulation
- Survive worst case event
- Including Failure of your largest counterparty at an inconvenient moment
 - Risk falls back onto your balance sheet
 - Current losses plus re-establishment of capital position
 - Management actions and time is allowed
 - But consider feasibility and timescales in distressed environment
 - Recovery and Resolution Plan
- Increased Emphasis over past couple of years
 - Counterparty calculation now a common negotiating point in reinsurance treaties

Regulatory Response

Make insurer's own balance sheet more attractive

- Solvency II and UK
 - Recognition that Risk Margin is penal
 - Are MA and VA fit for purpose?
 - Various QISs in progress to address
 - Market in short term capital relief solutions in anticipation of long term capital changes
- US
 - Own balance sheet looks like most efficient capital solution
 - Reinsurers only competing on risk management and demographic assumptions

Implications for Reinsurance

Minimise the impact of reinsurer failure

- Various tools exist
 - Some in terms of reinsurance
 - Some in constructing the reinsurance program
- Collateral
- Diversification of Reinsurance
- External Guarantees - step into the shoes of main risk taker
- Recouping

Implications for Reinsurance

Collateral

- Protects against failure
 - Only called in adverse situations
 - Treaty terms should ensure it is kept up to date
 - Commercial tension between parties on recalculation
 - Generally covers surrender value
 - Initial premium if any
 - Variation due to experience

Implications for Reinsurance

Collateral 2

- Every enhancement has its cost
- Overcollateralisation
 - Haircuts etc
 - Collateral above current surrender value
- Contingent Collateral
 - Interferes with reinsurer's own risk management
- Restriction of assets
 - Controls what insurer gets back if reinsurer fails
 - On asset deals it is the asset mix that drives competitiveness
- Offset Longevity and Mortality Collateral
 - If insurer and reinsurer have relationship on both pieces of business

Implications for Reinsurance

Diversification

- Do not become over-dependant on one provider
- Panel of Reinsurers
 - Own panel or complied by lead reinsurer
- Diversify over time
- Have different lines of business reinsured with same reinsurer

Implications for Reinsurance

External Guarantees-step into the shoes

- Create panel of reinsurers willing to accept business from a defaulting reinsurer
- External Guarantees
 - E.g. Credit default swaps
- Route through one reinsurer into another
 - Effectively a credit wrap
- Cut Through to retrocessionaire

Implications for Reinsurance

Recouping

- If a swap gets out of line
 - Large collateral one way or another
 - Duration mismatched
 - Pay down collateral
 - Reset terms to something closer to now expected

Conclusion

- Deals in longevity are large enough to effect balance sheets
 - Either individually or in totality
- Situation is specific to each insurer/reinsurer relationship
- The counterparty situation will affect who is the best partner for each deal
- Reinsurers are working to facilitate deals to the satisfaction of all parties involved

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