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Risky Moves in the Game of Life Insurance

By MARY WILLIAMS WALSH APRIL 11, 2015

In July 2013, the smart money was saying the company that runs the Caesars and Harrah's casinos would go bankrupt, when a big investor, Apollo Global Management, offered a lifeline: It was willing to pump millions of dollars into the parent of the struggling casino company.

And where would Apollo get the money?

Not a problem. Apollo, which already had a big stake in Caesars, also had been building a life insurance division called Athene. That division was bursting with cash from the premiums paid by life insurance policyholders.

"Athene Life Insurance and Annuity Company has tens of billions of dollars under management," said Steve Pesner, a lawyer who took Apollo's proposal to the Nevada Gaming Control Board for approval. It could spare some to help Caesars, in exchange for a promissory note and some nonvoting stock.

"This is essentially an investment by Athene, indirectly, in Caesars," another lawyer for Apollo, David Arrajj, told the board.

State insurance commissioners are supposed to watch the premium dollars that policyholders send their insurers, making sure the money is invested safely so that policies can be paid out when the holders die. Investment-grade bonds are fine. But money for a troubled casino company? Controlled by the same giant investment firm as the insurer? That could be a

problem.

But the Nevada Gaming Control Board polices casinos, not insurers. It unanimously approved the transfer. This January, the operating company that runs much of Caesars went bankrupt. That does not mean that Athene will stop paying its claims tomorrow, but it suggests that something bigger is afoot — something that affects all American taxpayers, whether or not they buy life insurance.

Changing the Rules

The life insurance business is supposed to be dull — sell policies; collect premiums; salt the money away in the safest sorts of investments, mostly bonds; pay out benefits; and make money along the way by investing surplus assets prudently. No wild bets, no siphoning of assets, no off-the-books maneuvers.

This, at any rate, has been the idea since a crusading reformer named Elizur Wright set the standard 150 years ago and became America's first state insurance regulator, in Massachusetts.

Wright grew up helping his family shelter fugitive slaves; he went to school with John Brown, ran an abolitionist newspaper, and at age 40, visited the Royal Exchange on a trip to London. There, he saw feeble, penniless old men auctioning off their life insurance policies to speculators. After faithfully paying premiums all their lives, they were too old to work, but they could not withdraw their accumulated savings because, alas, they were not yet dead. Their best hope for survival was to parade their decrepitude and hope speculators would bet on their imminent demise.

To Wright, it was little better than a slave auction. Upon his return to America, he began campaigning for a cleanup of the life insurance business, setting a strict, even moralistic tone that persists to this day. He required insurers to pay "surrender values" to policyholders on request and to hold adequate reserves to do so. Seeing how easy it was to cheat, he devised formulas for calculating the reserves. He even invented a device called the "arithmeter" — a 30-foot slide rule, more or less, wrapped around a spinning drum — that crunched the numbers when the user turned a crank.

The companies bought in. Reform fostered trust, and trust spurred sales. Under the gimlet eyes of Wright and his successors, life insurance has blossomed into an $18 trillion business, with millions of policyholders who can sleep soundly on solvency laws as immutable as Newton's laws of motion: For every liability, there has to be an asset.

Or at least that's the way it may seem.

Over the years, life insurance has gone global and created products of dazzling complexity; many companies have gone public, too, creating shareholders who think they should have priority over all those pesky policyholders whose money built the business.

With these changes, a belief has taken hold in some quarters: Wright's principles may still guide us, but they are too old-fashioned. They force life insurers to hold more money than they need to — the way Athene Life Insurance was expected to sit on its millions when there were needy casinos to help.

You hear a lot about "redundant reserves" in the industry these days. Many companies would prefer to hold fewer of the stable, low-yielding assets required by law and use the extra money to pay shareholder dividends. Some also want to build more risk into their investment portfolios, in hopes of receiving the higher returns that Wall Street expects.

Policyholders may not perceive any of this. But regulators, perhaps paradoxically, are not only aware, but sometimes even eager to allow insurers to add leverage and satisfy their growing appetites for risk. The National Association of Insurance Commissioners, a 144-year-old support group for state regulators, still issues special reporting standards, called "statutory accounting," to help states enforce the law. But the states are also free to administer the rules as they see fit, and in recent years, this has often meant waiving certain rules. The waivers, called "permitted practices," can be worth a lot of money.

"Any state can deviate from statutory accounting," said Nick Gerhart, Iowa's insurance commissioner. "And states do deviate."

Inside the 'Black Box'

This might not be an issue, except that in recent years, more and more deviations have been granted. One maneuver known as "captive reinsurance" grew to $364 billion in 2012 from $11 billion in 2002, according to a Treasury Department report issued in 2014. The report said captive reinsurance exemplified one of the three most important types of risk to financial stability that emerged last year.

Here is how captive reinsurance works: A life insurer sells policies, creating long-term obligations. Then it packages the obligations and puts them into a wholly owned subsidiary, called a captive. The captive is said to have reinsured the obligations, meaning that it now has the duty to pay the future claims. The parent is no longer responsible for payment and no longer has to keep all those low-yielding bonds on hand to satisfy the liabilities.

You've heard of reinsurance; it helps companies spread out risk, which promotes stability. Reinsurance companies tend to be large, independent firms with abundant capital, able to evaluate the risks they take on. A captive reinsurer, by contrast, is just an appendage of its parent, taking over the parent's risks on the parent's terms. And the risks don't really change hands. Putting obligations into a captive and saying they are reinsured is a little like putting dirty laundry into a closet and saying it's being cleaned.

So why is this going on?

In its report, Treasury said the trend took off in the early 2000s, after the insurance commissioners association tightened certain reserve requirements. By law, life insurers must hold more than enough money to pay all future claims, and must calculate the amount needed the association's way. But captives can hold less — sometimes a lot less. Thus the deals free cash for other purposes, like paying dividends to shareholders.

As more and more money has flowed away from policyholder reserves and into the hands of investors, some state regulators have challenged captive reinsurance. New York State's superintendent of financial services, Benjamin M. Lawsky, has called the transactions "financial alchemy," because they can make money seem to pop out of thin air for insurance companies to grab.

Other states disagree. In an emailed response to questions, Mr. Gerhart of

Iowa called captive reinsurance “a pragmatic approach to address the nationally recognized problem of redundant reserves.”

The insurance commissioners association has been trying to put the genie back in the bottle, toiling over new rules that would limit captive reinsurance in the future. At a meeting in Phoenix last weekend, it formed a new working group, overseen by Mr. Gerhart, to study why captive reinsurance has now spilled over from life insurance into annuities, a popular retirement-planning tool. “Single-state solutions do not promote the uniformity that we have worked so hard to achieve in our financial solvency regime,” said Joseph Torti III, the Rhode Island insurance commissioner, who led the discussion. The 2014 Treasury report said that the multitude of “black box” deals was making it hard for policyholders, and investors, to find out an insurer’s true financial condition. In fact, it was sometimes even hard for state regulators to find out, the Treasury said.

But that’s not the case in Iowa. Not only does Iowa encourage the transactions, but in 2010 it enacted unusually open disclosure rules. In many states, and certainly in offshore havens like Bermuda, captive reinsurance is conducted under strict secrecy. But in Iowa, with a little sleuthing, it’s now possible to open the lid of the black box and peek inside.

Dealing in I.O.U.s

For years, Iowa has been working to make its capital, Des Moines, an insurance hub, with considerable success. Insurance now accounts for more than 24,000 jobs in and around the city, and for more dollars in the state economy than agriculture.

In 2006, a huge British insurer, Aviva, arrived in Des Moines, acquired an insurer based in Iowa and changed its name to Aviva USA.

Things seemed to go swimmingly at first. Aviva USA doubled the size of its local work force and spilled over into a handsome new office campus in the suburbs.

But then, in 2012, the British parent said it was leaving the United States. Aviva USA was put up for sale. Apollo beat out rival bidders by offering $1.5 billion. But it actually paid the British seller more than that, using about $2.2

billion of the target company's own money in the form of an "extraordinary dividend." By the time all the money changed hands, Apollo had paid only $400 million of its own funds for the prize.

Sending $2.2 billion to the British seller meant less money to backstop policies in the United States, of course. When asked about this in an administrative hearing on the acquisition, led by Mr. Gerhart, a representative of Athene testified that there was still enough money to keep the insurer well within the regulatory safety zone.

But that was with the help of captive reinsurance.

The details are complicated but can be pieced together from an outside auditor's report and regulatory filings that Iowa is making public for the first time. Here is the nutshell version: Apollo wanted only Aviva USA's annuities business, which it could reinsure through an affiliate in Bermuda. A spokesman said Athene provided $2 billion to the affiliate "to support the new risks it assumed." In addition, Apollo brought a second company into the acquisition, Accordia Life and Annuity. Accordia was a new insurer created by Global Atlantic, a Bermuda company controlled by Goldman Sachs. As soon as the acquisition closed, in October 2013, Apollo transferred the life insurance business to Accordia.

If Accordia followed the N.A.I.C. rule book, it would need about $7 billion in high-grade assets to secure the obligations. But it didn't have that much.

So instead, Accordia set up six subsidiaries to reinsure part of the business for less. Iowa granted a "permitted practice" exception, allowing i.o.u.s to back the obligations instead of the solid assets, like bonds, that the N.A.I.C. requires.

Public financial documents in Iowa show that Accordia followed a pattern set by Aviva. The company and its parent declined to confirm the details in those records or comment on the record.

Four subsidiaries, in Iowa and Vermont, were to serve as Accordia's reinsurers. Accordia sent them some bonds, but nowhere near enough to secure the $3.3 billion worth of obligations that they were to reinsure.

Two Delaware subsidiaries then issued the first four subsidiaries

contingent notes to fill the gap. Such notes are unsecured promises that Accordia, the parent company, would not be permitted to use. For example, one of the Delaware subsidiaries, named Tapioca View, issued a $499 million note to Cape Verity I, an Iowa subsidiary, which made it look as if Cape Verity I were flush. But if anyone looked closely, they would see that Tapioca View was just a shell, with no business operations, no revenue and no means to make good on a $499 million promise.

"Hollow assets" is the term New York's Mr. Lawsky uses for deals like this. But there is little a New York regulator can do when the transaction is in another state.

To bolster the credibility of Tapioca View's i.o.u., footnotes on financial filings show, Cape Verity I then issued a $499 million note of its own, and gave it to Tapioca View. Now, if people glanced at Tapioca View, they would see that it had some sort of asset to back up its promise of $499 million to Cape Verity I — except it was nothing more than a note from Cape Verity I.

To put it more bluntly than the footnotes do, the two subsidiaries were propping up each other's balance sheets with i.o.u.s.

"They're enhancing their capital and making themselves look good by using these exotic techniques," said Joseph M. Belth, a professor emeritus of insurance at Indiana University. "The whole thing is just a classic shell game."

To take it one step further, Cape Verity I called its note a "surplus note," a unique instrument that does not have to be recorded anywhere as a debt. Thus, without so much of a penny as real cash changing hands, Cape Verity I could claim nearly $1 billion: a $499 million note and $499 million of "surplus." All six subsidiaries passed notes back and forth in this way, making themselves look fit to reinsure $3.3 billion of Accordia's obligations. A footnote on each of the three Iowa subsidiaries' financial statements said that without the permitted practice allowing the notes, they would be insolvent.

But that information did not flow through to the parent company's consolidated financial statements. Accordia's statements showed it as financially sound.

In his written responses to questions about captive reinsurance, Mr.

Gerhart, Iowa's insurance commissioner, declined to discuss individual companies or transactions, but he said that his staff monitored all deals in Iowa carefully and would intervene if a problem arose. He also said that by opening up certain details of Iowa-based transactions to public scrutiny, Iowa had made it possible for interested parties to assess the risks.

"We wanted to bring transparency to these transactions," he said.

So, before you blame Iowa for playing fast and loose with the legacy of Elizur Wright, remember: Most states now allow captive reinsurance. So do the traditional offshore insurance havens like Bermuda. And most keep it secret. But Iowa has decided to stick its neck out and let people look at the deals, knowing full well that they might not like what they see.

The Tax Bill

Those of you who have never bought life insurance or an annuity may, at this point, be thinking: All these perplexing transactions, these assets that may or may not be real — aren't they all somebody else's problem?

Not entirely. You could still be liable if the N.A.I.C.'s old-fashioned formulas turn out to be right and insurers come up short at some point because they bestowed so much money on their shareholders. Mr. Lawsky keeps saying that captive structures remind him of the deals that proliferated in the run-up to the financial crisis of 2008. That ended in a giant taxpayer bailout.

"I really think what's going on now is bigger than anything I know of in the past," Mr. Belth said. He should know. As the author of the article "More Than a Century of Efforts to Weaken Life Insurance Reserves," he can compare today's captive-reinsurance phenomenon with other skirt-the-rules tactics dating all the way back to 1863.

American taxpayers are paying for captive reinsurance already, even without another cataclysmic bailout. Life insurance reserves are a business expense for the companies; as such, they are deductible from the insurers' federal income taxes. And the boom in captive reinsurance deals has led to billions of dollars of unpaid federal taxes.

The Internal Revenue Code says companies must use the National

Association of Insurance Commissioners formulas to calculate their reserves, and deduct that amount. Then companies do a second calculation of their reserves, which is smaller than the N.A.I.C. method. Accordia, for example, sent $3.3 billion of obligations to its family of subsidiaries, but secured only $1.7 billion worth with admissible assets. The tax code tells Accordia to deduct the entire $3.3 billion, even though the backstop it built cost just $1.7 billion. So its tax deduction was inflated by $1.6 billion.

At the top federal tax rate of 35 percent, this suggests about $560 million of taxes avoided.

Remember, Accordia is far from the only company using these techniques. Indirectly, invisibly, the taxpayers are shouldering the cost of these activities, through their taxes.

If the insurance commissioners association ever finds consensus, it may reduce some of the gamesmanship in the future. But it’s unlikely to require life insurers to unwind their existing reinsurance captives. Some analysts say that if the N.A.I.C. really does rein in captive reinsurance, the industry will just invent some new transaction, and the show will go on.

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