Principal Reinsures $25 Billion of Fixed Annuity and Universal Life Business

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On January 31, 2022, Principal Financial Group, Inc. (PFG) entered into an agreement with an affiliate of Sixth Street Partners (SSP) and its insurance platform Talcott Resolution (Talcott), to reinsure a total of $25 billion in policy reserves (and accompanying investments), which relate to fixed annuities and universal life insurance with secondary guarantees.

Details of the announced transaction, which is expected to close by June 30, 2022, include:

- PFG, through its subsidiaries Principal Life Insurance Company (PLIC) and Principal National Life Insurance Company (PNLIC), will cede $16 billion of fixed annuity reserves and $9 billion of reserves for guaranteed universal life insurance. The reserves will be assumed by Sutton Cayman, Ltd (Sutton), a Talcott-owned Cayman Islands reinsurer.

- Whole life, term life, variable universal life, indexed life, and non-guaranteed universal life insurance contracts issued by PLIC or PNLIC are not part of this transaction.

- The reinsurance arrangement will be structured as a coinsurance transaction, but on a "funds withheld" basis. Under funds withheld reinsurance, PFG's insurance subsidiaries will retain legal control of the policy liabilities and the assets the associated with the ceded business, though the economics related to the ceded business will be transferred to Sutton. Sutton will also carry capital in support of the reinsured business. Funds withheld reinsurance is common for U.S. insurers that cede business to foreign reinsurers.

- While the investments related to this transaction will be legally under the control of PFG's life insurers, SSP/Talcott will manage approximately $21 billion of the total $25 billion of investments related to the reinsured business, while PFG will manage the remaining $4 billion (largely in commercial mortgage loans and private credit assets) for at least five years.

- PFG expects the transaction will lead to $800 million in "freed" capital for its life insurers, but it will also result in a $189 million loss (recorded as a "negative" ceding commission).

- PFG will continue to provide policy service for the fixed annuities and universal life insurance, and existing policy terms and conditions are unchanged purely as a result of this transaction.

About Principal Financial Group

- The life insurance operations of Principal Financial Group, Inc. (PFG) are led by Principal Life Insurance Company (PLIC), which has an extensive presence in the small to mid-size group retirement market. PLIC was historically a significant issuer of individual life insurance and annuities as well, and to a lesser extent accident and health business (disability, vision, and dental insurance).

- PFG has another insurance subsidiary as well, Principal National Life Insurance Company (PNLIC), though PNLIC is a much smaller company and cedes 100% of its business to PLIC.

- In June 2021, PFG announced a number of significant changes to its business strategy[1] following a strategic review that was initiated earlier in 2021 and was spurred on by activist investors, most notably Elliot Investment Management LP.

- These changes included the cessation of writing new fixed annuities and guaranteed universal life insurance, and PFG also announced that the company would explore strategic alternatives for these blocks of business.

- The transaction with Talcott represents the completion of PFG's goal to reduce exposure to these businesses, as well as other strategic goals such as improving group return metrics and increasing shareholder returns.

- Going forward, PFG has stated its business focus will be on the U.S. retirement market, select emerging markets, global asset management, and U.S. specialty benefits.

About Talcott Resolution

- Talcott's business is concentrated on running blocks of life insurance and annuities in runoff, and the group has positioned as a solution provider for other insurance organizations in terms of capital flexibility and risk management efficiencies.

- Talcott is comprised of U.S. life insurance subsidiaries Talcott Resolution Life Insurance Company (TRL) and Talcott Resolution Life and Annuity Insurance Company (TRLAIC, which is directly owned by TRL), as well as newly formed reinsurance companies in Bermuda and the Cayman Islands.

- TRL and TRLAIC were previously the main U.S. life insurers of publicly traded Hartford Financial Services Group but were sold to a group of private investors in 2018. The Talcott group, including TRL and TRLAIC, was subsequently acquired by private investment firm Sixth Street Partners (SSP) in July 2021.

- TRL and TRLAIC historically were leading variable annuity issuers (both individual and group), and the companies also issued fixed individual and group fixed annuities, and individual life insurance. TRL and TRLAIC are presently in run off and have not issued new business for some time, and the companies sold (via reinsurance) their individual life insurance business in 2013 and half of their fixed annuity business in 2018.

- As mentioned above, Talcott recently established two reinsurance affiliates in Bermuda and the Cayman Islands, which are part of SSP's stated plan to deploy an additional $1 billion in capital towards growth initiatives.

- Talcott's reinsurance transaction with PFG follows its large reinsurance transactions with Allianz Life Insurance Company of North America (ALNA) and Resolution Life Group Holdings LP in December 2021, where Talcott (through its insurance subsidiaries) ultimately assumed $20 billion in fixed indexed annuity reserves from ALNA[2].

- Under Talcott's reinsurance transaction with PFG, Sutton Cayman, Ltd. (Sutton) will be assuming the entirety of the fixed annuities and guaranteed universal life insurance business from PLIC and PNLIC. As PNLIC cedes 100% of its business to PLIC, it appears that Sutton will be assuming this business via retrocession.

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[1] For further details, please see ALIRT's client release *"Principal Financial Exiting U.S. "Retail" Individual Life and Annuity Businesses"*.
[2] For further details please see ALIRT's client release *"Allianz Reinsurers $35 billion of Fixed Indexed Annuities"*.

Industry Trends

PFG's planned sale of its fixed annuity and guaranteed universal life business is the latest in a long and growing list of major transactions that have taken place in the life insurance and especially annuity industry over the last 12 years. The chart below includes a list of all of the organizations that have sold portions of (or their entire) U.S. life insurance and annuity businesses since the beginning of the 2010s.

AIG / American General Life	Hartford Fin'l Services Group*	Phoenix
Allianz	ING USA	Principal Financial Group
Allstate	Jackson National	Prudential Inc. (U.S.)*
Aviva	John Hancock / Manulife*	Prudential plc (U.K.)
AXA	Liberty Mutual	Sun Life of Canada
Equitable	Mass. Mutual Life	Symetra
Great American	MetLife	TransAmerica
Great-West	Ohio National Life*	Voya*

**More than one major transaction executed or announced*

The long-dated liabilities associated with many life insurance and annuity contracts are under pressure (from a profitability perspective) from the multi-decade fall in interest rates and investment returns, and as a result individual life insurance and annuities are out of favor with investors in publicly-traded life insurance groups. This has led to pressure from investors, as well as from insurer managements anxious to boost share prices. To this end, life insurance organizations have sought to reduce exposure to equity market and interest rate sensitive businesses, increase the capital efficiency of their businesses, pursue growth in other businesses that are less capital intensive and less sensitive to financial markets (property/casualty and accident and health insurance, group retirement and asset management, international operations, etc.), and perhaps especially boost cash return to shareholders in the form of share repurchases and/or higher stockholder dividends.

Other dynamics behind these divestitures include:

- Memories of the steep drop in equity markets during the financial crisis,
- High persistency of existing life insurance and annuity policyholders,
- Increased regulatory activity at the point of sale,
- Changing financial reporting and reserve requirements (both in the U.S. and internationally),
- Tepid demand for many of the industry's products through most of the 2010s.

As this has taken place, privately-owned organizations and/or asset managers have become increasingly interested in the life insurance and annuity business. This is due to attractive pricing of blocks of business, the industry's stable and relatively long-tail liability base, asset management opportunities, and the greater ease for privately owned companies to hedge equity market sensitive businesses (as compared to a public company that is required to report quarterly earnings results to investors). The entry of privately-owned firms and asset managers into the life insurance and annuity space has created a market of potential buyers, which provides the opportunity for existing firms to sell blocks of business and/or entire insurance companies.

Asset managers and private investment firms in particular have a dual opportunity for returns from insurance operations, both as owners and via investment management fees.

All of these factors remain in place and as a result it is possible that we will see additional industry changes and transactions in the months and years ahead.

Effects on Principal Life Insurance Company

- Virtually all the business being ceded in this transaction will come from PLIC, as any contracts issued directly by PNLIC are 100% reinsured to PLIC.

- At 12/31/20, PLIC held $11.2 billion and $3.5 billion in fixed annuity and guaranteed universal life insurance reserves, respectively. In addition, PLIC held $5.9 billion in individual payout annuity reserves (i.e. annuities that have entered the annuitization process) and ceded $5.4 billion of reserves related to guaranteed universal life insurance to its (multiple) captive reinsurers. This is roughly equal to the $25 billion amount mentioned in PFG's press release earlier this week.

- The business being reinsured by PLIC comprises about 30% of PLIC's total policy liabilities as of 9/30/21, and as a result, the financial and operational profile of PLIC will change significantly post transaction. This will include a change in PLIC's business mix toward a greater share of group annuity liabilities and a shift in the mix of life insurance to whole life and non-guaranteed universal life insurance.

- In addition, investment risks on the $25 billion of assets that support the ceded business will now reside at Sutton. However, as previously noted, the reinsurance will be executed via funds withheld reinsurance, and as a result the assets that support the policy reserves will remain on PLIC's balance sheet. Thus, PLIC will not report a large drop in assets following the completion of this transaction, and PLIC may report higher asset leverage and investment risk to surplus measures.

- However, the economics (spread, claims, policyholder behavior, and investment risks) for the fixed annuities and guaranteed universal life insurance will reside at Sutton.

- Capital management may become more aggressive for PLIC going forward, as part of the stated rationale for the transaction was for PFG and its insurers to focus on less capital sensitive businesses. Additionally, management stated that PFG's Board of Directors approved a $1.6 billion increase to the company's already approved $1.1 billion share repurchase authorization for 2022.

- The increase in share repurchases is expected to be achieved through improved earnings, a favorable macroeconomic environment, and the $800 million in capital generated from the reinsurance transaction with Talcott. This could result in continued and possibly larger than usual shareholder dividends paid by PLIC to PFG, at least over the near term.

- However, PLIC has long been a substantial payor of shareholder dividends, as PLIC paid $6.5 billion to PFG since the beginning of 2016. Despite the large dividends paid, PLIC's capitalization measures remained steady, bolstered by the company's strong historical earnings and returns.

- PLIC's earnings are also highly diversified, across the core group retirement annuity business, accident and health insurance (disability, vision, and dental), and the company's remaining life insurance lines (especially whole life and non-guaranteed universal life).

Effects on Policyholders

- As PLIC is by far the largest life insurer within PFG, PLIC was likely the issuer of most of the business to be ceded, though over the last decade or so most non-New York state life insurance was issued by PNLIC.

- PFG stated that it will continue to provide client service for the policy contracts that will be ceded to Talcott. We would expect that PLIC/PNLIC and Sutton will have regular "settlements" of claims, premiums, policy benefits, and other items, as is customary in any reinsurance transaction.

- As Talcott/SSP will manage the majority of the investments related to the reinsured business, there may be some changes in the composition of the assets backing the reserves previously controlled by PLIC. However, PLIC and Sutton will have an investment management agreement that will govern how the assets are to be managed (within certain guidelines). Also, as the reinsurance will be executed on a funds withheld basis, the composition of most of the investments (excluding the capital held by Sutton) will be reported in PLIC's regulatory financial statement.

- Finally, we note that the business being ceded ultimately remains the legal responsibility of PLIC and PNLIC, and Sutton were to become insolvent - or were otherwise unable to honor policyholder claims - the economic responsibility of the reinsured business would once again fall to PLIC and PNLIC.

Conclusion

PFG's decision to reinsure its fixed annuity and guaranteed universal life businesses with Talcott follows a strategic review and change in business strategy that were announced in 2021. The business being ceded represents a considerable portion of PLIC's outstanding business (and investments) and will lead to a significant change in the company's operating profile, as it will reduce the business scope of PLIC, the capital intensity of its business, and will somewhat reduce its exposure to the continued low interest rate environment. In addition, PFG announced that the transaction will "release" $800 million of capital, which will allow for proceeds for additional share repurchases by PFG, though PLIC and PFG will recognize a loss of $189 million from the transaction.

As the transaction will be executed on a funds withheld basis, PLIC will retain legal control of the assets and policy contracts, though the capital supporting the business will reside at the reinsurer. Thus, PLIC's total reported investments and liabilities may not change much, but capital may decrease (from higher shareholder dividends paid). This could lead to a deterioration in reported capitalization metrics, and somewhat overstated leverage and investment risk to surplus measures.

As for Talcott, the ceded business will reside with Sutton Cayman, Ltd., a newly formed Cayman Islands reinsurer. As Sutton is a foreign reinsurer, publicly available financial statements will not be available for this company which adds some difficulty in assessing the financial strength of the company going forward. However, the ceded business does have protections in the form of investment guidelines, as well as the overcollateralization of the coinsurance agreement via a supplemental trust. Additionally, the PFG insurers will retain legal control of the assets that support the reinsured business, and thus ALIRT (and others) will be able to observe changes in the composition in the investment portfolio (though the assets will be mixed with PLIC's remaining investment portfolio).

As Sutton is an affiliate of Talcott, the company's capitalization and financial strength may impact the financial results for TRL and TRLAIC. As such, ALIRT will continue to monitor the Talcott companies, especially under the new ownership of SSP and amid the reinsurance transactions announced over the last year (Allianz, Principal, and the assumption of a portion of new variable annuity business issued by Lincoln National Life).

As always, please contact us with any additional questions or concerns.

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