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SECURITIZATION OF LIFE INSURANCE

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Briefly describe the ideal situation or company business suitable for securitization.

The ideal business situations for securitization would be those where a company faces significant risks or has significant growth opportunities and where conventional sources of risk hedging or financing are not available or are too expensive. Ultimately, securitization should be able to provide hedging and/or financing that is more effective and less expensive than the alternatives.

For example, a life insurer with significant growth opportunities may find securitization appealing in comparison with more conventional financing techniques such as issuing equity capital, because securitization may have more favorable effects on the insurer's leverage, cost of capital and financial ratings.

Briefly discuss the primary differences between life and P/C Securitization.

In principle, securitization can accomplish the same objectives for both life and P/C insurance companies. However, to date most life and P/C securitization deals have served different purposes.

Most P/C securitizations have been focused on hedging the risks of property catastrophes such as hurricanes and earthquakes.

In contrast, most life insurance securitizations to date have been financing transactions rather than risk-hedging transactions, and many have been motivated by regulatory requirements. One important class of life insurance securitization has involved the financing of acquisition costs. Insurers that are growing rapidly due to new business incur upfront policy acquisition costs that can place a strain on statutory surplus. Through securitization, insurers can sell off the emerging profits from a block of policies to recover the acquisition costs and realize future profits which otherwise would take many years to recover.

The transaction thus can improve the insurer's leverage position and provide cash to finance additional growth.

Another class of life insurance transaction has been associated with demutualizations. For example, Prudential Financial executed a so-called "closed block" securitization in connection with its demutualization in 2001.

The transaction raised $1.75 billion by issuing notes to investors, with repayment of the notes to be funded by the emerging profits from Prudential's participating life insurance business.

The deal provided cash to be used by Prudential in expanding its other businesses.

Recently, at least one major life insurance securitization has taken place to provide reserve relief under the National Association of Insurance Commissioners regulation Triple-X requirement, and the first mortality-index bond was issued in December 2003.

The mortality-index bond was structured similarly to a P/C CAT bond but is designed to protect against adverse mortality trends.

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For both life and P/C insurance, most securitizations to date have been fully funded, i.e. they have involved the issuance of asset-backed securities. However, there have been a few transactions that involve call or put options which are not funded in advance. It remains to be seen whether the volume of option transactions will increase in the future or whether insurance securitizations will continue to be mainly asset-backed transactions.

What risks, in your view, are ideal to try to securitize? Which risks will prove to be more difficult to securitize?

The risks that are ideal to securitize are those that are relatively easy to quantify and also are transparent to investors. Catastrophic property risk falls into this category because there have been major advances in catastrophe modeling over the past 15 years that have enabled modelers to quantify the risk.

Life insurance mortality and longevity risks also are ideal for securitization. However, it is generally the case that transparency for investors is enhanced when the securitized risks are based on a readily observable index rather than on the results for any specific insurer. But basing the results on an index means that the payoff from the securitized instrument is not perfectly correlated with the underwriting results of the issuing insurer, creating a type of risk known as "basis risk."

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One of the challenges in future securitizations will be to create securities that are transparent to investors and reduce the basis risk inherent in indexed securitizations. This is an area where reinsurers can play an important role by creating portfolios of reinsurance policies from primary insurers and using securitization to transfer risk to the capital markets and manage the basis risk.

With life insurance products becoming more complex, and hence riskier, how do you manage the growing number of risks?

The asset-backed securities market in general has proven to be very efficient in dealing with complex transactions such as commercial mortgage cash flows that are subject to various types of economic risks. Insurance transactions are in principle no more complicated than many other asset-backed securitizations. One way to deal with complex products is through tranching, i.e. the creating of different classes of securities with varying degrees of seniority and risk exposure. Tranching has not yet been fully exploited in the insurance securitization market.

How have regulatory changes or interpretations affected securitization possibilities?

One of the most important regulatory decisions affecting securitization is the decision to allow reinsurance accounting treatment for indemnity securitizations. Indemnity securitizations are those that pay off based on the insurer's own loss experience rather than on an index. At least one recent life insurance securitization involving Triple-X reserves has been given reinsurance treatment by the regulators. Although the NAIC is studying the possibility of giving reinsurance treatment for indexed securitizations, currently it is uncertain whether such transactions will be treated as reinsurance for regulatory purposes.

What could hinder further development of the market?

Adverse regulatory, accounting or tax rulings are the principal threats to the securitization market. For example, denial by regulators of reinsurance accounting treatment could create serious problems for securitization. Accounting rule changes requiring the consolidation of special purpose reinsurers (SPRs) for GAAP accounting purposes also would hinder the market as would any adverse rulings involving the taxation of special purpose reinsurers or the deductibility of risk premiums paid by insurers to SPRs.

How do you factor the lack of pricing transparency into the securitization?

Clearly, achieving pricing transparency is one of the challenges that must be overcome if securitization is to continue to grow. However, it is worth keeping in mind that there have been some very successful transactions that have been quite complex, including Prudential's closed block transaction and a recent transaction involving insurance subsidiaries of Barclay's Bank.

In such cases, the lack of transparency is often overcome by using credit enhancement mechanisms to provide further guarantees to investors. These can involve third-party credit wraps or internal credit enhancements such as over-collateralization. These mechanisms also have been used successfully in other complex securitizations involving other types of asset-backed securities. It is also possible to use tranching to create classes of securities that have high transparency and relatively low risk to appeal to conservative investors while creating other tranches of securities with low transparency and higher risk that appeal to investors who have informational advantages enabling them to undertake the higher risk classes of investment.

What is required to make securitization a successful risk transfer option?

Continued evolution of the insurance-linked securities market will require insurers and investors to gain more familiarity with insurance-linked securities. Insurers need to develop confidence that securitization has an important role to play as part of their risk management and hedging strategies and to develop more experience in working with insurance-linked securities. Investors too will need time to become familiar with these relatively new investment vehicles. Continued innovation by reinsurers and investment bankers to create transparent securities with lower transaction costs also will be important to the future development of the market.

How do securitization transactions affect the income statement and balance sheet? What kind of revenue recognition do these deals receive?

Properly structured securitization transactions can have favorable effects on the balance sheet by reducing required reserves and enabling insurers to recover prepaid expenses and emerging profits. Such transactions thus have the potential to reduce leverage by decreasing liabilities and increasing equity capital. Risk premiums paid to special purpose reinsurers and expenses incurred in structuring securitized transactions are deductible for tax purposes.

In the case of risk hedging transactions such as CAT risk and mortality risk bonds, the release of funds from the SPR on the occurrence of the covered event provides funds needed to pay losses and thus prevents financial dislocations and potential ratings downgrades.

Securitization thus has significant potential to maintain and enhance the financial health of the issuing insurer. ✷

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PROPERLY STRUCTURED SECURITIZATION TRANSACTIONS CAN HAVE FAVORABLE EFFECTS ON THE BALANCE SHEET BY REDUCING REQUIRED RESERVES AND ENABLING INSURERS TO RECOVER PREPAID EXPENSES AND EMERGING BENEFITS.