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ON THE PATH OF SECURITIZATION

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The Setting

Since the early 1990s, regulators and industry representatives have worked at trying to devise a reasonable approach to reserving for life insurance products with limited level premium guarantees or no-lapse guarantees. We have evolved from unitary reserves to Regulation Triple X reserves, through modifications under Actuarial Guideline 38, and now on to the 2005 CEO Compromise amendment to AG38 which sunsets in 2007. Already in the works is a proposed "Interim Solution" to set reserving standards starting in 2007, which would stay in effect until principle-based reserving becomes a reality. However, until principle-based reserves arrive, we will continue to live in a rules-based reserving world where the rules result in statutory reserves well in excess of what anyone today would consider economic reality. The problem then becomes how does one insulate their company from the financial affects of these non-economic reserves so that the company can continue to offer products that are economically attractive.

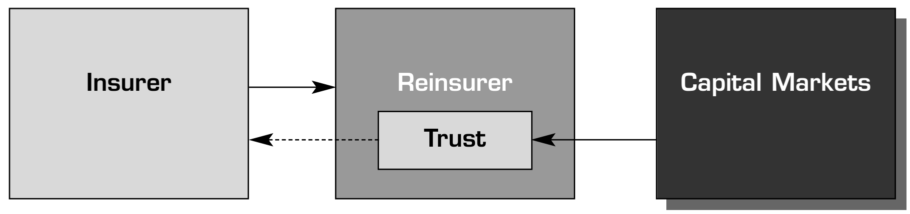
The historic solution sets have tended to rely on conventional reinsurance and, in the case of no-lapse guarantees, perhaps some creative policy design. Neither of these approaches are problem free. From the reinsurance perspective, the historic reliance on letters of credit is raising some issues regarding pricing risk and capacity. And regulators' reaction to policy design ideas, as evidenced in the debate leading up to the 2005 CEO Compromise amendment to AG38, certainly has put a damper on this approach to addressing the high level of reserves on policies with no-lapse guarantees.

New Alternatives

So the industry is looking for new alternatives for dealing with these non-economic sources of capital strain. Banks have been anxious to step into the fray here. A number of banks are offering multi-year letters of credit—something that three years ago would have been unimaginable. Moreover, they are more frequently available not only with current-issue dates but also with future dates to create a synthetic LOC that's even longer term.

Capital market funding of reserve credit trusts is also beginning to attract attention, with contingent funding, direct funding and securitization being seen as popular variations. All of these structures follow a model similar to Figure 1. The insurer originates the risks and cedes it to the reinsurer, the reinsurer establishes a reserve credit trust for the benefit of the insurer, and the capital market provides the funds to be deposited into the trust.

Figure 1: Basic Capital Market Solution Model



Determining the Deal Structure

A key issue here is deal structure. What will the capital market see when it looks at this structure? Whose credit risk are they seeing—the reinsurer's, that of the reinsurer's parent or affiliate, or some other party's credit exposure? From the standpoint of the parties involved, what are the impacts on their financial ratios? How does it affect metrics such as debt/equity leverage or spread-products exposure? Is the deal structured to be on- or off-balance sheet? What is the line of recourse? Bottom line, if something goes bad whose funds will fill the hole?

Figure 2 on page 32 shows a typical securitization structure. A parent owns both the reinsurer and the insurer in the transaction. In addition, there's an issuing vehicle, the capital market and a guarantor.

In this structure the reinsurer issues surplus notes to the issuing vehicle, the issuing vehicle uses those surplus notes to collateralize a debt offering to the capital market, and a guarantor guarantees to the capital market that the debt collateralized by the surplus notes will in fact perform. In this structure the capital market will see the credit rating of the guarantor, but also knows that behind the structure are the surplus notes whose repayment is dependent on the performance of the business within the reinsurer. This model is a classic non-recourse structure.

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Figure 3 involves a rated affiliated holding company serving as the issuing vehicle. As with the earlier structure, surplus notes are issued by the reinsurer but now instead of using a monoline's credit as a guarantee, the capital market looks to the credit strength of the affiliated holding company. This structure is recourse and carries the rating of the holding company.

A little twist on the structure involves a situation where the reinsurer is downstream from a special-purpose holding company and the holding company issues debt to the capital market (See Figure 4 on page 33). This could be done without a guarantor but more typically would involve one since the effort to get the holding company rated may not be wholly worthwhile.

The basic difference is that this model does not involve issuing surplus notes. The special-purpose holding company issues debt and the reinsurer has a capital-dividend relationship with the holding company. Probably the biggest advantage of this structure is the switch to dealing with regulatory rules for dividends and capital, as opposed to those for surplus-note treatment.

Establishing the Reinsurance Company

Other considerations involve how the reinsurer will be organized. The most common approach today is to form a captive reinsurance company. Hawaii, South Carolina, and Vermont are common onshore jurisdictions, while Bermuda, the Cayman Islands, and Ireland are common offshore places for incorporation.

Figure 2: Typical Securitization Model

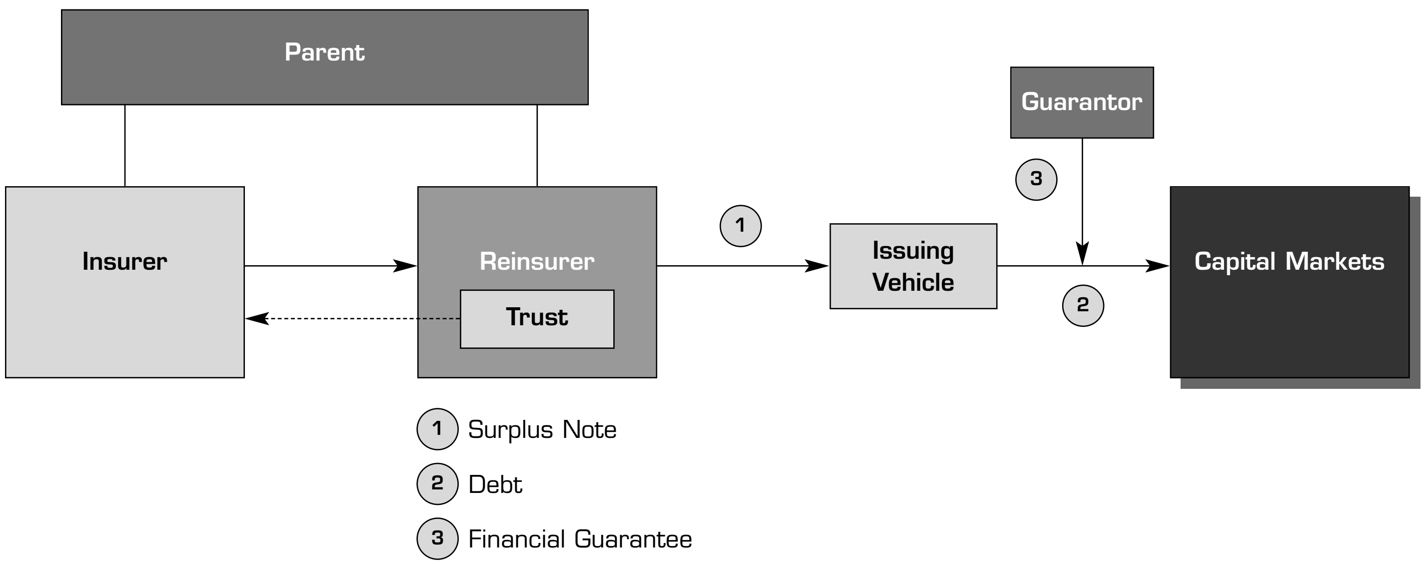


Figure 3: Securitization Using Rated Affiliate

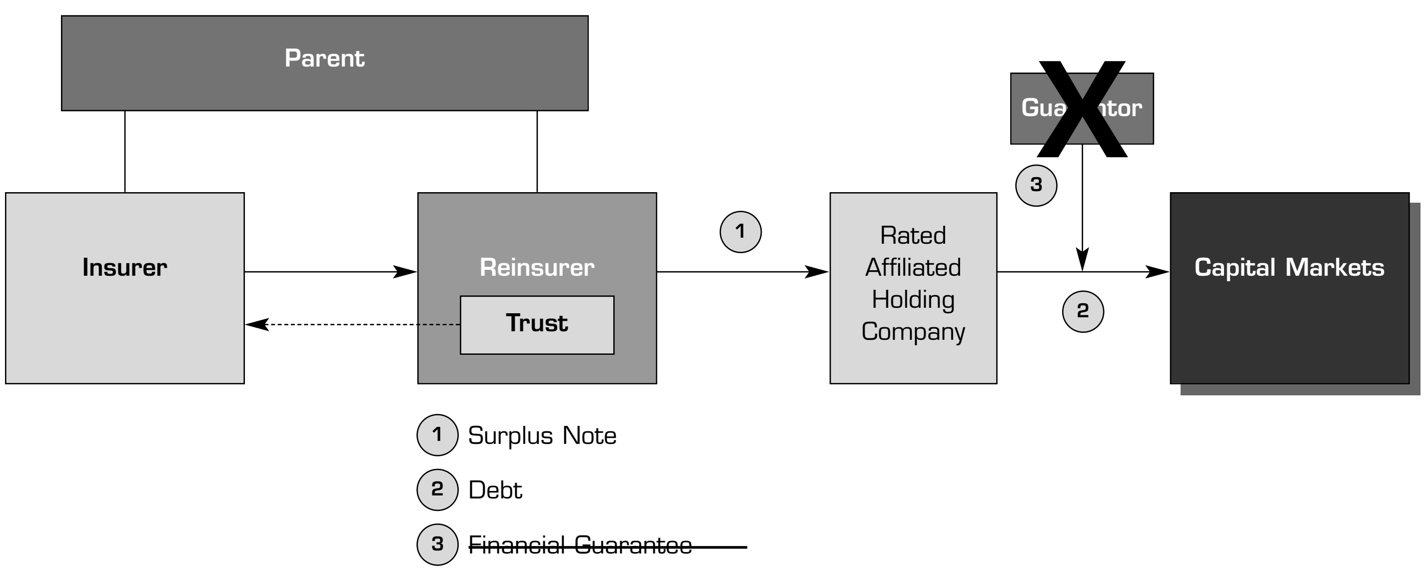
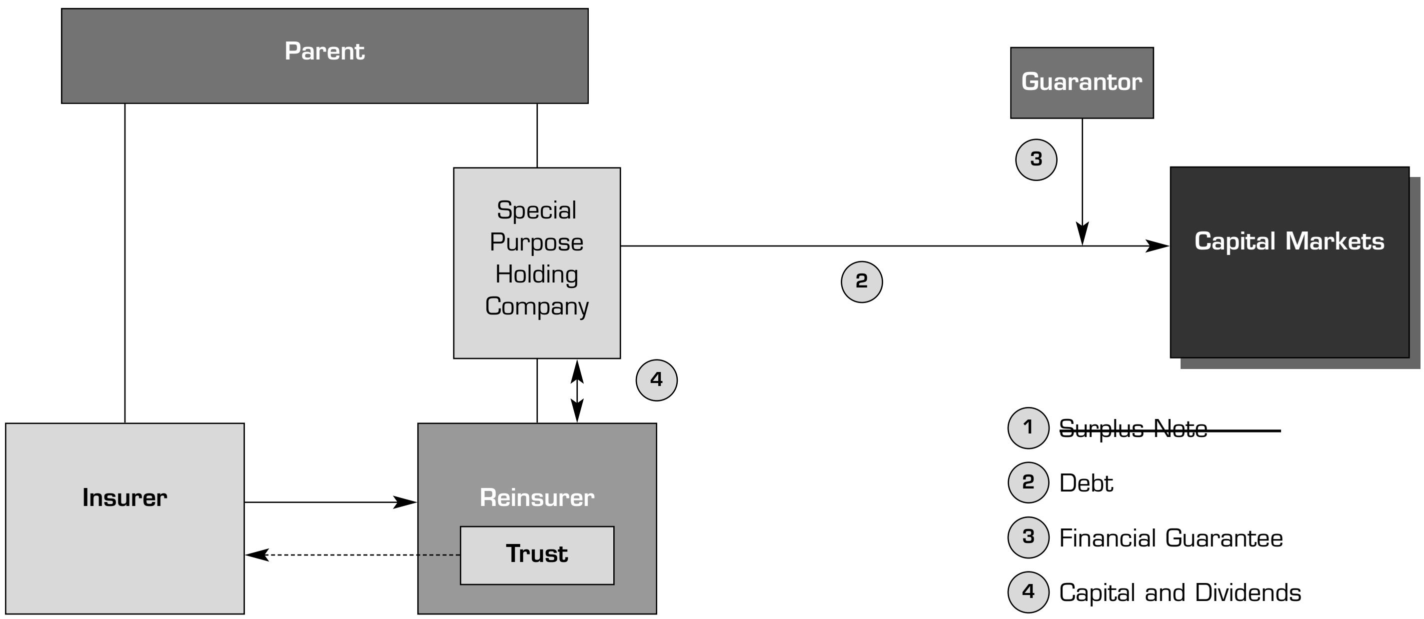


Figure 4: Downstream Reinsurer Securitization



An important consideration in making this choice is tax treatment. Management should consider not only where the reinsurer will fall within the organization from a capital and ratings standpoint, but also consider which tax group it will join. They should also consider what accounting basis they will adopt for the company to make sure that the anticipated tax effects will actually come about.

Securitization—The Advantages

Why is securitization so attractive? Securitization using surplus notes and a monoline guaranty is one of the few non-recourse approaches to addressing non-economic capital strain. In this case the guarantor is on the hook in the event that poor performance from the underlying block of business prevents expected debt service payments.

Securitization also offers financing for the entire size and life of the reserve hump. Some early transactions have funded the reserve buildup incrementally, issuing layers of debt as the reserves built up. Other approaches fund the entire reserve hump up front, in essence prefunding the ultimate strain. This offers the advantage of simplification, reducing the number of offerings required over time. However, it carries the risk of resulting in more funding than is actually necessary and increasing the overall cost of the deal.

Securitization—The Disadvantages

But securitizations are not a panacea. Securitizations involving surplus notes and guarantors are time intensive. As more transactions are completed, as the underlying blocks of business get better understood and as the requirements and deliverables are better defined, execution time will in all likelihood shorten. But currently nine to 12 months is still a reasonable target.

Securitizations are also difficult to manage due to the number of stakeholders involved. Figure 5 on page 34 lists a sample of these parties and their numbers. Each of these groups will enter the transaction with their own agendas and mandates, and their own sense of where the risks are—both with respect to the deal as well as to their professional duties to their clients. Managing these agendas to a common end can become a little arduous, particularly since many of the parties are not comfortable with insurance risk—certainly not as comfortable as professional reinsurers are.

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Figure 5: Parties Involved (Other than the Insurer and Capital Market)

Party Involved	# of Teams
Investment Bankers	Usually one
Ratings Agencies	At least two
Regulators	At least two
Guarantors	Usually one
Consulting Actuaries	At least two
Underwriting Consultants	One
Attorneys	At least three
Accountants	At least two

With all of these parties and the time it takes to execute these deals, execution risk also becomes a notable factor. A company can get fairly well down the path and discover that, for one reason or another, it no longer makes sense for its particular situation. The path to successful execution is not always obvious up front.

Because of the large fixed costs involved, having a sufficient volume of business available to put into the structure is important. If a company does not have critical mass, it must consider if and how it can accumulate a sufficient volume out of several years' issues and both the financial and mortality risks of doing so. Even after the securitization, the insurer needs to consider what to do with mortality exposure in excess of its retention, remembering that the external parties do not like to be exposed to risk.

A final consideration before proceeding with a securitization is the insurer's ability and willingness to provide documentation and data on processes for and controls over sales, risk selection (including exceptions), pricing, premium collection, claims settlement and experience studies. The guarantor and its advisors will want to see evidence (data) that the business has the characteristics and is of the quality that management has described ("show me, don't just tell me").

The Role of the Independent Reinsurer

Recall that all of these transactions have the same basic pieces to them—the insurer, the reinsurer and the capital market. There is no reason why the reinsurer cannot be independent of the insurer. In fact, there can be some advantages.

The professional reinsurer is in the position to aggregate business to critical mass. So for companies with smaller books of business, the reinsurer has the opportunity to pool that with others to build a sufficient volume of business to support a securitization.

In addition, the professional reinsurer can convert a potential on-balance-sheet issue to an off-balance-sheet solution for the insurer. They also may be able to provide better support for assumptions by virtue of their position with respect to multiple blocks of business. Unlike some of the other parties in the transaction, the professional reinsurer is in the risk business and is accustomed to evaluating, pricing and holding risk.

By translating the capital support need into a reinsurance solution, the professional reinsurer transforms the insurer's execution management to simply that of a reinsurance transaction. The more uncertain execution risk associated with providing reserve credit security passes to the reinsurer.

Conclusion

The path towards securitization as a solution for redundant reserve strain really has only just begun. The key argument for pursuing securitization usually involves separating the financing need from mortality risk transfer and focusing on the most efficient solutions for each.

The opportunities that securitization promises to provide are truly impressive for both insurers and reinsurers, but it will be some time still before all of those promises become a reality for all companies. As it stands today, there is still a premium to be paid for being one of the first companies to execute these transactions, limiting its scope to only the largest of companies. And the jury is still out on how future regulatory or accounting changes may affect the future attractiveness of securitization.

In the meantime, the industry still has a demonstrated reliable solution in the form of reinsurance. It is in the best interest of all parties for the reinsurer to clearly explain to its clients all the advantages and risks associated with tapping the capital market, and work together toward solutions that meet the client's current and future needs. ✷

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