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## SECURITIZATION OF ASSETS

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- o With the advent of securitization of policy loans, there is movement to securitize other insurance company assets and receivables. Investment bankers, commercial bankers and consultants are pursuing this effort.
  - Securitization of assets:
    - Objectives and benefits of securitization
    - Legal and accounting structures for securitization
    - Securitization of mortgages, auto loans, credit cards etc.
    - Asset-backed securities market
    - Securitization of policyholder loans
  - Securitization of insurance premiums:
    - Description of the product
    - Enhancing statutory surplus
    - Is it debt or reinsurance?
    - Economic comparison to reinsurance
  - A consultant's perspective:
    - Securitization versus reinsurance
    - Accounting issues
    - Regulatory issues
    - Commercial banks versus investment banks
    - Strategic issues
  - What's next?

MR. ALAN R. BADANES: Every successful life insurance company has to deal with the problem of maintaining its statutory surplus at a time when its sales are increasing.

For stock companies, surplus can be raised directly by a stock offering. More commonly, a noninsurance parent company will raise funds through debt and downstream the funds. If funds are downstreamed via a surplus note, the life company gets the surplus benefit of an equity investment while retaining the tax-deductible interest benefit of debt. Among the disadvantages of this approach is an increase in the company consolidated debt, which will ultimately affect the cost of all corporate borrowings.

As for surplus notes, because of regulatory restrictions, they are used almost exclusively between affiliated companies. They are of little value to mutual companies (except to capitalize their own subsidiaries). Another option, surplus relief reinsurance, is probably the most popular tool for meeting temporary surplus needs and is well known to the readership.

I would like to describe four alternative tools that accomplish similar results. I refer to these alternatives as "the sale of statutorily undervalued assets." Such transactions include the sale of agents' debit balances, or the sale and leaseback of real estate or furniture, fixtures, and equipment. These techniques involve the sale of a nonadmitted asset and do not require a favorable reserve adjustment to achieve the desired surplus enhancement objective. Recently, a few

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companies have sold an asset, future profit loadings, which have heretofore had no recognition for statutory accounting purposes. This type of transaction has come to be known as "deferred acquisition cost financing" or "securitization of policy loads."

The Chase Manhattan Bank is one of a very small group of financial institutions active in developing such innovative financial solutions for the life industry. Chase's approach has been to use many of the techniques used in another banking product -- project finance. Project finance has traditionally been understood to mean nonrecourse finance of a specific project, typically making use of a special purpose vehicle. The benefit to the users of the product is to transfer the financial risks of the project to other capital providers, avoiding the need to expose all of the corporate cash flow and assets to the risks of the project. The classic example of project finance is the production payment financing deals done in the petroleum industry. Initially used in the development of the North Sea oilfields, production payment financing essentially allows the oil producer to finance the development and production of proven oil reserves on a project-by-project basis, without co-mingling the project risks. An important feature of production payment financing is the necessary reliance by the capital providers on the opinion of a petroleum engineer as to the adequacy of project cash flows. This type of conceptual structure and nontraditional credit analysis provided the framework for us in approaching the life industry (and in the process we saw the need and hired an actuary).

Among the transactions which we have done we believe three are particularly noteworthy. In 1987, we developed deferred loan financing for Monarch Capital Corporation. This transaction involved a group of banks, organized by Chase, purchasing a stream of cash flows from Monarch on a limited recourse basis. These cash flows represented the deferred loads owed to Monarch by policyholders of its single premium variable life product. In 1988, Chase purchased certain asset charges from the distributor of mutual funds on a fully nonrecourse basis. This was a transaction in an industry with many parallels to the insurance industry. Finally, in 1989 Chase arranged another bank group to finance the levelization of a large life insurance company's commission obligations. Once again this transaction was completed on a fully nonrecourse basis.

This last transaction, levelized commission finance, does not represent the purchase of profit streams or any other hidden asset. Rather, it allows an insurance company to postpone the payment of an expense. The ultimate obligation to pay the expense is fully contingent on persistency levels. The insurance company has no obligation to the bank(s) and has not guaranteed the obligation of any third parties. Its only obligation is to make renewal commission payments such payments now having been "factored" to the bank(s), as and when it collects renewal premium.

The result of levelized commission finance is to take the insurance company out of the agent financing business. Financing the heaped commission, heretofore done by insurance companies, has been done at an ever-inflating cost to the companies. Insofar as commission levels are similar in percentage terms today as they were 25 years ago, the secular upward trend in interest and lapse rates over this period has increased significantly the real commission cost to the company. As in tax rates, this inflation trend may be referred to as "commission creep." Of course, levelized commission finance does not solve the problem, but at least it puts this issue on the table and may focus more attention on the subject leading ultimately to some form of true level commission scales removing the role of the financial intermediary entirely.

**MR. DANIEL D. OLSON:** Actuaries have an important role to play in the financial management of their companies, and securitization is one area where they have much expertise to offer. However, since securitization raises issues of financial and corporate strategy that are much larger than technical expertise, I ask you to approach the whole subject with an open mind that is not limited by narrow definitions nor the debate in the insurance press.

I was invited to discuss a securitization transaction which Citibank recently completed. But first, I want to share with you the perspective Citibank brings to this type of transaction. Financial institutions, especially those that many people used to call commercial banks, have financed and/or purchased receivables from corporate customers for centuries. With this purchase, a company is able to complete its production cycle by receiving cash for one of its most liquid assets -- the receivable. Banks solved a timing problem for the customer and provided it with cash -- or working capital -- to grow. Citibank believes insurance companies are really not much different

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than industrial companies in this respect. In fact, their production cycle is so long that it takes more than a year before the sale is profitable.

Several decades ago, the automobile finance and banking industries developed agreements whereby the banks would purchase car loans, a long-term receivable. This transaction gave the seller cash and, because the agreement was structured as a sale, removed the asset from the books of the seller and improved leverage. As a result of these and other early securitizations, the banking industry has developed norms which govern, among other things, structure, risk transfer and pricing. Citibank has designed its general securitization products to fit within these norms and our insurance securitizations require only slight modification.

The insurance industry's largest receivable is its premiums and as it happens, the accounting asset -- the premium receivable -- bears no relation to the size of the future cash collections. As actuaries, you realize the value of this "receivable" is significant; but, the accounting profession does not because the collection of cash is uncertain as to amount and to timing. By selling some part of the premiums, the company is able to realize a certain amount and a certain timing. It is also able to use the cash proceeds to begin anew the production cycle.

Citibank recently began to purchase insurance premium loadings, defined as the difference between the gross premium and the net valuation premium. We focused on loadings to avoid compromising the safety of the reserves set aside for the policyholder. In the pool of purchased receivables, we included the loadings from products such as whole and universal life. The purchase of deferred loads, which are part of annuities and single premium products, is essentially the same although easier to accomplish because of the policyholders' contractual responsibility to pay these loads and the existence of surrender charges.

The analysis of loading risk differs slightly from other receivables. Typically, purchasers analyze default experience to determine the value of the receivables they buy. The approximate equivalent for loadings is lapsation. The analysis of lapse risk is the most difficult part of the transaction since it models many different product types in many different scenarios. Further, our analysis must include a business and interest rate environment that, for the last ten years, is unlike any the industry has experienced. Citibank is constantly refining its ability to analyze the risks of lapse, but we can comfortably say that, if we used techniques developed in 1988, we would have lost money in the early 1980s if we had purchased the loadings in 1979. As a general rule, the amount of risk transferred from seller to buyer must be consistent with the uncertain environment and the price paid for the receivables.

As a side note, one of the harder aspects of most insurance asset securitizations, including premium loading sales, is developing a useful information base. Citibank finds that, compared to companies in other industries, insurance companies do not normally create the information needed to manage receivables effectively. Without historical data collected consistently, neither the buyer nor the seller can efficiently value the receivable; data presented in the statutory statements provides limited usefulness. Because our purchase of these receivables is made with recourse only to the pool of receivables and not to the seller, the importance of utilizing reliable information to get the best value for the assets is understandable.

The benefits of asset securitization are considerable. In the micro sense, you can manage your production cycle so that there is working capital for continued growth. A sale of premium loadings should result in additional surplus since the sale is without recourse to the seller, it guarantees a minimum value to the receivables and the liabilities are still contingent. Unlike reinsurance, there is no counterpart risk and the seller receives cash. Finally, compared to reinsurance and other forms of capital, a premium loadings sale is significantly less expensive.

Needless to say, a significant development, such as purchasing loadings, usually draws some criticism. This is healthy as long as that criticism is analytical and not emotional. Just like the regulators, bankers are concerned about the profitability of the industry as well as new products. We would not purchase receivables from any company if we felt it was writing unprofitable business to the detriment of its long-term viability. Because we view the cash proceeds of a loadings sale as equivalent to equity capital, we believe the seller should earn equity returns. In today's market, this is 16-18% for the average insurance company. Clearly you can't earn that rate merely by reinvesting the proceeds in most financial investments. You need to use the capital to write profitable new business.

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In fact, asset securitization is helpful both to regulators and consumers in that it brings new capital to the industry as well as allocates that capital to better run companies. Efficient capital markets tend to provide capital to companies that earn good returns on capital. Because securitization usually allows the seller to remain the servicer of the receivables, the buyer bears some of the seller's risk. Therefore, the seller's long-term credit standing is very important. Over time, this allocation will be consistent with the efficient allocation of capital within the industry, the health of the industry and the safety of policyholder benefits.

I began my remarks asking you to avoid narrow definitions of securitization. I would like to finish with an idea as to how securitization is important in two areas of your business not related to existing assets or products. As you consider new products, begin to apply the concepts of securitization to provide features which the capital markets will find attractive. The "securitization principles" of product design mean you should recognize the value investors see in your receivables; isolate that value or cash flow; standardize the cash flow so investors can value it; and realize the value by selling it to the capital markets investor. In this process you are no different than Citibank with its credit cards or General Motors with its auto loans.

A broader perspective also allows you to view your entire company as an asset that can be securitized. This results in what I call "expense securitization" -- doing well what you do well and letting someone else do the rest. For example, late last year Merrill Lynch announced it was going to let third-party vendors bid on a contract to manage its telecommunications network. Merrill believed those vendors provided an equivalent service for a cheaper price. In effect it realized it did not have to self-manufacture this service and management could concentrate its resources and capital in more productive areas.

In conclusion, securitization will be an important part of the insurance industry in the future, just as it has become important to the banking, thrift and finance industries. The capital markets will provide capital efficiently and will also help regulators allocate resources effectively for a healthier industry. Your role as actuaries is important for two reasons: providing the technical advice that is part of a receivables sale and advising management on the effective use of new capital.

MR. ARNOLD A. DICKE: On their way to Vancouver, three people were sitting together on a train. One was a banker, another was a consulting actuary and the last was a regulator. To pass the time, the three were looking out the window when they saw a flock of sheep. The banker immediately remarked, "There are black sheep in the province of British Columbia." The actuary gave the banker a withering look and said, "If you look closely, in that flock of sheep only one black sheep is visible. All you can really say is, 'There is at least one black sheep in the province of British Columbia.'" At this, the regulator looked at both of them. With a weary but patient voice, he counseled: "You both must learn to express yourselves with more accuracy. The only statement which is currently permissible is this: there is at least one sheep in British Columbia of which at least one side is black."

That's one story that fits this group. Another concerns Norbert Wiener. I've made a habit of telling Norbert Wiener jokes at actuarial meetings because he seems to have affected people in much the same way as actuaries do. Norbert Wiener was the quintessential absent-minded professor who wrote the book *Cybernetics*. He was a real mathematician who nevertheless liked to delve into lots of other areas.

One of the stories told about Norbert Wiener concerns the proof of a very difficult theorem which he was going through in class. Frequently, his sentences would begin: "Now it is obvious . . ." There was one step in the theorem that puzzled a certain student. The student raised his hand and said, "Sir, is that step really obvious?" Professor Wiener turned to the blackboard and looked and looked and looked and did a few calculations on the side of the board, did a few calculations on a pad of paper and so on, until 20 minutes had passed. At this point, he turned to the class, looked the student in the eye and said, "Yes, it's obvious."

In many ways, these stories represent the way that people have been approaching asset-based transactions: it seems obvious to certain people that this clearly is one kind of animal while it seems obvious to others that it is another kind. No one, I think, is consciously biased. However, our judgment is inevitably colored by our point of view.

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For a consulting actuary, the problem is that we don't have just one point of view. We have many different clients and all of them have different points of view which we must temporarily adopt. I will consider some of these points of view and the different advice that the consultant might give to the corresponding client.

First of all, there is the point of view of the purchaser of the assets (if you think of this as a sale) or the lender (if you think of it as a loan). Generally speaking, this party is referred to as the transferee -- the person to whom the rights are transferred. On the other side of the transaction is a person, the Chief Financial Officer (CFO) perhaps, representing the seller or transferee of the assets. Third, a stock analyst might have an interest in this transaction if he or she is following the insurance industry. Regulators would have an interest in the impact these transactions might have on the opinion expressed by valuation actuaries while a rating agency wants to understand how such transactions affect the ability of a company to pay claims, now and in the future.

Let's look at each of these potential clients, one at a time. From the point of view of the transferee or purchaser of the asset, the critical thing is to assure that the desired mix of risk and return is actually achieved. If you were to be retained as a consulting actuary to help a purchaser of these assets, what would you talk to them about? In most of the current transactions, risk transfer is fairly minimal because of guarantees and because some of the transactions are over-collateralized, i.e., the fair market value of these assets (or the present value of the cash flows that are involved) is greater than the consideration that was paid. But in the future you may expect that the purchaser is going to have to take on more risk in order to obtain regulator assent to the idea that the transaction creates surplus for the transferee. Some regulators are taking the position that some degree of risk ought to be present if surplus is going to be created; otherwise the transaction might be considered some form of recourse borrowing, for example. So, in the future you might expect asset-based transactions to involve a higher level of risk. Managing this risk is something the purchaser of these assets might be looking to a consulting actuary to help him with.

On the other hand, the CFO of the seller or transferee wants to minimize the cost of capital. There are a lot of ways to raise capital. A stock company could receive an equity contribution from its holding company which could, in turn, raise the capital via debt. In fact, the business of levelizing commissions can be done in this way, too, utilizing a subsidiary of a holding company. Retained earnings are, of course, another source of capital. A lot of questions relating to the rights of participating policyholders in a mutual could be raised. Nevertheless, retained earnings represent another way that growth can be financed. In addition, financing can be accomplished through reinsurance, and it now appears that, perhaps, asset-backed transactions may be a viable approach. So, for the CFO, the idea is to find a way to compare the costs of these different methods of raising capital.

The stock analyst wants to value a life company's stock correctly and thus, if a transaction has been entered into, the analyst wants to know how the consideration that was paid relates to the value of the pledged assets. In a certain sense, an asset-based transaction can be thought of as a divestiture. Thus, the analyst might ask: Was the right price paid? What kinds of rights were received in return? And, regardless of legal status, should this sort of transaction be considered to be debt in some form when debt-to-equity ratios are calculated?

The last is a very fundamental question. Debt-equity ratios are used to help determine whether a company can handle the strain of rapid growth. If the example showing a zero cost of capital is true, asset-backed transactions would permit very rapid growth.

Is this growth going to be healthy for the company in the long run? This must be one of the questions that a stock analyst has to ask.

State regulators have the job of protecting policyholders of all companies -- so when regulators adopt rules they must feel the rules will work for the weakest companies as well as stronger companies. Because of this, regulators need to ask if a company's balance sheet is really improved by asset-based transactions. A lot is made of the fact that cash is received. But if no risk has been transferred, the regulator might well ask whether the long-run outlook for the company is really any better. Has the company mortgaged its future? Is the net result of the transaction to pay out all the future profits (or even more than the future profits) of the company now, allowing these profits to be squandered? If such transactions are used to support increased growth, how

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will the new level of sales be maintained after the proceeds of the transaction have been dissipated?

Another issue of a different sort should concern regulators: do these transactions allow banks to enter the insurance or reinsurance market without authorization (and perhaps in violation of laws that are on the books)? Such considerations might be behind some of the pronouncements that have been made by state insurance departments.

Finally, regulators must consider the rights of policyholders and other parties if an insolvency should occur. The stream of loadings has been "sold." Will these loadings nevertheless be available to satisfy policyholder claims if the company experiences financial difficulty?

The valuation actuary, like the regulator, has the job of protecting policyholders, but in this case the job is to protect the policyholders (as well as the management and board) of a particular company. In contrast to the regulator, the valuation actuary isn't ordinarily asked to look at the surplus of the company, but rather is asked to give an opinion about the adequacy of the reserves. A transaction which results in putting money into surplus isn't going to increase the likelihood of a favorable reserve opinion. On the other hand, from a valuation actuary's point of view, there is no such thing as an off-balance sheet risk. Anything that might happen in the future is something the valuation actuary needs to take into account. Thus, the valuation actuary is more concerned about the long-term changes in net cash flow than about the immediate receipt of statutory surplus.

Rating agencies are new players in the life insurance game. Claims paying ratings are becoming more and more important for insurers, and consulting actuaries are getting calls for advice as to what would improve or help maintain a company's rating. On the other hand, rating agencies themselves occasionally retain actuaries. Suppose a rating agency has retained a consultant to help it determine how to evaluate the impact of asset-backed transactions. What kind of questions might the consultant raise in this case? The rating agency wants to get the claims paying rating right, and this means that it wants to provide prospective policyholders with a measure of the relative security that various companies may provide. In other words, if there are two companies, one that does an asset-based transaction, and another, essentially identical, that does not, has the relative security of these companies changed? Is one now a better bet than the other? How do both compare to a third company which effects similar funding with reinsurance?

All the points of view listed above could belong to clients of a consulting actuary. When a client retains an actuary, the actuary is not being asked to give accounting advice (dealing with formalized sets of rules specifying the treatment of these transactions in published financial statements) or legal advice (regarding the rights of different parties). Rather, he is being asked for actuarial advice. To give such advice, the consultant must apply actuarial techniques. Actuaries typically like to start with cash flows, trying to look through all the legal and financial form into the substance of economic reality. So the first question is: In what way are the cash flows affected? To answer this, various kinds of asset-based transactions must be distinguished.

The sale of loadings has been mentioned prominently here. For this type of transaction, it's the insurance cash flows that are affected. A lump sum of cash is received currently, and future cash flows are reduced by the excess of gross premiums over net valuation premiums.

Another type of transaction is the factorization of commissions. Usually, this involves setting up some sort of special purpose corporation which may be either related to the insurer or not. Level commissions are paid by the insurer to the special purpose company, which in turn pays heaped commissions to the agent. The special purpose corporation, of course, needs financing. This may be supplied through ordinary borrowing from a bank. Since the special purpose corporation is not an insurance company, long-term debt counts as capital. (Of course, it does not count as equity and so the effect "washes out" for the downstream subsidiary of an insurance company.)

For a factorization transaction, cash flows must be monitored for both the insurer and the special purpose corporation. The insurer pays leveled commissions, so insurance book profits become flatter -- a smaller outflow at issue, smaller gains in future years.

For the special purpose corporation, cash outflow is heavy at issue and must be financed. The leveled commission stream should be sufficient to cover the debt service. However, this

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commission stream is subject to the risk of policy lapsation, which in turn is affected by economic conditions.

For example, suppose a transaction requires that principal and interest be paid back over a period of time from policy loadings, defined as gross premiums less valuation net premiums, but at a given time the loadings that are available from the remaining policies are insufficient. What does the transaction provide in this case? Is the payment period going to be extended? Also, are there any guarantees or options available to the lender which could act to terminate the transaction and cause repayment? All such circumstances need to be understood in order to accurately model the post-transaction cash flows.

There are many ways to categorize these sales or transfers. One important way to categorize them is by what the transfer purports to be, sale or debt. This categorization is very important to accountants working under GAAP rules. However, for actuaries the formal designation has very little impact. We don't generally worry too much about what something purports to be; we try to look through the form into the economic reality.

Transactions may also be categorized as recourse or nonrecourse. In general, transfers such as we have been discussing can be categorized as sales with and without recourse and debt with and without recourse.

To understand these distinctions, let's first ask: What would a pure sale be? For me, a "pure sale" would be a transaction in which my payback function is well-defined in its entirety and I, as the purchaser, receive whatever cash flows are specified as long as they continue and, therefore, have both upside and downside potential relative to the value I placed on the transaction at the time it took place. On the other hand, a "pure loan" or "pure debt" would be a transaction in which the payback function is a prespecified dollar amount representing debt service -- the payments are scheduled and have to be made when due or else default will occur.

There are many, many forms of transactions that don't fit either of these "pure" categories and are in some way "mixed." There are different possible ways of determining "recourse" in these transactions. For example, FASB 77 is a ruling that deals explicitly with transfers with recourse. In FASB 77, a sale is defined to be without recourse if there are no calls and no puts and the seller's obligation can be well-estimated. In effect, neither party can terminate or reverse the transaction at will, plus (and this should be interesting to actuaries) the value of the obligation under the transaction has to be capable of being estimated fairly accurately. Apparently, a sensitivity analysis must be performed, and there exists some so far undefined level of sensitivity which, if exceeded, creates recourse.

There are other ways of defining recourse. One approach would be to list explicitly the provisions that create recourse. Some of these will appear obvious and some not. For example, accountants typically take guaranteed maturity to be an indication of recourse. Overcollateralization is also typically seen as an indication of recourse. Overcollateralization can take various forms. All, however, have a similar economic reality in that there is some way to go beyond the initial market value to tap another value that is stored some place or other in the originating company. Holdback reserves also may create recourse. In this situation, the entire purchase price isn't paid at once; part is paid later on a contingent basis. To complete my list, consider transactions with senior and junior participation in which one class of participation receives preferential access to the cash flows. In this situation, if both levels of participation are sold, we have a nonrecourse transaction, but if the seller retains the junior participation, we have a recourse transaction.

From the actuary's point of view, of course, cash flow is primary. I have defined pure sales and pure debt based on the degree of transfer of cash flow contingencies. There can be mixed transactions in which these cash flow contingencies are neither fully transferred nor fully retained. Let me call a transaction debtlike, if, for all scenarios, there is some interest rate at which the proceeds are essentially equal to the present value of the paybacks. The idea is that if the repayment, including specified interest, is actually made in full for all scenarios, then the transaction is debtlike. An equitylike transaction is one for which there is at least one scenario such that the initial proceeds received by the transferee exceed the payback; in other words, there is a chance for the lender or buyer to lose some of its principal.

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Another aspect of these transactions (which apparently is important to regulators) is subordination. Normally, subordination would mean that payback is made only after the current claims of policyholders on the cash flow are taken care of. I use the word "claims" to mean not just insurance claims, but claims of any sort, including the setting up of reserves. Another form of subordination is specified in the insurance laws of various states. Surplus notes represent debt in which payback is subject to various conditions related to statutory surplus. These conditions vary from a requirement that payments cannot be made if surplus is thereby reduced below its level at the previous year-end to a rule requiring each and every payment to be preauthorized by the insurance department. In some ways, subordination is the reverse of recourse because the policyholder in effect has recourse back to the collateral in times of bankruptcy.

Let me return to the list of potential clients I started with. Given the differences in their points-of-view, what kind of advice might a consulting actuary give?

When advising the purchaser of the assets, naturally the actuary would look at lapse and mortality risk. More subtly, the actuary would have to take account of the fact that unbundling can sometimes mean mismatching. Consider the policy loan transaction that was discussed by earlier speakers. If you look closely, you realize that separating the payment of policy loan interest and principal from the other cash flows of the insurance policy actually creates two mismatched cash flow streams. Scenario testing is obviously critical. More generally, I'd ask the purchaser why it thinks it can do a transaction which seems similar to a reinsurance transaction at such a different price.

Anyone advising the CFO of a seller should counsel caution as regards the regulatory reaction to the transaction. In addition, when comparing the cost of various methods of raising capital, the actuary must be very concerned to get apples-to-apples comparisons. For example, all tax effects must be included. The analysis should focus on the seller's own cash flows including the impact on reserves -- i.e., it should focus on flows into and out of free surplus. Often, if you look at the purported cost of borrowing you don't get the full picture. The best approach is to take a set of cash flows that is all-inclusive and calculate the net present value. The only accurate way to compare the various options is to compare these net present values. For example, the receipt of cash at inception could actually increase the cost of a transaction. This will occur if you're not able to earn your hurdle rate when you invest the cash.

A stock analyst would also be interested in determining the actual cost of capital for these transactions. A lower cost of capital presumably means increased value. Stock analysts should be aware of the fact that the accounting profession is studying certain financial instruments as well as off-balance sheet financing. They must consider what will happen in the future if the accounting treatment changes for these transactions. Also, full acceptance of these new financing techniques could allow easier takeovers of insurance companies. Naturally, this would impact stock prices. To gain perspective, however, it might be asked whether these techniques have any inherent advantages over leverage provided through a holding company.

Regulators have various concerns relative to asset-backed transactions. In New York, the regulator's concern was with proper accounting. The New York department has come out with a circular letter expressing a very negative point of view. According to the circular letter, many of these transactions create liability. This might not be true of the factorizing of commissions, but it's certainly true of the sale of policy loadings. In Illinois, the department appears less concerned with formal rules of accounting, but wants assurance that policyholders are protected against any recourse from the buyer of the assets.

Transfer of risk is something that may be important to regulators. Generally, transfer of risk seems to create a favorable attitude toward surplus creation. However, if risk is in fact transferred, one might ask: Is this actually reinsurance, and if so, do the participating banks have to be authorized reinsurers?

If I were consulting with an insurance department, I might ask if these transactions could be handled by applying surplus note regulations. In other words, the transactions could be allowed to create surplus if they were subordinate to the same degree as surplus notes. This approach could be more acceptable than, but just as effective as, a simple statement that a liability must always be booked.



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Now let's take the valuation actuary's point of view. Valuation actuaries are involved in doing cash flow projections under various scenarios and some of the cash flows are always functions of the economic environment connected with the scenario. I think for a valuation actuary the right approach to asset-based transactions is to include the payback function in the cash flows, modeling all its contingencies and all its functional dependencies. Of course, the proceeds are not part of the analysis. The proceeds have been added to surplus, but they are not part of the future cash flows which are being modeled. The only way that they would become so is if a liability has to be set up. In the latter case, I think the right thing to do would be to test the adequacy of the assets backing both reserves and the required liability. If, however, you're only required to set up reserves and are not required to set up a liability for the asset-based transaction, then I think you have to include the payback in the modeled cash flows to make sure there is adequate provision for payback within the reserves. If not, you would have to increase the reserves, setting aside, in effect, some of the initial proceeds.

Another interesting question for valuation actuaries is this: suppose some of these transactions require a lump sum payback at some point in time. Would it be reasonable to assume that you could refinance it with a similar transaction in the future? Could you, in effect, assume reinvestment by the financial community in the asset? I think it might be reasonable to do this if the market for asset-backed transactions got to be more robust; i.e., if such transactions prove to be ordinary everyday occurrences.

From the point of view of a rating agency, the impact of an asset-based transaction depends on the utilization of the proceeds. Most rating agencies focus on surplus, earnings and the overall strategy of the company. So, the questions that a rating agency might ask are: What are the proceeds being utilized for? Should target surplus formulas be affected by this transaction? Will unhealthy growth result from the transaction? Could unprofitable lines be disguised by these types of transactions?

One potential client that I didn't list before is the chief executive officer. Some of the questions that a CEO might ask are important for the whole industry. For example, what are the overall strategic implications of asset-based transactions? Certainly there are short-term advantages, but what are the long-term implications? If an easy way of financing becomes available, are there takeover implications? In fact, is lack of financing the reason for the fragmented insurance industry that we see today?

What about the implications for growth and, in a mutual company, what about the implications for equity? Can each generation of policyholders now be asked to fund itself, and has the whole necessity of funding one generation by another now disappeared?

Should the proceeds of any asset-based transaction be used for the general purposes of the company or in fact should those proceeds, particularly if realized on participating policies, be returned to the policyholders as a dividend? In fact, if these transactions are readily available, do policyholders have the right to demand that their company do a transaction and return the value that is outstanding to them in a big lump sum dividend?

These are the kinds of questions that I think a consulting actuary could run into if asset-based transactions become well established. I expect to hear a lot of discussion of these issues over the next few years.

