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Session 115PD
Credit Enhancement of Guaranteed Investment Contracts and Funding Agreements

Track: Investment
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Recorder: VICTOR MODUGNO

Summary: Several mono line financial guarantee insurers are providing triple A wraps for GICs issued by life insurers, usually through separate account structures. These guarantors are also wrapping secondary GICs owned by GIC managers for 401(k) plans. In this session, panelists provide an overview of structures used for credit enhancement of GICs as well as an understanding of how financial guarantees work in the GIC market.

Mr. Victor Modugno: I have been involved in several of these programs in my current position at Transamerica Asset Management. We have a distinguished panel with a representative from a financial guarantor, a bank, and a rating agency.

The most common form of credit enhancement of GICs today is from mono line financial guarantors, the municipal bond insurers. There are four major firms remaining after recent mergers: MBIA, AMBAC, FGIC, and FSA. Our first speaker, Carl Favelukes, is a director in the Structured Finance Division of MBIA. He is responsible for marketing and structuring financial guarantee insurance transactions

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Editor's Note: This is not a true transcript of this session due to poor tape recording.

with insurance companies and other MBIA clients. He is also responsible for MBIA's GIC wrap transactions with stable value managers. Carl came to MBIA when they purchased CAP-MAC last year. Prior to Cap-Mac, Carl was with Citibank. Prior to that, he worked for Coopers & Lybrand. Carl has an MBA from Columbia University and is a certified public accountant.

Carl will speak about both primary and secondary GIC wraps. A secondary wrap is used when a GIC Manager owns a GIC that he wants to get out of. Perhaps the credit has been downgraded or he has taken over a fund with a credit that he doesn't like. Instead of trying to cash out the GIC or sell it in the secondary market, the most cost effective solution may be to buy a wrap from a bond insurer. The two largest programs are the MBIA/SunAmerica and the AMBAC/Transamerica program with a $1.5 billion limit. Under the SunAmerica program, the separate account structure is rated triple A and the investors get a ratings letter for GICs issued from the separate account. Under the Transamerica program, a separate financial guarantee contract is issued with each GIC issued from the separate account, under which AMBAC irrevocable guarantees payments due under the GIC. MBIA has both types of programs, and so Carl can discuss both approaches. The Transamerica/AMBAC program is also unique in focusing on the municipal reinvestment market, although it does have other investors, while the other programs focus on the stable value market.

These wrapped separate account GICs have assets held in an insulated separate account guaranteed by a triple A financial guarantor and an unrelated double A insurer. To me this appears to be much stronger than an unsecured contract issued by a triple A company. Yet the acceptance of these programs has been surprisingly slow.

Our next speaker is Jim Peterson. Jim heads up capital markets at the New York branch of Bayerish Landensbank (BLB). He handles securitization and structuring for the bank and its clients. Prior to joining BLB, Jim worked for Laughlin, in Portland, trading GICs. BLB is an agricultural bank of the German State of Bavaria and has triple A ratings. Jim will be discussing credit enhancement using trust structures, such as the BLB ARMs structure (BRAVO Trust), where triple A notes were issued by a trust that purchased GICs from ARMS (at that time a triple B mono line GIC company). Jim will also be talking about other programs, such as euro-MTN programs. Here the rating of the insurer is passed through to the purchaser of the trust notes. Jim will also comment on current market conditions. Given the recent turmoil and widening credit spreads.

Last, but not least, is Pat McWeeney. Pat is a director of insurance ratings at S&P. She heads up the separate account unit, which develops ratings for derivative

products companies, structured life companies, muni-GIC underwriters, and wrapped GIC providers. Pat specializes in A/L management and derivatives used by life companies. Prior to joining S&P in 1993, she worked for MetLife as a portfolio manager. Pat also has an MBA from Columbia University. In addition to commenting on what the other speakers have said and giving a rating agency perspective, Pat will discuss structured GIC companies. This includes life companies such as the SunAmerica AAA company and structured and parent supported companies that are common in the muni-GCI market, such as Solomon's Sarco, Lehman's ARCO, and FGIC's Trinity Funding.

[Recorder's note: The tape recording begins at the end of the second speaker (Mr. Peterson). The part of Mr. Peterson's speech that was recorded was very poor. Both Messrs. Favelukes and Peterson's presentation were extracted from their slides in outline form]

Mr. Carl E. Favelukes:

Introduction
- August 1995 NYS Insurance Department ruling permits mono line credit enhancement of GICs-Circular Letter 13
- Strong and lasting impact on stable value market
- MBIA (CapMAC) completes first GIC credit enhancement transaction for SunAmerica Life Insurance Company
- GIC WRAP® activities
- Broad application to stable value market

Credit Enhancement
- Used successfully to place debt obligations and GICs
  - Increases safety of an obligation by raising its rating to triple-A
  - Increases liquidity, while providing attractive yields
  - Increases pool of institutional investors willing or able to invest
- Only financial guarantee insurance is applicable to the stable value market

Mono line Financial Guarantee Industry Background and Evolution
- Municipal Bonds
- Securitization-Asset-Backed Structures
- Non-Traditional Applications

MBIA Insurance Corporation
- Rated triple-A by Moody's, Fitch, S&P

- Largest triple-A rated financial guarantor focused primarily on municipal and ABS market
- Write to a zero-loss underwriting standard

GICs/Stable Value Products

- Newly issued GICs or Funding Agreements
- GIC WRAP® program: already issued, GICs
- Synthetic GICs
- Muni GICs

Objectives of Credit-Enhanced GICs

- Mitigate large exposure to any one name
- Rebalance portfolio and achieve more desirable credit rating distribution
- Mitigate perceived impending loss
- Insurance protection

Synthetic GICs

- Credit wraps may also be used in conjunction with synthetic GICs to achieve a desired triple-A rating for the total structure, if all elements in the structure are not rated triple-A
- MBIA has guaranteed a $500MM synthetic GIC program for a major bank wrap issuer (1997)

Newly Issued GICs

- General Account GICs
- Separate Account GICs
- Synthetic GICs
- Muni GICs

Benefits

- To issuers:
  - broaden customer base
  - enhance market acceptance and attractiveness
- To employee benefit plans:
  - diversification
  - triple-A ratings

Results

- Financial guarantee industry results:
  - MBIA has done five of the six credit enhanced separate account and synthetic GIC stable value programs done by the industry to date

  - Industry wide structured stable value programs in excess of $4 billion
  - GIC WRAP® and similar programs
- U.S. Asset-Backed Securitization Market
- New Issue Municipal Bond Market

Financial Guarantees
- Value-added, expanding credit enhancement technique
- Widely accepted by capital markets investors
- Virtually free of event risk
- Popularity of financial guarantees is increasing
- Circular Letter 13 expanded use of financial guarantee insurance in stable value market
- Benefits stable value issuers, pension and savings plans

Mr. Jim Peterson:

Introduction to Bayerische Landesbank
- Currently one of the 40 largest banks in the world
- Current asset of over $225 billion globally
- New York branch has assets of approximately $30 billion
- Principal Bank for the Free State of Bavaria
- Central Bank of the Bavarian Savings Banks
- Provide a full range of banking products to public, corporate, institutional and private clients in Europe
- Provide a full range of commercial banking products in the United States
- Highest Ratings from all major rating agencies, AAA/Aaa/AAA S&P/Moody's/FitchIBCA
- Bayerische Landesbank is committed to providing securitization services to the insurance marketplace
- Bayerische Landesbank believes that securitization and capital market funding technologies will be used by insurance companies on a broader and more frequent basis
- Increasing assets under management
- Increasing fee based business
- Capital formation
- Risk transfer, sharing and or management:
  - In response, Bayerische Landesbank is expanding its securitization capabilities in terms of staffing and products
  - Focus on high-quality, client driven transactions
  - Provide comprehensive (one-stop) structured finance solutions

General Paradigm of Structures

- Funding through a special purpose vehicle (SPV) can have any (or all) of the following advantages:
  - Diversification
  - Access to new markets
  - Access to new client bases
  - Lower costs of funding
  - De-linking of credit quality between company and issuing entity
  - Reduce capital requirements

Discussion Transactions

- Euro-medium term note funded by an investment agreement
- Asset-backed commercial paper conduit funded by an investment agreement.
- Credit enhanced asset-backed commercial paper conduit funded by an investment agreement.
- Credit enhanced asset-backed commercial paper conduit funded by a synthetic investment agreement.

(1) GIC Backed Euro

- Medium-term note program
- EMTN result:
  - New source of funds for insurance company by accessing the EMTN market
  - The market can be accessed opportunistically by the insurance company
  - No credit enhancement
  - No delinkage between insurance company and EMTNs.
  - Most U.S. insurance companies do not have significant market presence in the European markets

(2) ABCP Conduit

- Conduit Result:
  - New source of funds for insurance company by accessing the ABCP market
  - Funding can be increased and decreased by the insurance company
  - No credit enhancement
  - No delinkage between insurance company and CP
  - Minimal liquidity requirement
  - Insurance company has 5-day liquidity risk

(3) BRAVO Credit Enhanced ABCP Vehicle

BRAVO Result:

- Immediate funding source for insurance company
- Partial de-linkage of funding source and insurance company

- Long-term liability for insurance company
- Funding off "short-end of the curve"
- Mechanically intensive internal credit enhancement
- Sample transaction

(4) Credit Enhanced ABCP with Synthetic Investment Agreement

Contract Features:

- The insurance company is the "named" investment advisor (can name sub-advisor).
- Investment portfolio managed to pre-determined guidelines
  - Credit quality
  - Duration
  - Issuer and industry concentration
  - Key contract features
  - Reset mechanism
  - Looks like conventional "synthetic GIC" reset formula
  - Appears to conform to NAIC Synthetic Contract Model Legislation
  - Initial indication from counsel is that the contract would qualify as an insurance product as a "Synthetic Funding Agreement"
  - Results of sample transaction
  - Immediate funding source for the insurance company
  - Portfolio is funded through an SPV.
  - Insurance company "synthetically" owns a portfolio of securities.
  - Assets are owned by the SPV
  - "Off balance sheet" for statutory and GAAP purposes
  - Reduced regulatory capital attraction due to reduced credit risk
  - Economics of the portfolio are transferred back to the insurance company through the Coupon Guarantee.
  - Long-term liability for the Insurance Company
  - Credit enhancement is a familiar insurance product
  - Credit quality of the portfolio is partially supported by guarantees from the insurance company and Bayerische Landesbank

Advantages To The Insurance Company:

- Business diversification
- Spread income generation
- Capital efficiency
- Long-term business
- Business block is not credit sensitive

Discussion Issues
- Funding
- EMTN market
- ABCP funding
- Third-party conduit vs. proprietary conduit
- A1+/P1 or A1/P1
- Tax and accounting issues
- Withholding taxes
- Priority of liability in capital structure
- Credit enhancement
- Internal vs. External

Ms. Patricia Mcweeney: Actually, I'm going to give you a little more detail on what both Carl and Jim have gone over. The Bravo trust was an Integrity deal, and it was a complicated deal.

Before I start on what's going on in the insurance market and structured deals Jim was talking about, it's interesting to note that for years banks have been using the structured technology to help take credit off their balance sheet or to create capacity. Insurance companies really didn't have a need to do those kinds of things and didn't use structured technology very much. The other complication with an insurance company, which raises difficult issues, is the state regulator. When you're doing a structured deal, you're always trying to get to a bankruptcy remote vehicle which isn't something you can do with an insurance company, but what we've been able to do is find a way to get it as clean as possible and like a bankruptcy remote trust. So what we're doing is really trying to predict how a regulator will act.

For example, in the Bravo Trust we had two separate accounts A and B. One of the advantages of that was that we felt that if you put additional money in the separate account, the regulator could come back and get that. We wanted the A structure protected from the ability to do that. So it's a little different use of structured technology, but what's interesting also is the difference between life and property casualty companies. Life companies are using the structured technology to help them get into other markets and new products. It's a way of doing additional kinds of business and doing the kinds of businesses they've been doing for years and are very good at, but it's another way to open additional markets to them. On the property casualty side, you see it more like the banks where they're trying to create capacity by taking some risk off the balance sheet, and you see those with the Catastrophe (CAT) bonds. Those haven't quite gotten efficient yet, the market hasn't completely accepted them, but there are all kinds of structures and transactions

going on. So I think these are interesting times, and I think insurance companies are using the structure technology quite effectively.

The first thing I'll talk about is what Carl talked about, which is a credit wrap GIC. Most of you are very familiar with the 401(k) market. It's probably one of the most credit sensitive markets there is. If you don't have a double A or better, they won't talk to you, and triple A will allow you to have a bigger portion of a company's pension plan. So for some companies that aren't in that rating category, for some companies that would like to play at the triple A level, it's been an effective means to get in or stay in the market, and to do what they would like to do with more efficient pricing.

When you're looking at a credit wrap GIC, there are three components. There are the separate account assets, guarantees by the general account, and the mono line. You have a first lien that goes to the insurance companies so the insurance company writing the GIC is really guaranteeing it first with the second position taken by the mono line. There are three pieces: the separate account assets, the guarantee from the insurance company, and the wrap from the mono line. And that's the most efficient way to structure it because the way you'll get the lowest pricing from the mono line because it has the insurance company credit in front. That's typically the way you see them.

When looking at this as if it is a structured vehicle, you need to look at the guarantee from the insurer, make sure it meets our requirements and look at the surety bonds from the mono line. It's very important and you must be careful when you're looking at these that they cover both the assets and the liabilities. If you think about what a mono line, like Municipal Bond Investors Assurance (MBIA), typically does, the core business is wrapping municipal credit, wrapping assets, or getting involved in asset-backed transactions. Here they're doing something one step further, they're wrapping the asset and the liability and in order for you to get the rating—both the asset and the liability have to be covered. So that's a distinction from what mono lines have done in the past.

Now the third part that you need to look at is the regulatory environment. You're going to look at the state where the insurance company is regulated out of to see what their definition of separate account is, and if the separate account will be insulated. This will remove some of the risk from the insurance company's credit if the assets are insulated from other policyholders. So that's an important part of both the capital analysis and the structural analysis. And not all states are equal. We've gone through quite a few states, and some will have better legislation than others. I'll get into that a little bit more later.

When you're looking at rating one of these transactions and when companies are looking to do this as efficiently as possible, what they'll do is set up portfolio guidelines that the separate account will live within so that you can size the credit risk and the asset liability risk for the GICs that they're underwriting. When you're looking at a structured deal, the first question you're asking as a rating person is, what's the worst thing that can happen? The worst thing that can happen is the insurance company is going into insolvency. How will things react then? You want to take the worst case scenario and sort it out. The issue of state laws regarding separate account insulation is important.

So you're looking at the portfolio for credit quality, the asset liability management capability, interest sensitivity of the underlying assets, and convexity within the assets versus liabilities. You want to look at it from the business perspective. Does this make sense? Does everything sort of fall into place? Does the insurer have the underwriting capability, do they have the appropriate systems to monitor the things that are going on, and does it make sense from an expense perspective? So at the end of the day, what you have is a rating that's placed on the product or program. You have the insurance company first and the mono line second, and you have the mono line no matter what happens. Even if there isn't a serious problem, but there's a problem, the mono line has to pay immediately and then he has to go back to the insurance company to get reimbursed, since timely payment of principal and interest is imperative.

Now I know how much you all like probabilities so I'm going to go through a credit default matrix. This is a cumulative default matrix. For an asset bought today, what's the probability of default? I buy an investment grade asset, triple B or better today, and I hold it in my portfolio for a year. It's got a .0009% chance of defaulting, pretty low, and when you look at a speculative grade asset, you see that that's quite different, and the more you go out in time, the greater the probability. Now keep in mind, there is no asset management so you buy today and you hold it. So as you go out three years, five years, ten years, etc., that number increases, and there's clearly a significant difference between investment grade and speculative grade. This is across the board--the difference between triple A, single A, double B, again at years three, five, and seven. When you're looking at GICs, there is typically the three- to five-year range.

What we're going to look at is what's the probability of a joint default, and the probability of a triple A default in five years. If I buy an AAA asset today and I hold it for five years, what's that probability at this point? It's .0028%. The probability of a single A default is a .8%, and the probability of both of those, assuming that they're independent and I'll talk about that in a minute, is .002%. So really you've gotten the probability of default almost down to zero. This enables the most credit

sensitive pension plans to take very little credit risk. Now when I talked about the probability of joint default, I assumed that these two were independent of each other. There hasn't been a mono-line default. But there has been some muni credit and some insurance company defaults. There is a little overlap, but if there's a poor economy it affects all of them. The municipalities and insurance companies tend to do better than other types of companies in a poorer economic environment so I think you could make that argument.

Here are some of the programs that have been out in the marketplace. SunAmerica has been very successful, the first one out there. Prudential used MBIA to do that kind of a program. BT actually had their wrap of their synthetic GIC wrap. They were a major provider of stable value synthetic GIC wrappers. When they got downgraded, they weren't able to do that business any longer, and that was a big business for them so they went and got a wrap from MBIA. And BMA also wanted to utilize this since they were a split-rated company and this made them a more solid performer, and so it's really helped them in that marketplace.

Now I'm going to talk about structured GICs, and this is really something very interesting that's going on now. SunAmerica was probably the first to do this two or three years back, and it's really gone mainstream at this point. In addition to SunAmerica, you see John Hancock, Pacific Life, Travelers, Keyport (a single premium deferred annuity writer) issuing these programs. Transamerica is about to come out with one this month; there are three or four other companies in the process of coming out with this product. I'm going to talk a little bit about why these companies are so interested in doing this. But basically if you look at the structure, you have a trust, it's typically a Cayman or Jersey as Jim said, and what you want to do is keep that trust absolutely clean and bankruptcy remote, and then it issues medium term notes (MTNs) into Europe. Now one of the reasons why you need the Cayman trust is not to pay taxes. The structure and technology is really what's enabled this product to work in Europe. So you have a trust and a single purpose vehicle, clean, bankruptcy remote backed by an insurance company GIC or funding agreement, and it's typically sold internationally.

One reason for these programs is that the 401(k) market, which is a major product line for a number of highly-rated life companies, is really off, as the market has gone more towards synthetics. As rates come down, there is a squeeze on spreads. Lower rates and a flat yield curve also favor short products. So companies that were issuing three- to ten-year GICs are forced into three year and under which relative to their assets provides additional challenges. In the MTN marketplace, insurance companies get to set more of the parameters. If I have a ten-year asset, I want a ten-year liability; you can set up a program that will work that way for you. There's a lot more flexibility. There's another advantage in that there is no benefit risk--there's

no optionality. So it's actually improving your liquidity because you're selling a ten-year note, and it's not due for ten years, there is no prepayment. So in terms of looking at your liability, you have better convexity relative to a 401(k) GIC. Now it only makes sense if the pricing works so that it's efficient for you to do this relative to the assets that you purchase. There have been opportunities throughout the last several years that really worked very well for certain insurance companies.

Now as Jim talked about, the market is a little off right now, but I think people feel that it will come back, and they're sort of gearing up to be ready for that when it happens. One company has sold over two billion in the first five months of 1997, so it's a significant size market. What's interesting is insurance companies have all kinds of agents and distribution forces, but this is really using the investment bankers or the foreign banks to distribute it in Europe, and what's been amazing to me are the conversations I've had with foreign investors, they're very thorough, very knowledgeable, typically pension plans and people looking for good, high credit that are investing in insurance companies, but they don't know companies that well. They're asking all the right questions, they know those types of companies are around, but they don't know the U.S. market. SunAmerica has become, believe it or not, the best-known life insurance company in Europe because of these issuances. So I look at that as an ancillary benefit. It’s a way to get your name and your credit known, as I can attest to that from the number of conversations I've had with investors all over Europe and Japan. I think it's a good thing because at some point in time, it may make sense to sell some of your other products into that marketplace if the pricing works.

Some of the rating considerations in looking at the structure are--keeping the trust clean and perfect, the form of the underlying GIC or funding agreement, and the GIC treatment under the state law. The rating of a program depends on the clarity of the state law--whether you're going to get the rating of your financial strength which used to be called CPA, or your counter party credit rating or your Debt rating. For highly-rated companies, those are usually the same, but there's an advantage to getting your financial strength rating in that it implies *pari passu* treatment with the other policyholders so it's a higher status. And in Europe, they are very sensitive to that, and a big advantage if you can get it that way.

One of the parameters that we use to determine how we're going to rate this is if the statute is clear about funding agreements and GICs. Does it describe how it will treat those programs? Some statutes don't mention it at all, some are very clear; some subordinate it so it's very important. Companies have actually been going to their states and getting the statute clarified and working with the state so that they get the best treatment. And they've been writing GICs for years, and it's never come up before we started doing these Euro MTN Programs but depending on the

state you're in, it can provide advantage. The Travelers was done with a financial strength rating, Keyport is in Rhode Island and Rhode Island is clear and they have their financial strength rating. Now Massachusetts is not clear on that so that would be based off the counter party credit rating; California is clear but there are some tricky tax issues so that one gets a little complicated. It's very interesting going through the states, and I think it's very positive that companies are going back and getting the clarity on the liabilities and the statute. We look at how the regulator would react, what can happen. What's the worst thing, if the regulator takes over, how is he going to treat it? To what extent does the statute say how this should be treated? We get legal opinions that verify that. The opinion process in a structured deal when you're talking about an insurance company is very important, and we do rely on it. It's really an expertise of our legal department to look for certain things in the opinion. So that's been interesting and that's really allowed us to get comfort on how a regulator would treat this.

Now a number of highly rated major life companies' financial strength rating and counter party credit ratings are the same as their debt rating, but at some point those things could tier, so the best possible treatment is this policyholder status. That has been an interesting part of the process. Jim discussed following the cash flow in any structured deal from the GIC to the trust to the medium term note, the priority of payments, and the coverage of expenses. You could never have any liens in that trust because you never want anyone to be able to put it into bankruptcy. So expenses have to be sized for and covered in a side letter and any potential liabilities have to be looked at and cleared through. Whether we treat the insurer's liability as a GIC or a debt is based on their ability to match fund it.

People ask me from a rating agency perspective if we think this is a good business or a bad business. I think it's the same business that you're doing so we're sort of neutral. I think the advantage that has occurred is where the 401(k) market has fallen off and companies would have lower profits. This business has enabled them to keep profits more stable so that's really been an advantage to them. And it really has gained quite a lot of acceptance from when it started. A few companies have really been leaders in this area, but I think it's one that you'll see expand quite substantially in the next six months.

SunAmerica has a structured life company which is triple A which worked very efficiently for them in Europe, and allowed them to write longer paper out of it and also at more efficient rates.

Euro-MTN programs have been done in the U.K., Spain, Germany, Sweden, Italy, Japan, France, and even Switzerland. And when you're doing these, there is always a currency swap, since nobody takes currency risk. You always have to swap, and

you can do that at the trust level or you can do it at the insurance company level. And initially, a lot of them were done at the trust level, but now they're primarily done at the insurance company level because when you're rating the notes, it's going to be the lower of the swap provider or the insurance company. The insurance company didn't want to take swap provider risk, but they do it at the general account level and not risk the trust level so that's pretty much how that's gone on. If anybody would like more details, I'm going to make some additional work available to the Society.