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Session 55PD GIC in a Box

Track: Investment

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Summary: With the decline in traditional stable value guaranteed investment contract sales, life insurers are looking to the capital markets to replace maturing guaranteed investment contract liabilities.

This session looks at a variety of capital market structures used to fund guaranteed investment contract liabilities from accounting, regulatory, rating agency, and investor viewpoints.

Mr. Victor Modugno: We could have called this session FANIPs for Funding Agreement Note Issuance Programs or capital market GICs. This refers to issuing GICs or funding agreements (the term used depends upon the insurer's domiciliary state) to a special purpose corporation that issues notes to investors. Starting from the first program in 1994, issuance of these note programs has grown to more than \$15 billion per year by 1999. These programs have supplanted 401(k) GICs as the main source of institutional business for many insurers as synthetic GICs replaced traditional general account GICs. We have assembled an outstanding panel representing investment banking, insurer, and rating agency views. I'm a consulting actuary who specializes in institutional products.

Our first speaker is Patricia McWeeney. Pat is a director in the Financial Services Group of Standard and Poor's (S&P). She is currently responsible for developing the insurance capital markets business. Prior to this, Patricia was the team leader for capital markets. This area develops ratings for insurance derivative product companies, structured life insurance companies, structured GICs, municipal GIC underwriters, wrapped GIC providers, and other investment-related structured insurance products. In addition, Patricia specializes in the asset/liability

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Note: The charts referred to in the text can be found at the end of the manuscript.

management analysis, including derivative activities for the general accounts of insurance companies. Prior to joining S&P in 1993, Patricia was a portfolio manager at MetLife.

Pat's work has been published and quoted in *The Wall Street Journal*, *Derivatives Quarterly*, *Standard & Poor's CreditWeek*, and other trade publications. Pat holds an M.B.A. from Columbia University.

Our next speaker, Teresa Radzinski, is the director of global debt capital markets at Merrill Lynch where she is responsible for fixed-income business for the insurance sector. She has covered all segments of the insurance industry for more than ten years. Teresa is a member of the new product team that developed the AIG/SunAmerica and Allstate Global Funding Agreement-Backed Debt Issuance Programs. Prior to joining Merrill Lynch, Teresa held similar positions at Donaldson, Lufkin & Jenrette (DLJ) and Salomon Smith Barney. Prior to that she was senior vice president of Bank of America's insurance corporate finance business. Teresa has an M.B.A. from Georgia State University.

I will be the final speaker. As previously mentioned, I'm a consulting actuary. From 1990 to 2000, I was a vice president at Transamerica Asset Management in institutional markets, where I worked on several of these programs. I will give the insurer's viewpoint and talk in detail about a program we completed in 1998. Prior to Transamerica, I was at Executive Life, Pacific Mutual, and Metropolitan Life, where I got my FSA.

Ms. Patricia E. McWeeney: How many people are familiar with structured GICs? How many companies are issuing them? I'm going to go over how S&P looks at these products from a structural, analytical, and legal perspective. I'll give you a lot of color on the market—what's been issued and how much has been issued, which is a very surprising number. I always spend a few minutes, when I have an insurance group, going over a default study. And in this case, I'm going to go over it as it pertains to insurance.

Chart 1 is a typical diagram of a structured deal. On the far left is a life insurance company, which issues a funding agreement, which is an insurance contract, to a special purpose vehicle (SPV). The SPV, which is not technically owned by the insurance company, then issues notes. To rate the notes that are being issued out of the SPV, you need to look at the structure, the form of payment, which is the funding agreement, and you need to look at the SPV to make sure it's a clean vehicle. We have rules that we look at to make sure that it's clean, and nothing is going to impinge on the payment of those notes being issued. In a structured deal, you have a lot of legal and structural issues. You need to make sure it is clean and everybody is satisfied. So what we look at is the cash flow. Basically, when you're an analyst looking at a structured deal, you're following the cash flow to make sure it's going to the right places and nothing's going to get in the way of it, since it's not going directly from the insurance company to the note holder. So you're going to look at the priority of payments within the SPV to make sure that you're comfortable where the funding agreement comes out in the priority of these notes.

You're going to look at the coverage of expenses; that there are no expenses that are going to get in the way of payment of these notes, and you're going to look at any other potential liabilities.

What's happening on these notes is that a funding agreement is being issued from the general account of the insurance company into an SPV. The SPV is then issuing notes. Initially, they were sold into Europe, but we're now doing Europe, Asia, Australia, and the U.S., so there are various currencies that are issued. So if there's a currency swap, you have to make sure that that's not a weak link—that it has the same rating as the notes. And last, there are some indemnification issues and SPV criteria which S&P has which, again, make sure that nothing's going to impinge on the notes. Typically, we're going to put the rating of the insurance company's general account on the notes because the notes are backed by a funding agreement which is issued by the general account, as long as the structure doesn't do anything to incur any additional risk, whether it be from a lower-rated swap counterparty or anything else that might impinge on the payments.

The way S&P gets at the insurance company rating is we use both a quantitative and a qualitative approach. I think most of you are probably familiar with S&P's different models. An insurance company goes through a lot in the rating process. We have a capital model, a liquidity model, an earnings adequacy model, a mortgage-backed interest-rate risk model, and a leverage analysis, which says that insurance companies, relative to their rating, are limited to the amount of debt they can issue. When looking at structured GICs, a very important part of the analysis is asset-liability management, because after you sell a GIC or any insurance product, the ability to retain the profitability that was scheduled is really driven by asset-liability management. Typically, the companies issuing these have been GIC writers that have been very familiar with what it takes to manage the GIC risk. But what we've also seen is single-premium deferred annuity writers issuing these notes. I'll talk about these in a minute; it could be any insurance company issuing these kinds of products.

Another question that comes up is, because you're issuing a note, isn't that really debt as opposed to an insurance product? That's something we go back and forth on, but what S&P has said is that we'll look to the use of those funds as opposed to whether it's in the form of a medium-term note program or a typical debt issuance. Because the insurance companies are taking the money and investing it and earning a spread, we're looking through to the purpose. Instead of going into the leverage ratio, it goes into the capital analysis. And so we charge capital against it as a liability. That probably had a lot to do with companies being able to issue these to try to earn spread.

So we have an insurance company issuing a funding agreement. The funding agreement goes into the SPV. The SPV then issues the notes. In structuring these products, the insurance companies and their bankers try to get the best of both worlds. You would have an insurance liability, and the note holder would be treated *pari passu* with other insurance obligations, which is better than a debt holder, which would typically come after the insurance company liabilities. The investor

really has an insurance contract that backs his or her note, so he or she has a better product than just the debt of an insurance company. And because it's in the form of a medium-term note, it purports to have liquidity, which I think Teresa will talk about. So if you buy a GIC, typically you do have the general account backing it, but you don't necessarily have liquidity because a GIC is a buy-and-hold product. To make this product viable for investors in Europe, they try to provide notes with liquidity from highly rated insurance companies to get the best of both worlds.

I spoke about getting through the legal criteria when you're looking at structured deals. While I've gone through some of this, I'll just make sure that I've touched the following points: the structure of the issue and the venue. Typically, it's been the Cayman Islands or Jersey. Typically, if you're going into France, you use Jersey. And now there is a third venue being used. Companies initially started with European programs through the Cayman Islands. Now they're restructuring them, taking all the knowledge from the last three or four years, and setting up global programs which are actually based out of Delaware.

I think Vic talked about the GIC or the underlying form of contract, the treatment under state law. I started to address that in talking about policyholder status. This is really interesting because in the U.S. companies have been issuing GICs for years and no one ever asked, are they *pari passu* with other policyholder obligations? There are billions and billions of dollars out there in the U.S., and that question, at least in my knowledge, never came up. But in Europe, it is the number one question asked: am I *pari passu* with other policyholders? When we started to do structured deals for insurance companies, which is only about five or six years ago, what you had to do was understand that insurance companies, unlike banks, aren't governed by trust law, etc., which is how we get comfortable with these structured trust deals. But with an insurance company, you're regulated by a state regulator, so you need to understand what the regulator would do in a worst-case scenario. How we do this and how we get comfortable is by looking at the statutes for guidance as to how the regulator would work. Because Europe cared a lot about this and insurance companies wanted to broaden their horizons to that marketplace, almost all of these companies have gone back to their statutes—most recently Massachusetts—to get funding agreements clarified so that they're *pari passu* with other policyholder obligations so that you get the right priority. And on doing these deals, we get a variety of opinions, one of which is the priority of the GIC being issued. So because of Europe, some of the U.S. investors are better off.

Chart 2 is what we call a plumbing diagram, to give you a feel for what you go through in a legal structure. And there is a lot of time spent with lawyers and documentation. But I want you to focus on the triangles, which are the opinions on each of the notes being issued. When S&P rates these programs, we don't actually rate the program as a whole; we only rate each of the notes coming through the program. And the reason is so that no other notes get issued that might impinge upon it, for example, a bad-swap counterparty. So you want to make sure that there's nothing happening, as you follow the cash flow, which would hurt any of the other GICs that have been issued through that. We rate them one by one. They

all get opinions. They're typically at least \$200 million in size because there is a lot of paperwork just to get one of these out. And the opinions that we get are: bankruptcy remote opinion of the SPV, which is typically located in the Cayman Islands or now Delaware; a priority opinion, which tells you where it comes out in the insurance priority and whether it's *pari passu* with other insurance obligations; an issuer or corporate authority opinion, that they have the ability to issue these notes; and a security interest enforceability opinion, which is very important when you're looking at a structured deal, to make sure that the paper you have is enforceable. So, all of these are really at the behest of the note holder to get him or her comfortable. Because it isn't straight from the general account to the note holder, there's an SPV in the Cayman Islands that it goes through.

Just a little bit about where these notes have been issued. They really started in Europe, primarily France and Switzerland, but more recently Germany, Great Britain, Norway, the Netherlands, Spain, Italy, Tokyo, Hong Kong, Singapore, and Australia. And, more recently, they're being issued out of the U.S. Insurance companies have not been issuing products from the U.S. to Europe. What's important for the investors is that they don't pay taxes both in the U.S. and in their own jurisdiction. So by structuring the vehicle that way, they pay only in their own jurisdiction. That was important to making that product viable.

The most issued currency, even though they're primarily all done outside of the U.S., has been in dollars. It's followed up by Euros and Swiss francs, British pounds, and then Japanese yen. The hope is, because so many companies have come into it, that the U.S. will become a very big market since it has a huge capital market. That's really what's being worked on right now—these global programs. I think Teresa is going to talk about that later.

In 1995 and 1996, \$167 million was issued; in 1999, about \$14 billion was issued. I would predict for 2000, there will be about \$20 billion by year-end. What started this was SunAmerica wanting to issue GICs and not being able to issue as many as they would have liked in the U.S. because they had a split rating, which was an AA-/a1. And so what they said was, "We want to sell this product and bring the money in to invest. How do we do it?" And they found a way, working with a banker, to sell product into Europe. So that was the beginning, and what was driving it was that they couldn't issue to the capacity they wanted in the U.S. That started to make sense for other insurance companies when, as Vic alluded to, the 401(k) market, where a number of mainline insurance companies had issued GICs, was starting to dissipate because everyone wanted to be in the stock market and in competing synthetic products typically issued by banks. This became a way for insurance companies to find another way to preserve profitability by opening a new market. That's what the driver was, though a little different for SunAmerica, that's what got everybody else involved.

In these programs to date, \$70 billion has been set up and \$36 billion has been issued. If you look at the companies issuing these products, they are AA- and better, which is pretty much the same as GICs. You wouldn't be precluded from doing this if you were rated A or A+, but what you have to remember is the way GICs work. You're looking at making a spread, so it's really arbitrage. If I'm an AAA or AA and I sell a product at one rate, I need to be able to invest it and still earn a spread and also pay for capital in the model. So typically, well-capitalized companies getting the best execution would be AA or AAA. Whether we'll see A+ companies or not is questionable. It's a spread question. SunAmerica, Protective Life, Pacific Life, John Hancock Mutual, Travelers, Principal, Jackson National, Monumental Life, AIG, Mass Mutual, Allstate Life, Nationwide Life, First Allmerica Life, Combined Insurance, and Sun Life of Canada have set up their own programs. There are also bank programs set up by Lehman Brothers and Bear Stearns, and Keyport Life Insurance Company, BMA, Kemper Financial, Hartford Life, and GE Life and Annuity Assurance Company have issued out of these programs. They haven't set up their own programs. You'll see a fair number of annuity writers that have also used this vehicle to grow their balance sheets.

If we think about what an insurance company does, it puts bells and whistles on products, and the bells and whistles might be mortality, an annuity with a tax-deferred buildup, or different kinds of savings products. But basically, they put bells and whistles on products and then they look to bring money in, invest the money, and earn a spread. When you look at this product, it really takes all the dressing off of it. It's really just a straight cash flow. There's a fixed date, typically when it matures, and it has a coupon that could be fixed or floating. But basically, you bring it in today, and five to ten years later you pay it back. There's no disintermediation risk. There's no optionality in it. It gives you an opportunity to say, "Here's what the cost of bringing straight cash flow in is. Let's compare that to writing a life product, writing a SPDA, and writing a traditional GIC with benefit responsive risks. Which is more efficient for me?" It really just gives you another choice. What's nice about it is that it gives you some diversification. So if the market dissipates, through no fault of your own, here's another avenue. And that's been a good thing. If you get pushed back in the one market, you have another market available. But there's a pricing discipline that you can think about, if you think about what's going on here. Insurance companies are always very careful to have an insurance product. This is really a note, and you're really just talking about what I can earn on this—just straight cash flow. So it's a little bit daring in that way.

S&P does credit default studies every year, and when I get an opportunity to talk to insurance companies I always like to show Table 1 because, having talked to so many investors in Europe about insurance credit, there hasn't been, prior to these products, a lot of insurance paper in the marketplace or a lot of insurance debts. Typically, insurance companies sell products and bring the money in that way; they're not issuing a lot of debt, typically. What you have here is a study that shows, based on the last 18 years, what the probability of a company defaulting is, not by credit rating, but just on industry. Now, obviously an insurance company is one of the better-rated industries, so it is one of the better default studies. But I don't think people always recognize, certainly investors haven't recognized, that

the probably of an insurance company defaulting is almost as low as telecommunications and utilities. I have 1998 and 1999 to be fair, because 1999 was a pretty visible year. General American, which was a technical default, meaning that it did default, but within a month everybody was pretty much paid off, and you also had Integrity and ARM Financial. So you had three very visible company defaults in there, and you see the number go from 2.81% to 3.3%. I wouldn't just do it this way, I would look at what the probability of a company defaulting was and I would look at it by industry, and insurance would be one of the better industries.

TABLE 1
1998-99 Default Rates by Industry

Period; 1981-99/ In Percentage		
	1998 Average: 7.37 %	1999 Average: 7.99%
	1998	1999
Consumer/ Service Sector	12.70	14.62
Leisure Time/ Media	2.20	14.46
Energy/ Natural Resources	11.57	15.63
Transportation	9.84	11.80
Forest/ Building Products/ Home Builders	9.54	10.64
Aerospace/ Auto/ Capital Goods/ Metal	8.35	9.98
High Technology/ Computers/ Office Equipment	6.65	7.90
Healthcare/ Chemicals	5.91	7.90
Financial Institutions	3.82	2.80
Insurance/ Real Estate	2.81	3.30
Telecommunications	2.72	3.45
Utilities	2.35	1.84

If you look at a financial institution other than insurance in 1998, that was the year when Russia defaulted. In 1999 they actually passed the insurance industry because a lot of banks came and got rated, so the denominator improved and that number went down. But I don't think people always recognize what a good credit insurance companies are, just based on industry. And this is 18 years of data, so it has some sticking power. All the major companies that defaulted have been GIC writers, so it's a very sensitive subject in the GIC marketplace, which is why they do require an AA- rating or better.

Securitization has become a solution, whether it's catastrophe bonds being issued as a way to increase capacity, or different kinds of life insurance policies being used to securitize a loan, or the structured GIC as a way to open products into the European market. It's really provided a solution. When you think about securitization, think of it just as a tool. We talked about structured GICs opening

up new markets for U.S. insurance companies. It's a very simple product, but it's been pretty significant.

Ms. Teresa A. Radzinski: Much of the year 2000 at Merrill Lynch has been focused on assisting insurance carriers to grow assets under management through funding-agreement-issued liabilities. I'm going to give you an overview of what the current funding agreement market looks like, as well as product innovation this year, and then the issues that face the three constituents that really make up the market: the insurance carriers, the investment community, and the broker-dealer community. Then I will tell you where we think the market will evolve next year.

As Patricia said, the Euro Medium Term Note (EMTN) market has been around for a couple of years, and is well-accepted by the marketplace. However, several market dynamics happened in 2000 which really begged the need for further product innovation. One is that we've been in a Fed-tightening mode this year, which has made for a less-than-robust fixed-income market. Europe began to embrace credit product. Historically, they have been involved in currencies as well as just buying AA and AAA paper, so this year they've had the ability to buy BBB industrials from U.S. companies. That has caused further pressure on the EMTN GIC market. More insurance companies established programs this year. If you talk to our traders in London, they felt like the market was fairly crowded already, and more and more carriers were coming on-line. And investment banks were looking for any and all ways to exploit every potential market for this product. So to deal with issuers' desire for the most cost-effective funding, as well as recognizing the concerns of the investors, which were liquidity, credit, and new issue supply, investment banks really spent the time focusing on how to expand the market and attract potential new investors. So from our perspective, what better way for insurance companies to access the market, but bring the product to the U.S. fixed-income market, where they are well-known.

In April 2000, Merrill Lynch introduced the first global funding-agreement-backed structure to the market for AIG/SunAmerica. The R&D for this took close to a year. To make it a global product, we needed to tackle three things collectively that were different from the EMTN market: accounting consolidation, which is much more sensitive in the U.S.; the regulatory environment, which numbers 50 regulators; and the due diligence standards and disclosure, which is much higher in the U.S. than what is accepted in Europe and markets around the world. Currently, there are four global programs. We introduced AIG/SunAmerica in April; John Hancock came to market shortly thereafter with a slightly different structure than the Merrill Lynch structure. We've subsequently launched Allstate, and then AEGON has come to market as well.

Chart 3 shows the basic EMTN funding agreement structure. From the investor standpoint and issuer standpoint, it's absolutely clean; it's much more of a pass-through. The actual funding agreement very closely matches the notes that are actually issued into the market. Now, when you compare that with the global structure, and again, keeping in mind that accounting consolidation is extremely important as well as the regulatory analysis, we had a big challenge. Our solution

was to put a 3% equity piece underneath the senior notes, which at Merrill Lynch we're calling auction market equity securities, which is really a perpetual money market preferred. From an accounting consolidation view, that 3% makes most of the accounting professionals comfortable that the debt would not be consolidated back onto the insurance company's balance sheet.

The equity from the regulatory analysis also made it much clearer that the two were very distinct instruments, meaning the senior notes and activities of the SPV were very separate from what the insurance company was engaged in. So the regulators, when we went to pitch the structure to them, were comfortable that, from an insurance company perspective, you were issuing a funding agreement and your activity stopped; that really the SPV was what we refer to it as an orphan entity. And so the activities of that entity were not party to the insurance company. For the regulatory analysis, the other thing we had to do this year is to get 50 regulators to agree on two things: that the insurance industry was issuing funding agreements and that the SPV was issuing notes. Merrill Lynch, being the underwriter of these securities, was not selling participations in funding agreements, but we were selling securities. So that was not a small feat to get all 50 regulators comfortable with what this activity was.

Investor considerations are next. It's one thing for AIG/SunAmerica to be in a market. They benefit from being a AAA on both sides, which makes things easier. In September 2000 we brought the Allstate Life Insurance transaction to market. They're rated Aa2/AA+, stable, by both agencies. It was one of the first true AAs to come to market. John Hancock had been in the market prior, but it was broadly marketed, both here in the U.S. and in Europe. Some of the issues we faced from investors were: why are they doing this? What's in it for the insurance company? So you had to really get investors comfortable that it was part of their overall spread business, that this was a strategic part of what the insurance company was looking to accomplish, and that it wasn't the GICs of the early 1990s that got insurance companies into trouble. So they spent a lot of time, probably more than we would have anticipated, just asking the fundamental question: what's in it for the insurance company?

Also, regarding structural issues, where in AIG/SunAmerica they wouldn't have delved into the *pari passu* issue, they clearly delved into it here. They wanted to know, in the state of Illinois, where does this product fall out and how strong is the legal opinion? Again, we were a little surprised at how much effort investors spent on this point.

Last was the credit analysis. In Europe, our feeling is that this product gets broadly characterized as a AA-structured note product. In the U.S., what they're trying to do is really distinguish based on credit. So we had to start from the beginning. Allstate is known as a personal lines company. Investors had no idea it had a life insurance company, much less that it was the 13th largest. That ended up being much less of an issue. Again, I think the U.S. is the most sophisticated credit market, and has clearly seen debt issuance from holding companies of all sorts. Less time was spent on that issue, but again, it wasn't something you could take for granted.

Liquidity is really a big issue from the investors' standpoint. On the Allstate program we had nine dealers, which ended up being extremely important. Investors want to know that they can count on getting a bid from the brokerage community; that if they want to trade out of these securities, who's going to make the market in them? And so, from Merrill Lynch's perspective, having a broad distribution group was important for investors. Our firm trades this product. We have two traders in London. We trade it in Australia, and we also have two traders in Tokyo. So that was something that couldn't be taken for granted as well. And then, there was new issue supply. There were analogies drawn to this product with finance companies, meaning there will always be product available. So when investors bought this paper, they wanted to know, if I buy Pacific Life today, am I going to see another \$500 million issue from Pacific Life next week? Therefore, I should have asked for more coupon as part of the transaction. It was important to be able to give them an overview of who the players are in the market, what kind of new issue supply you could expect now, and what kind of supply is anticipated next year. It was very important to know that there would be a liquid market, but that it wouldn't be oversaturated in a very short order.

Broker-dealer involvement and investors' and issuers' concerns are driving the activity of how we spend our time. Developing this market is extremely important for everyone. We should make sure we get all the structural, regulatory, and credit issues disseminated; that we're supporting the market and that investors are accepting this product. We spend a lot of time, not just at Merrill but also at other firms, making this a viable market. So we're doing things like Bloomberg road shows, away from transactions globally, just to talk about the structural issues. We also have published written research pieces on the industry, and on this product in particular. We do investor one-on-ones through our fixed-income salesforce. And in secondary trading, our traders now quote these bonds in a regular basis in all markets.

Insurance companies' issues. Again, everyone's driven by earning the largest spread they can, so that as insurance companies assess distribution alternatives and means to raise liabilities, they face a lot of hurdles. They need a larger investor base, and, again, everyone's looking for global arbitrage. That is really the challenge insurance companies face—how to be extremely nimble to take advantage of market opportunities when they open up. But they face hurdles, such as the appropriate credit curve. Again, our belief is that the investors, while they understand this product, aren't really differentiating on credit. They're not saying Pacific Life is a better credit than Allstate Life, or AEGON, for example. They're still lumping them in broadly as a AA credit. Next, 144-A [Private Placement] premium is a big issue. These securities come as a 144-A with no registration rights at this point, so you're subject to what the market is demanding in terms of a liquidity premium. So that's a challenge for us to try to make that number as small as possible and really help insurance companies develop the appropriate credit curve, going forward, that allows them to issue more efficiently in the future.

Table 2 is a quick compare-and-contrast on the EMTN versus the global structure for the companies that may be thinking about Euro programs, already have them, or may be considering global programs. Again, tackling the accounting, I think everything starts with the accounting profession. They're a big driver of how the structure actually works. I think the most conservative is the 3% equity that we've been using in both of our deals. The legal cost to deal with the U.S. regulators, to get these 50 opinions, adds to the cost on a global structure. I would say, you can expect that to come down substantially next year. There are three law firms that have done all the regulatory work that you, as a carrier, could consider using. So I think that'll go down. The big positive is that I think Europe is a very crowded market. I think the other markets, whether it's Australia, Japan, France, etc., are, in our view, very much niche markets. So windows open up and insurance companies are able to take advantage of it, but they also close pretty quickly. The huge advantage of doing a global program is really to be able to tap the U.S. investor market. Weighing the costs of dealing with accountants and attorneys to get a program structured, the benefit is that you have the largest investor base to deal with in a global program.

TABLE 2
EMTN VS. GLOBAL GIC-BACKED PROGRAM COMPARISON

PROS:	
EMTN Program	Global Program
<ul style="list-style-type: none"> • Easier to document • Limited regulatory hurdles • Less expensive to document 	<ul style="list-style-type: none"> • Broadest market access: U.S./Europe • U.S. market is most sophisticated Credit on credit and not just on ratings • Less competing supply- due to a limited Number of Global GIC Programs
CONS:	
EMTN Program	Global Program
<ul style="list-style-type: none"> • Market limited to Europe/ Asia/ Australia which may constrain annual issuance • Ratings very important to investors • Would incur additional set-up costs if Issuer decides to establish a subsequent Global Program • Plenty of competing product with 14 EMTN Programs 	<ul style="list-style-type: none"> • Longer to document 12-16 weeks Due to (i) U.S regulatory hurdles; (ii) accounting • More expensive (legal costs) • More rigorous disclosure/ due diligence For U.S. investors • State Regulatory Survey • Brokers-dealers' indemnification for Insurance regulatory risks

Where do we go next? We're working on trying to whittle away the 144-A premium. What you'll see next year from investment banks is additional structures that are looking for more arbitrage opportunities, as well as taking this structure we've spent a lot of time on and making sure everyone understands it, and getting that information disseminated as broadly as possible. We're also going to work

very hard with the accountants to try to get some consensus on their views on consolidation issues—that would make the structures much more uniform than they currently are—and then continue to work with regulators to be able to expand the potential universe of buyers that they would find acceptable to buy this product, as well as working on whittling down the legal expenses, as far as this product goes. So, I think the bottom line on this is, the global product was a huge breakthrough this year, but we're not stopping there. We have a lot of resources dedicated to this product that make this a really viable market. We understand the insurance companies' challenge of looking for the widest arbitrage possibility they can, so we're going to be as nimble as the insurance companies that we are servicing.

Mr. Modugno: We talked about using EMTN programs to replace stable-valued GICs. Here, funding agreements are issued and match-funded to the trust. The program that I'm going to talk about is using a commercial paper (CP) conduit, where the funding agreements are issued to a CP conduit and the funding is through issuance of CP. Now, the difference between this particular structure and EMTN is that there's a liquidity facility, so the funding agreements don't match the maturities of the CP. The funding agreements can have any maturity, and in the event that the CP is not able to roll, there's a draw against the liquidity facility. The procedures in setting up a CP conduit are quite similar to an EMTN program. One of the advantages of the CP conduit is issuing in the U.S. We did this program back in 1998, and at that time there were many reasons that companies were issuing in Europe. There was a thought that European securities don't compete with their U.S. securities; that they might get better pricing in Europe, even though I haven't really seen that. But another reason was that there were regulatory and tax issues in using a domestic trust. However, the use of the liquidity facility obviated that need, because the CP was not supported directly by the funding agreements, but there was a bank liquidity facility that went in between the funding agreements and the notes to the investors. And I had to explain many times to nervous CP dealers why they were not life insurance agents. The reason that the EMTN programs were set up in Europe was, at that time, there was a letter from the staff attorney at the New York department that seemed to indicate that if you were selling funding agreements through domestic trusts, that would be the equivalent of selling the funding agreements directly to the investors.

The conduit is probably more suitable for shorter-term funding agreements, and that's what we viewed it as being used for. And while you could get a liquidity facility for five years, the pricing of the facilities was very expensive; the one-year facility makes much more sense. This is a 364-day-renewable liquidity facility. In our program, we were actually using a partial liquidity facility, so the liquidity facility would cover 10% of the maximum CP allowed, and we would arrange the maturities of the CP such that no more than the amount of the liquidity facility could mature in any five-business-day period. We arranged it so that the funding agreements could be drawn with five business days notice to repay the liquidity facility. This got the cost of funds down to a level that actually is much cheaper than an EMTN program.

A CP conduit is more suitable for muni-GICs and floating-rate funding agreements. Once again, you could have a five-year facility, but the cost was quite significant. The real problem here is that CP is constantly being reissued. The cost of funds is not fixed. So that's why an EMTN program is better for medium-term liabilities.

Back in November of 1997, the asset-backed CP of A-1/P-1 programs was trading at London Interbank Offered Rate (LIBOR) minus an eighth to minus .15%. What we were finding, in seven-day put funding agreements, was that no one would accept a rate below LIBOR—that was like a line in the sand. There were a couple of reasons. CP is a more accepted investment for money market funds. A lot of money market funds cannot buy funding agreements, and also funding agreements can't be issued in all states. So there was a significant cost savings over seven-day floaters. The conduit, though, has a lot of cost associated with it. The dealer fees are the biggest costs; rating agency fees and liquidity are number two. And then there are some legal and administrative costs. But the net result, starting from LIBOR minus an eighth, you still come out ahead as compared to issuing floating-rate funding agreements. The conduit has some other advantages. The maturities are spread over 90 days, and a very nice thing about the conduit is you can get same-day cash. You can make a phone call in the morning and have \$50 million that afternoon. This can't be done in the funding agreement market.

Setting up the conduit is very similar to setting up an EMTN program. You have to choose a lead dealer who usually does the structuring and choose a legal counsel. Then you have other parties to choose: issuing and paying agent, liquidity banks, the owner, manager, depository, and security agent. The next step is to develop a term sheet and discuss it with the rating agencies and auditors.

I think I mentioned that this conduit was unique in having only 10% liquidity. Liquidity facility, at that time, was costing around ten basis points, so by only having 10% facility, it was a one basis-point cost. But what we had to do then was spread out the maturities of the CP so that no more than the amount of the liquidity facility would mature in a five-day period. The assets could be either general or separate account funding agreements. At Transamerica, we had a finance company that was doing a lot of CP conduits as part of their normal activity, and they didn't want us competing with them for liquidity. So by using a foreign bank, we didn't compete with them. The rating agencies have to be absolutely sure that the investors are going to get paid, so the funding agreements normally pay LIBOR, but in the event that the funding costs go higher the funding agreement rates can be adjusted up. If the costs are under LIBOR, we take out a fee at the end of the year representing the excess earnings in a conduit. We get that back as an administrative fee. Chart 4 is a schematic of how the conduit works. This is where the term "GIC in a Box" comes from.

What were the results? Remember, we introduced this program in the beginning of 1998. Initially, the conduit did achieve the cost of fund savings. However, what we found was that the CP market had all these dates—corporate tax payments date, Federal Reserve Board meeting, end of quarter, fiscal year-end of certain investment banks—where, if you issued around those dates, and it could be a

couple of days before or after, CP rates would shoot up. So the five-day requirement of spreading out the CP was causing a lot of problems. Finally, in the fall of 1998, you had that Russian debt crisis where the asset-backed market actually shut down for A-2/P-2 issuers. In A-1/P-1 asset-backed CP, there was only overnight liquidity for a few days. We had a lot of problems with the five-day limit on issuance equal to the amount of the liquidity facility since we couldn't term-out the paper. In the fall of 1999, there was the Y2K issue that caused a great deal of concern, and we decided to increase the liquidity facility to 25%. Now, as you know, nothing happened at Y2K, but because of that we did increase the liquidity facility.

So, how is the conduit today? We increased the liquidity facility. Because of rating agency issues with short funding agreements, we added a provision to the liquidity facility that allowed us to keep it outstanding at any time for one year so we could classify the funding agreements backed by liquidity as being one-year maturities. The cost of liquidity increased, and the liquidity facility had to be syndicated, incurring syndication fees, which were substantial. Another thing we found is that asset-backed CP is more expensive than corporate paper. Our asset-backed CP was rated A-1+. Transamerica corporation paper is A-1. Their paper, going out three months, was actually trading cheaper; they were getting lower cost of funds than we were getting, even though we were higher credit. And the reason for that is that a lot of money market funds have limits on asset-backed paper at 25%. There's a preference for corporate paper; they don't like the structured-type paper. So we tried to reposition it as a corporate program, telling investors this is really a corporate credit—it's not an asset-backed credit. We took it out of Moody's asset-backed book.

In 2000 the spreads that asset-backed CP was trading have increased from LIBOR minus an eighth to about LIBOR minus five, or LIBOR flat with dealer fees. The cost of funds, with the increased liquidity costs, is probably about LIBOR plus an eighth. The seven-day paper no longer exists either. After General American, nobody's issuing seven-day put funding agreements, and it is rolling off. So, the correct analysis is probably against 90-day put paper, and maybe those cost of funds are competitive. The main use of the conduit is for cash management, with the muni-GIC business. Muni-GICs tend to be very short—they're constantly coming in and out. If you're managing a long-term floating-rate portfolio, you need something to bridge the cash flows in the muni-GIC business. It is a very convenient facility to use for cash management, since you can make a phone call and get cash the same day.

Ms. McWeeney: We might want to clarify that what Vic was talking about was short-term funding agreements that had puts like General American, and what we were talking about were longer-term funding agreements—same underlying form of contract, but totally different product use. There's no option, no puts, and they tend to be five to ten years as opposed to one year and rolling.

Mr. Modugno: Yes, this is short versus long.

Mr. Paul J. Donahue: I have two questions. The first has to do with policyholder status. I begin with the view that there is no real economic difference between these funding agreements and debt, so it seems strange that regulators should be willing to make them *pari passu* with policyholder obligations. As a lawyer as well as an actuary, I begin with the assumption that the only thing that's truly safe is if a statute says that they are *pari passu*, as opposed to regulatory opinions, because I think we saw, in the Executive Life and Mutual Benefit Life situations, that even when regulations were clearer, GICs did not receive as favorable treatment as other policyholder obligations.

So, I don't think I could ever be comfortable short of a statute, which makes me wonder about people relying simply on an opinion.

Ms. McWeeney: They get an opinion even when it's in the statutes. And most of the statutes have been clarified for the companies issuing these programs; then they get an opinion that details what the statute says. Some statutes are better than others, or clearer than others. That's right.

Mr. Donahue: So, is it true that most states would clearly say, in a statute, that a funding agreement is a policyholder obligation in the current environment?

Ms. McWeeney: It varies a little. You have to look at each state, because I can't say there is one answer for 50 states. You need to look at it state by state. Where we've rated a program, we have gone in and looked at the statutes. Some are better than others. In terms of our rating, we differentiate based on whether the statute's clear and the opinion is good. Even when there's a good statute, sometimes a lawyer doesn't issue a good opinion, although he or she should be comfortable enough to do that. We base the rating on the financial strength when we're comfortable that the statute's clear and that the opinion confirms that. And we base it on the counterparty credit rating where the statute isn't clear, saying it really falls more to debt rating of your operating account, as opposed to the financial strength rating. So that's how we deal with it in the rating platform.

Mr. Donahue: And the second question is, what is the practical day-to-day liquidity of the medium-term notes issued by the SPVs? Is there really a day-to-day market? Do third-party pricing services provide daily prices? How effective is the daily liquidity?

Ms. Radzinski: Yes, our insurance traders in New York publish an insurance run, just like every other sector. Our analysts now publish a weekly piece that does a recap of all the insurance holding company paper, including the GIC bonds. There is a broker market that trades it, and I will say, of the ten dealers that traffic in the securities somewhat, probably 50% of them you can consistently count on to get bids in products. So it truly is becoming a tradable liquid market. Some weeks, we may trade \$100 million of the security and some weeks, \$50 million of the security; it depends, but we do trade the security.

Ms. McWeeney: There have probably been 20 banks involved altogether, and as Teresa said, probably ten, or really five or six that are the major issuers.

Mr. Richard S. Mattison: I have a couple of questions. One is, if you can comment on the spreads on the notes. For example, was the Allstate deal consistent with swaps spreads? And second, what do companies view as adequate capital to back the funding agreements?

Ms. Radzinski: I can comment on the spreads. Allstate was priced, end of September, at Treasuries plus 128 basis points, which would have been LIBOR plus low 30's, at that point, which was probably a few basis points wider than their holding company was. Their holding company was rated A+/a1. This was a bit of contention because you have solid AA paper, albeit in structured form being issued at a slightly wider spread than the holding company. But again, a 144-A premium holds you hostage to what investors are going to require in order to get the notes issued. But that's fairly consistent for a five-year, fixed-rate deal. The paper subsequently traded in four or five basis points and actually was through the Allstate holding company paper, which was good news for everyone. When you're bringing this kind of paper to market, in addition to the 144-A premium you do deal with some new issue concession. Again, those are more general fixed-income market conditions. You have a lot of supply and you really have to induce investors to get involved. You may have to set price talk a little wider than where it theoretically should come.

But in terms of how we're looking to price things, AIG has built a credit curve this year. We did their three-year transaction in April. We followed up with a five-year deal. They've done a \$500 million deal in Euros, so they have a three to five curve. John Hancock has a ten-year out. AIG/SunAmerica really looks to GE as their benchmark for pricing. GE tends to be flat to the swap curve. AIG doesn't really issue much paper, but if it did I think our view is that it's maybe five to ten wide of swaps, depending on maturity. The real question now for the AA market, which is really the bulk market, is what kind of a concession do you really need to come to, compared to AIG? I think in a robust market, the concession could be five to ten basis points, but I think the reality right now is that AA paper needs to be 15 to 20 basis points back of AIG-structured product. But over time, I think our hope is, given AIG is a AAA on both sides, being the market leader, and given the kind of pressure they have from their management to benchmark against GE, that that curve and that integrity will be very tight and there will be lots of pressure on firms like ours to compete for the business, which will mean we'll have to really work the investor base to get the AA issuers as close to AIG-structured products as possible. So I would say this is all evolving. Right now, to get people interested, you have to start at the very basic level, which is, is this paper going to be liquid? Is it going to be a floodgate of issuance? Am I really OK buying this? Once we've gotten that universe up and running, the next step is to really differentiate on credit stories and really work to whittle down the AA-structured product versus the AAA. Does that answer your question?

Ms. McWeeney: I think there's more work to be done to get the pricing more efficient. I think as people were creating these global programs, focusing on the structure and going through the statutes, as Teresa described, there wasn't enough effort left to improve the pricing, and that really needs to happen. It is structured, so it is going to trade a little wider than a nonstructured paper. But it is backed by a general account. I think, as Teresa points out, there is work to be done to get the pricing more efficient. Some of you should really look at this opportunistically; it should be done only if it makes sense from a pricing perspective. Is this more efficient than the other products that I do, after I sort out the bells and whistles? I think there's work to be done; I think there's a market opportunity for portfolio managers, because I think it's trading a little wider than it should relative to the credit quality.

Ms. Radzinski: One other analogy I would use is the one we've been using in marketing these deals. Bank notes, which are at a bank operating company versus holding company paper, which tend to be traded through the holding company. I think what we'd like to do is be able to get that analogy through the market, to get investors to appreciate what it really means: that funding agreement paper is at the insurance company level, that it is *pari passu*, and to be able to have the paper trade through a holding company. But that wasn't an intuitive analogy when we were out marketing it. They were very much caught into the boxes and arrows at this stage and really didn't say, being at an operating company, in the unfortunate event that a carrier gets into difficulty, your agenda is now on the same side with the insurance company. If you are really, truly *pari passu*, which is much different from being at a holding company, which is really a regulator's last concern in the event of any difficulty. So, those are the messages we're getting out to investors, that the bank market tends to work that way.

Ms. McWeeney: The second question was how much do insurance companies think they need for capital for these products, which might be a different answer than how much a rating agency thinks they should have for capital. But our capital model, which is published, charges 2% on the liability. And then relative to the assets that you bring in to manage it, capital is charged, so there's a different price for AA versus BBB corporate credit. It's a formula. It's similar to the NAIC risk-based capital model, but it's different in lots of ways. We have an interest-rate risk charge that's significant relative to the NAIC, and we have a charge for liabilities, which I don't think the NAIC has yet, although it's in the works. So the capital can be upwards of 5–6% for this product. And it really depends on the assets that you have backing it, which is going to be the driver.

Mr. Donahue: Do any of these existing structures have priorities within the medium-term notes, apart from the 3% equity structure?

Ms. McWeeney: Typically not, and most of them don't have the 3% equity. There are two global programs right now, which is the AIG global program and the Allstate. Otherwise, they're all just notes being issued through the trusts.

Mr. Modugno: Who do you sell the equity tranche to?

Ms. Radzinski: We sell that to money market funds.

Mr. Modugno: Is it rated A-1/P-1?

Ms. Radzinski: It carries the same rating as the notes, so it's AA+/Aa2.

Ms. McWeeney: Because it's backed by the same funding agreement.

Mr. Modugno: The fact that it's subordinate doesn't matter?

Ms. McWeeney: Not at that rating, no.

Ms. Radzinski: So everyone's clear that for the equity piece, if it was up to us they wouldn't have it. It has to serve a lot of different audiences because it's driven by the accounting profession. Even though you can use one auditor, your field office may say one thing and the home office may say another. And even if these insurance companies started with consolidation not being an issue, ultimately they had to put equity in it. So if there is some consensus with the accounting profession, a lot of the structural variances will duplicate. But that's why that really is there.

Ms. McWeeney: And depending on who your accountant is, there is some debate on whether you have the equity structure. There are certain accounting firms that don't require it, so those companies aren't using that structure.

Mr. Modugno: We were able to get the GAAP deconsolidation opinion for our program without subordinate notes.

Ms. Kimberly L. Monstvil: How does the investor base differ for the notes issued by the global program, compared to any debt issued by the holding company or even those who buy the traditional GICs?

Ms. Radzinski: The major difference is, if it's an insurance holding company that goes to market, it's generally a public, SEC-registered product, which means a lot of insurance money will be involved, even though insurance companies say they never buy insurance companies' paper—actually, they are the most prolific buyers of insurance company paper. You don't find that, thus far, of any size, with these global programs. The global programs have been bought by asset-backed buyers, so anyone who's looking at buying a Sears credit card deal is looking at buying this. You also have money managers and conduits. And we did get, in the initial AIG deal, the first deal in April, 75% of the transaction from Europe, and only 25% from the U.S. Two months later, we came back with their five-year transaction, and it was the reverse. By that time, the U.S. market really began to understand it, so 75% of the investors were here in the U.S. and only 25% in Europe. At Allstate, we had 75% here in the U.S. and 25% in Europe. But it was really money managers, conduits, asset-backed buyers, and European true, good money funds. We've had very small pieces of insurance money, and they were really the

insurance accounts. It was mostly life insurance companies that consistently bought insurance paper; they have dedicated insurance analysts and you can count on them, whether it's surplus notes you're bringing to market or holding companies' paper. But I think the challenge now, to really get insurance money involved, is the 144-A. There are no registration rights and the structure really causes them a lot of concern in terms of being involved, but that's really the breakup, which is pretty broadly distributed. They are very good money-type accounts that you'd be able to count on for additional issuances.

Mr. Donahue: A follow-up on that question. Has the improved liquidity and the global programs' availability to U.S. investors led any 401(k) money to start going into these programs in preference to traditional GICs?

Ms. McWeeney: I think I understand the question. OK, insurance companies sell funding agreements directly into a 401(k). So you wouldn't really necessarily want to go through a structured product to do it, except what's happened in the 401(k) market is a lot of money has gone into synthetics. And synthetics are a trust setup where the 401(k) owns the assets. The insurance company gives you a funding agreement; whether they make 5% or not, they still have to pay it to you, regardless. That's the guarantee; it's promised. The synthetic products are set up by portfolio managers, and how the assets do is really how the 401(k) performs. But what's been thought about is why not put some of these structured notes that are good credits and are trading a little wide—some of the actual funding agreements—into the synthetics along with all the other assets. The way synthetics work is they then get a benefit responsive wrapper over it so as to cover the 401(k) risk. I think that's how you'll see it go into that.

Mr. Donahue: Yes, my firm is one of the larger GIC managers.

Ms. Mcweeney: It's a good investment.

Mr. Donahue: Have other people been coming to buy it as an asset under a 401(k) synthetic wrap?

Ms. McWeeney: There have been others. I think in one of the more recent deals, PRIMCO bought their first, it might have been from Bear Stearns. But yes, your company bought it. It traded a little wider than it should have, so it's perhaps an opportunity to buy insurance paper.

Mr. Vincent Y. Y. Tsang: This question is for Patricia. I'm looking at the 1998 and 1999 default rates by industry. Some of these numbers, I must say, are quite shocking. Some of them, for example, the consumer and service sector, have a default rate of 14%, which is worse than junk bonds.

Ms. Mcweeney: But what does that tell you then? That probably the average rating is close to that of junk bonds. You have to remember, it's all issues, not by rating. We can go backwards and solve for the average rating. Well, 14% means

it's below investment grade, the average rating on that, or that's how you'd expect it to be.

Mr. Tsang: So if you look at the insurance row, it's roughly 3%. Now, is the investor getting enough spread to justify the risk?

Ms. McWeeney: Maybe that's a little confusing. Typically, how you would buy a bond or how you buy the note is based on its rating. So if you're buying Pacific Life, that's AA+; you should expect AA+ statistics. Within that default study, there are lots of charts that show you what the probability of default is based on the credit rating. So when you're buying these notes, you really should expect the defaults not by industry, but by credit rating. So, a AA might have a 1% probability default to buy and hold for ten years, or 2% at some point in time. So that's what you'd expect the probability of default to be.

I think Teresa said that insurance companies are buying a lot of insurance paper in the market; that it's number one. Part of that is because they understand it better. But there's also another advantage to insurance paper in that typically when a company does default, the salvage value is much higher than average. An average default salvage value might be 40% on a corporate bond. On an insurance company, it's probably more like 80%. On General American it was 100%. On Confederation Life it was 100%, although there was a little delay. On Executive Life, you probably know better than I do—maybe it was close to 80%.

So that's a little different statistic that isn't part of the credit default statement. That doesn't necessarily go into the pricing; that's a little advantage. So that's why you might see more insurance companies who understand this industry a little better than the average buyer purchasing that paper.

Mr. Tsang: Would you say that this is a good investment vehicle for diversification purposes? Or really just for investment?

Ms. McWeeney: If I'm a life company and I'm buying life paper, it is not necessarily good if there are industry issues that affect all of the life industry. I'm doubling up on my risks, so to speak. So it's not from that perspective. If you're buying this paper, it's all AA and better, so hopefully you would have time to trade it if you felt there were some industry issues. You always want diversification, that's important, but some of that would make sense, especially at the high credit level. But a consideration is the diversification issue.

From the Floor: You mentioned many of these are general accounts, and the rating follows the general account. Of those that are separate account vehicles does that make any difference in the way the rating is handled?

Ms. McWeeney: Most of them haven't been in separate accounts. There was one issue where the separate account was out of a subsidiary that wasn't linked directly back to the general account where the rating was housed. And that one came out a notch lower because we weren't as comfortable that they would get the priority.

Generally, if you structure it properly, you should be able to set up a separate account with a guarantee from the general account that should get the rating. This wasn't really structured properly, so they ended up a notch below. But you should be able to structure it in a way that you can be comfortable with the rating.

Mr. Arnold A. Dicke: I'm afraid I don't still quite understand exactly what those default rates were. There's an 18-year period there, and then there are two years. I'm afraid I just don't know what you're doing.

Ms. McWeeney: It isn't based on dollar value—it's based on individual issues. So if we go back to that chart, it's 18 years of data. It's cumulative default, so for 18 years the numerator is how many have defaulted, based on how many insurance companies are in the denominator.

Mr. Dicke: OK, and the number of the denominator is, over all those years, any time they issued it. Is that what it is?

Ms. McWeeney: There's some smoothing that goes on, but that's what it's trying to get at.

CHART 1

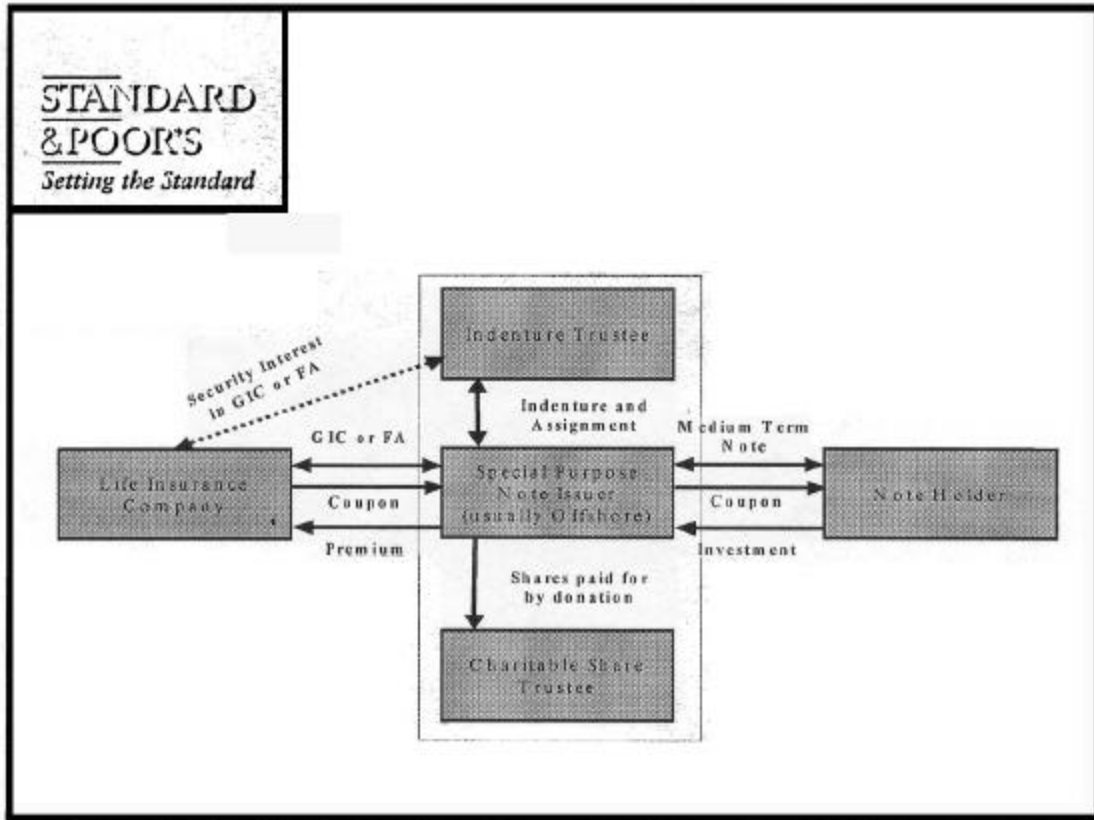


CHART 2

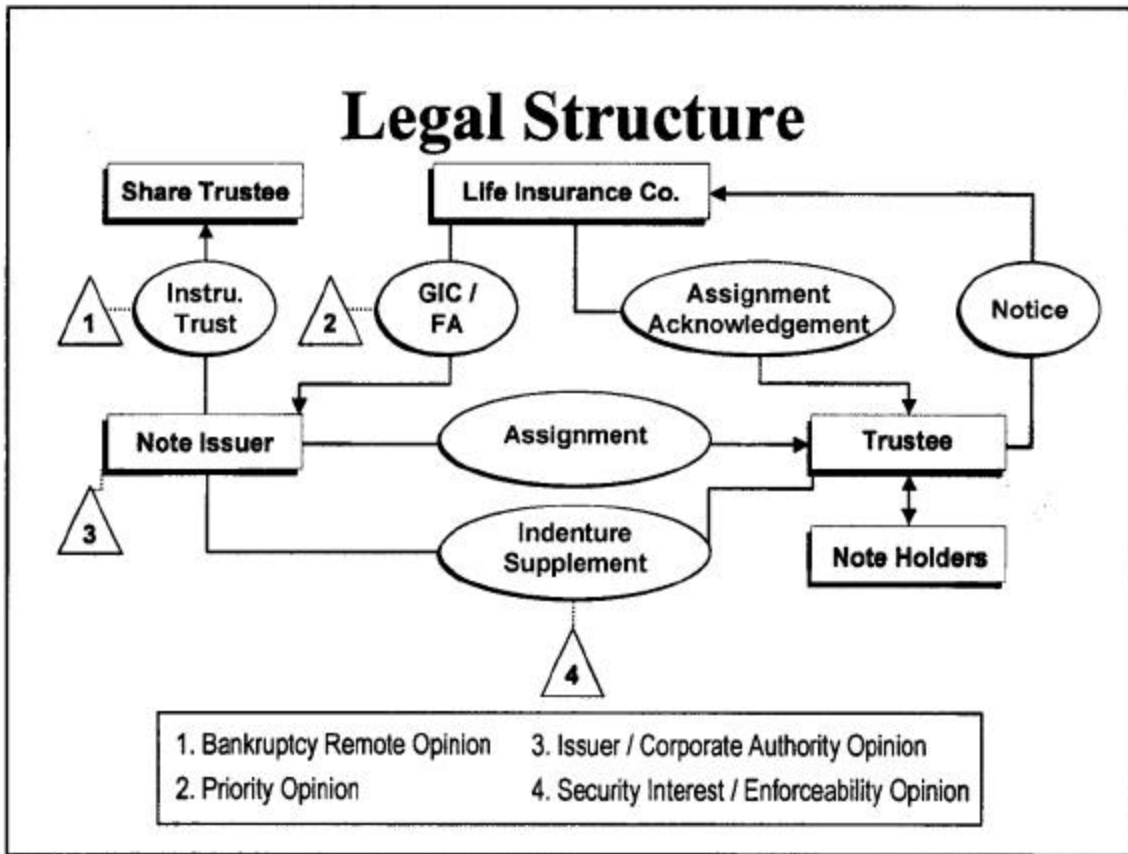


CHART 3

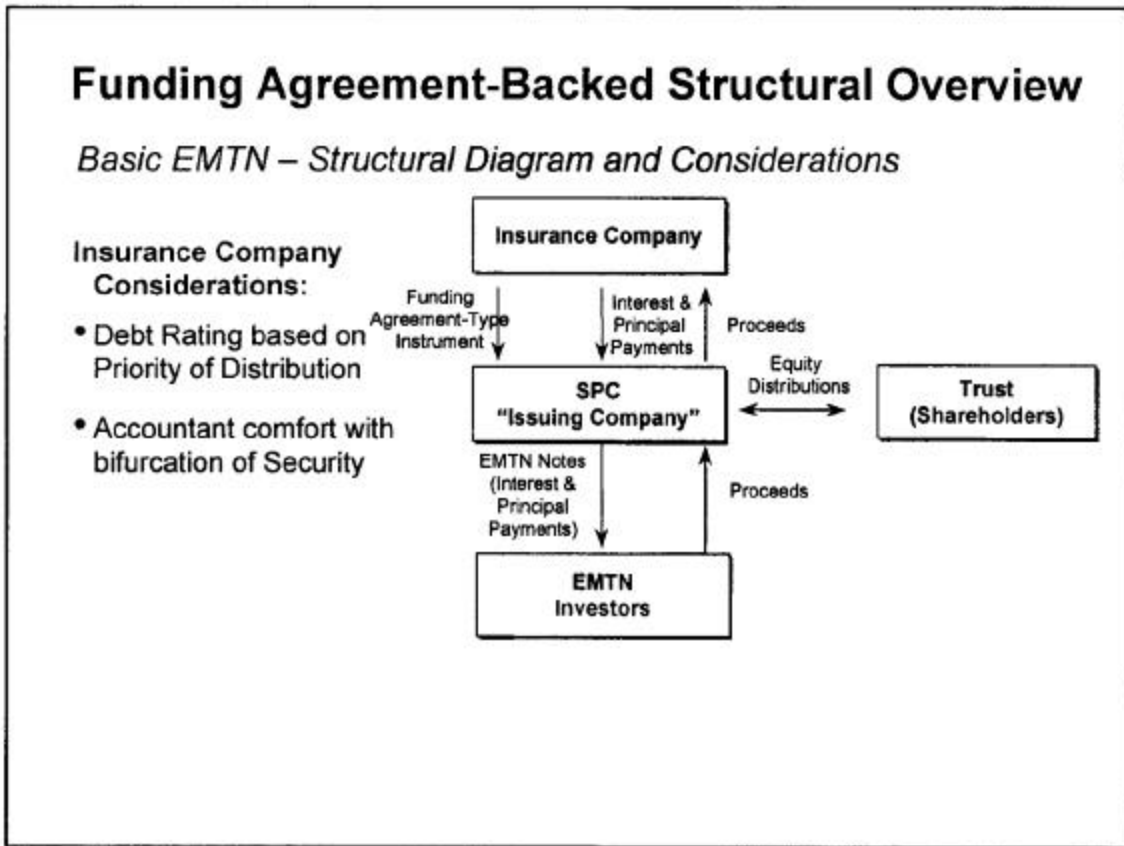


CHART 4

Schematic of Conduit

