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Capital Efficiency Drives Convergence Between Insurance And Capital Markets

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The capital markets continue to feel the effects of this summer's sub-prime mortgage situation. Although liquidity is returning to debt markets, equities are not yet out of the woods. With these factors in mind, some might have anticipated that the nascent market for insurance-linked securities would promptly wither and die.

On the contrary: The convergence between the insurance and capital markets continues apace and, in fact, only grows deeper. The sub-prime events of the summer have made investors more interested in risks that are a somewhat rare commodity—risks that are uncorrelated with more traditional investments.

As the sub-prime market's effects are rippling from mortgage lenders to hedge funds to investment banks and beyond, the diversification offered by insurance-linked securities (ILS) investments is more important than ever. In fact, new issuance in 2007 already exceeds that of 2006, with more than \$32 billion of total bonds outstanding.

The idea behind these securitizations is to offer industry gatekeepers and investors clarity and transparency regarding the risk profile of a specific block of business so that they can get comfortable with a higher degree of leverage for it.

Life insurance-linked securities have largely been wrapped by financial guarantors, and distributed across a relatively limited investor base. But in their quest for improved diversification, investors will become more familiar with ILS as an asset class, and we can expect to see issues involving unwrapped senior and subordinate securities.

Insurance-linked securities offer compelling benefits and the number of transactions is expected to grow significantly as life insurers look for ways to deal with large regulatory reserve requirements and low returns on equity. In fact, a growing number of life insurance companies are beginning to see the benefits of securitization as an important tool to help them improve capital efficiency. This bodes well for a strong future flow of life insurance-linked deals.

The majority of issuance to date has been regulatory reserve financing transactions more commonly known as Triple-X and A-Triple-X. The drivers for these transactions are the conservative assumptions embedded in the regulatory requirements regarding reserves. These involve outdated mortality information, little or no recognition for the likelihood of future lapses, and interest rate assumptions that are typically out-of-step with prevailing yields. All of these create a degree of redundancy in the level of required regulatory reserves, adversely affecting the insurers' ability to deploy their capital productively. This is particularly true for products such as level premium term life and universal life with secondary guarantees.

Most reserve financing structures have utilized an onshore captive as a reinsurer and as the vehicle for financing the redundant Triple-X and A-Triple-X reserves. This arrangement allows insurers to maintain tax consolidation of the subject block of business, so they can continue to utilize the net operating losses generated by the policies ceded to the captive.

The capital structure of a Triple-X Captive is comprised of 4 components:

- 1—Debt financing redundant reserves (surplus notes).
- 2—Economic reserves funded from policy cash flows.
- 3—Tangible equity (Sponsor's capital contribution and retained earnings.)
- 4--Embedded value (profits yet to emerge.)

The subordination available to the surplus notes is comprised of items 2-4.

Despite this growing acceptance, the volume of Triple-X and A-Triple-X transactions is expected to decline after 2010. This will happen as a result of the likely adoption of principles-based reserve methods over the current formulaic approach, and the regulatory reserve problem will become less critical. Instead, embedded value, or EV, transactions will assume a higher profile, and become the preferred solution for a range of capital management issues, including return on equity enhancement, capital redeployment and risk transfer.

Where Triple-X and A-Triple-X transactions are designed to deal with regulatory reserve requirements unique to term and UL products, EV can be applied to many different types of business. In contrast to Triple-X and A-Triple-X securitizations, EV transactions are essentially the sale of the future profit streams on a defined block of business.

One key benefit of an EV securitization is a significant enhancement in ROE, due to the amount of leverage that can be applied to a block of business relative to what is otherwise possible. In contrast to a conventional life insurer's capital structure, where debt leverage ratios generally do not exceed 25%, the special purpose vehicle created for an EV transaction will have up to 70% of its capital in the form of senior debt. In addition, if structured properly, an EV securitization should not impact a sponsor's debt leverage ratios.

EV transactions are also utilized as a means of raising non-recourse financing to redeploy into faster growing product lines. For example, a sponsor may look at its product portfolio and see a large slow-growing or declining book of whole life business that is generating free cash flow. Conversely, it may see that its variable annuity business is growing at a rapid pace and is a consumer of cash. An EV securitization of the whole life book's positive net cash flows could be utilized to raise funds to support VA use of cash.

Prior to the development of EV technology the only option typically available was a block sale via a reinsurance transaction. The buyer typically prices these transactions assuming a heavy proportion of equity capital. An EV transaction allows a sponsor to reduce the cost of capital component due to the heavier proportion of debt in the securitization and thus receive more proceeds from the securitized block of business.

Securitization can therefore be used to round out a reinsurance program, whereby varying degrees of risk are transferred to investors (with commensurate levels of financing cost).

Insurance-linked securities offer life and health insurers an opportunity to pursue more effective capital management. Over the last decade, they have grown and become more widely accepted by the institutional investors seeking uncorrelated risks to add to their portfolios. The 40% year-over-year growth in the last few years shows that ILS transactions are now considered to be credible solutions for all parties involved.

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