

Coming of age

Can small to medium-sized players take advantage of the life securitisation market? asks **Scott Willkomm**.

THE SECURITISATION OF LIFE insurance assets and liabilities is steadily evolving from a series of one-off transactions orchestrated by mad men and pioneers, to an organised and credible segment of the asset-backed capital markets. Today, life securitisation is emerging as a powerful, but subtle force that in the near term may afford early adopters an incremental competitive advantage; and in the long term, transform the industry's perspective on risk and capital management.

THE LIFE SECURITISATION LINE

Securitisation is one of the most important innovations of modern corporate finance. Developed in the US in the 1970s as a technique to efficiently finance mortgage loans, this segment of the capital markets has evolved into a vast pool of capital used to finance a wide range of financial and real assets.

Over the past 30 years, financial institutions have deployed securitisation as an effective tool for optimising balance sheets, managing or mitigating risk, creating liquidity and materially enhancing financial returns. As a result of broad acceptance, global securitisation new issue volume approached \$3trn in 2005, according to the Bond Market Association.

Very little of that volume can be attributed to life securitisation. While several life insurance securitisation transactions have been successfully completed since the mid 1990s, regulatory uncertainty and the abundance of competitively priced capital and alternative capacity (like low cost letters of credit or reinsurance) rendered the development of this asset class superfluous. Only in recent years have changes in the reinsurance markets, solvency requirements, cost of capital and macro economic conditions energised efforts to develop this asset class. With \$10trn of assets and liabilities – many of which are suitable candidates for securitisation – the life insurance industry is a prime candidate for securitisation transactions that meet regulatory scrutiny, mitigate risk and deliver efficiently priced capital.

Today, securitisation is gradually emerging as a catalyst that has the potential to transform how life insurance companies finance, transfer and transform risk. This pickup in securitisation activity has been driven by several catalysts: first, changes in regulation that are increasing solvency requirements and driving up the risk-adjusted cost of capital; second, limited capacity to fund growth through traditional forms of capital

financing; and third, an increasing focus on risk management disciplines and the use of the capital markets to hedge risk or diversify the sources of capacity available to an industry that has become increasingly subject to risk aggregation as a byproduct of consolidation among industry participants.

There are a number of common elements to virtually every securitisation. A sponsoring party (typically a bank or finance company) contributes a pool of assets or pledges the cash flows from financial relationships (such as auto loans, equipment leases or royalty payments), to a special purpose vehicle (SPV) that is isolated from the sponsor. The SPV issues securities to investors and uses the proceeds to compensate the sponsor for the contributed assets or cash flows. The asset values or cash flows in the SPV are used to repay investors, with a margin left over for the sponsor. Occasionally, the sponsor may contribute funds in addition to the assets or cash flow pledge in order to over-collateralise the structure and enhance the credit of the securities. The security provided by pooling assets or predictable cash flows (and any over-collateralisation) increases the credit quality of the SPV relative to the credit quality of the sponsor and, accordingly, reduces the cost of capital needed to fund the vehicle when compared to the sponsor's standalone cost of capital.

Yet, differences in the securitisation of assets versus liabilities hold important implications for regulated financial institutions. In an asset-backed transaction, such as an auto loan, the borrower receives funds at the inception of the loans and then makes payments of principal and interest over time to service and ultimately repay the loan. In this case, the originator is exposed to the credit risk of the borrower, but the borrower is not exposed to the credit risk of the originator. The transfer of this asset to another party, such as a securitisation SPV, does not alter the economic position or rights of the borrower. Thus, the regulatory authority that supervises the originator is not overly concerned about the borrower in this instance. In fact, the vast majority of asset securitisation transactions never reach the regulator's desk for approval.

The opposite holds true for the securitisation of life insurance liabilities. In this case, cash flows are paid to the insurer in the form of premiums, and benefits payments (such as an annuity payout or a life insurance death benefit) are paid to the policyholder in the future. Thus, the policyholder is exposed to the credit

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worthiness of the insurer. Since the transfer of such an obligation by the insurer to another party (such as a securitisation SPV) can dramatically alter the position of the policyholder, a greater degree of regulatory scrutiny and oversight exists. Accordingly, it has taken significant time and effort for regulators to outline a consistent framework for evaluating securitisation transactions, and few jurisdictions have the necessary legal constructs that enable securitisation transactions. Moreover, virtually all life insurance securitisations require explicit regulatory approvals in order to be completed.

REAPING THE BENEFITS

Nevertheless, there are numerous benefits to life securitisation that make the obstacles worth confronting, and the level of interest among life insurers suggests that the technique is more than the current fashion. The benefits of life securitisation may include:

Reducing the insurer's risk adjusted cost of capital

– In general, securities that are backed by specific assets or a pledge of cash flows enjoy higher credit ratings than the unsecured indebtedness of the insurer and, accordingly, bear a lower cost of capital;

Transparency – Securitisation requires greater transparency surrounding the nature of the assets or cash flows backing the securities issued by the SPV and in the process, offer a greater amount of information and comfort surrounding the insurer and its risks;

Risk transfer or mitigation – Securitisation transactions tranche a gross pool of various risks into discrete ones that investors can understand and digest, reducing the risks retained by the sponsor. Such risk transfer can serve to diversify one's risk exposures. Key risks that may be securitised include mortality, longevity and persistency risks;

Accelerate the balance sheet – Securitisation allows a sponsor to temporarily commit capital to fund the accumulation of pool assets. When the SPV issues securities to investors, it often uses the proceeds to recycle the capital committed by the sponsor so it can be redeployed to support the growth being experienced by the firm;

Level the playing field – Securitisation can serve to "level the playing field" in three important ways: (i) to enable smaller insurers to access cost of funds that are competitive with the cost of funds enjoyed by larger competitors; (ii) allow insurers to compete more effectively with other financial institutions and (iii) afford mutual life insurers the opportunity to access a deep segment of the capital markets while preserving the company's mutuality;

Create liquidity – Securitisation transforms relatively illiquid assets or cash flows into tradable securities and assists in monetising an insurer's balance sheet;

Reduce interest rate risk – Securitisation allows companies to match long-duration liabilities with duration-matched assets, reducing the firm's exposure to changes in interest rates;

Competitive advantage – The securitisation of life insurance assets and liabilities has been used by several

insurers to increase their capacity for growth or to crystallise tax and other benefits that can be used to improve product pricing; and

Improve capital adequacy and solvency – Life securitisation can enable the monetisation of an insurer's embedded value and improve the capital adequacy and solvency position of an insurer.

The benefits of securitisation are many, but all share the common feature of decreasing the risk-adjusted cost of capital of the sponsor and thereby increasing the sponsor's return on equity.

Securitisation is also prompting changes to the business model of life insurers to one characterised by capital and risk management expertise. The traditional "buy and hold" approach is evolving with securitisation to include a balance sheet "acceleration" component. The new model calls for companies to source and aggregate risk on the front end, and to intermediate risk to the capital markets.

To date, the vast majority of life insurance securitisation transactions have been successfully completed by large organisations. Yet, several small to medium-sized companies (SMEs) have demonstrated that a focused effort can drive a successful securitisation effort and deliver significant benefits. In fact, SME life insurers stand to benefit the most from a successful securitisation programme by closing the cost of capital gap and providing access to significantly more capacity to support growth. The challenge for SME companies is to accumulate a sufficiently large, homogeneous block of business that can be analysed and securitised efficiently. In addition to having sufficient business to contribute to a securitisation, the sponsor needs to be prepared to make a significant investment in actuarial modelling capabilities, corporate finance expertise and administration capabilities. For the SME, a more efficient means of accessing the securitisation marketplace and reaping its benefits might come from having a relationship with a reinsurer willing to aggregate risk from several ceding companies and contribute it to an efficient securitisation process.

While securitisation has been slow to catch on in the life insurance industry as compared to other financial institutions, the recent increase in the number of transactions suggests that the technique is beginning to gain acceptance among an expanding constituency. Ultimately, broad acceptance of this corporate financing tool will be driven not by fashion, but by economics. As insurers recognise and embrace the ability to optimise their balance sheets and reduce their risk-adjusted cost of capital through innovative securitisation structures, activity in this asset class will accelerate. Over time, widespread use of securitisation to repackage traditional life insurance risks into something that can be absorbed by the capital markets will have a transformational effect on the life insurance industry and how it sources, retains and funds risk.

By Scott Willkomm, president and chief executive officer of Scottish Re Group.

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