The Future of Securitization and Onshore Facilities

Presentation to the Actuaries' Club of the Southwest

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Agenda

I. The Past

II. The Present

III. The Future

I. The Past

Background / Experience

- Milliman has advised on, at least 80 life ILS transactions involving over $46 billion of funding
  - $36 billion (56 deals) of XXX or AXXX excess reserving financing transactions
  - $4 billion (12 deals) of Longevity, CAT mortality or CAT morbidity transactions
  - $6 billion (12 deals) of Embedded Value financing transactions

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“Securitization”

- Pooling of risks and creating securities, which are sold to capital market investors
- e.g. MBS, ABS
- Insurance examples (often referred to as “Insurance Linked Securities” or “ILS”)
  - Natural catastrophe bonds
  - Mortality and morbidity catastrophe bonds
  - Embedded Value (or VIF) securitizations
  - Excess reserve securitizations
  - Longevity risk securitizations

Why Securitize?

- Risk Transfer – "nat cat" bonds & "mort / morb cat" bonds
- Monetize future profits – EV or VIF
- More efficient capital – Excess reserve financing transactions structure

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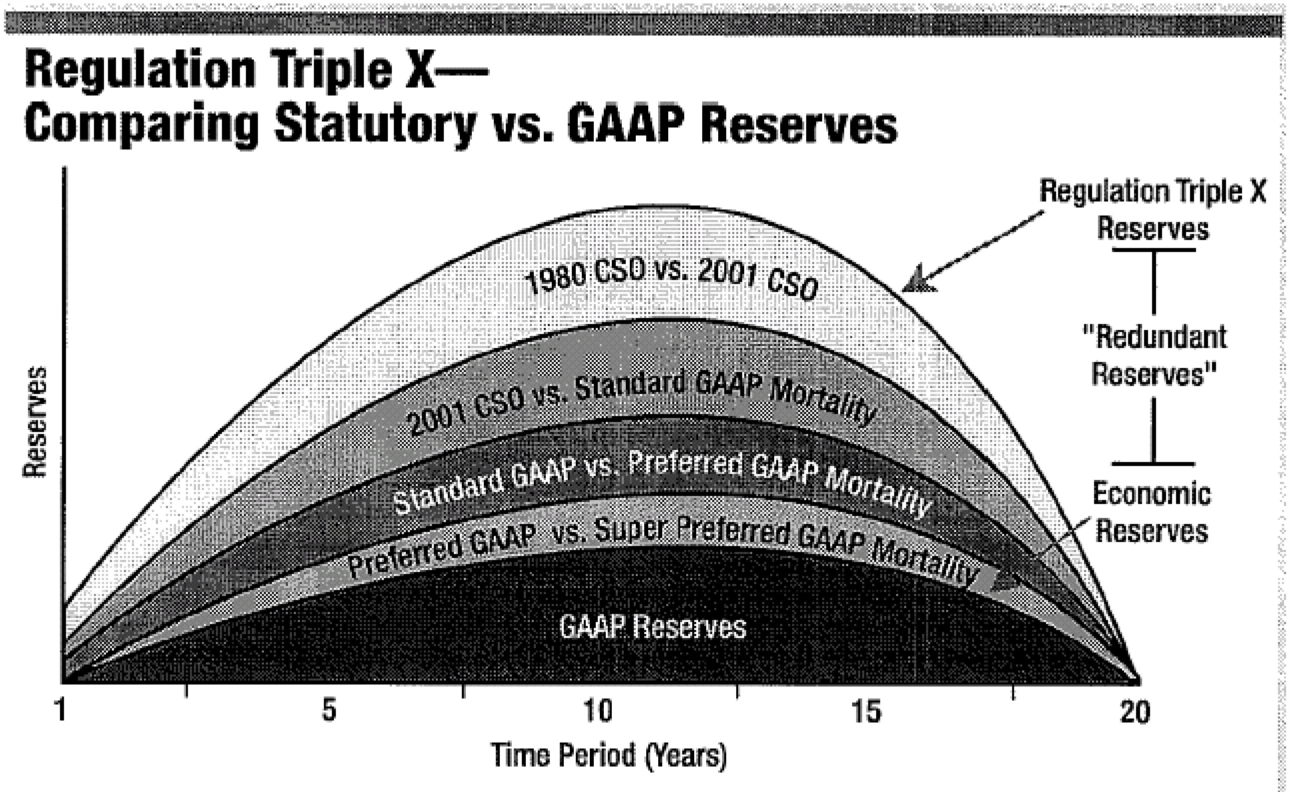
The Problem



Source: A.M. Best Co.

History of XXX / AXXX

Pre 1995 – Industry effort, NAIC effort, NY effort

1995 – NY adopts Reg 147, industry and NAIC back to drawing board

2000 – X-factors, other changes, leads to NAIC Model

2003-2007 – Various iterations of AG38, interim solutions, push for PBR

2009 – SVL Model adopted, but not yet sent to States; work on VM

2011-2012 – Revisiting AG38, bi-furcated approach approved

2012 – VM adopted; SVL and VM to State Legislatures in 2013-2014

2015 (?) – PBR

So Why Are We Still Talking About This?

- Marketplace has confirmed excess reserves
- Regulators haven't "fixed" XXX / AXXX
- PBR May Be Coming in the Future
- But When?
- And PBR is Just Prospective
- In force blocks of level term and UL-SG continue to grow
- Companies continue to sell products generating significant levels of excess reserves

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Why are Companies Executing Reserve Financing Transactions?

- To obtain <u>low-cost</u> financing of excess reserves
- In a structure that <u>meets statutory risk-transfer</u> requirements
- With <u>favorable rating agency treatment</u>
- In a <u>tax-efficient</u> structure

History of XXX / AXXX Financing Market

2003-2007 – Non-recourse funded securitization deals with monoline wrap

2005-2007 – Private recourse deals, typically with CDS protection

2008 – Freeze through most of year; several LOC deals closed late in year

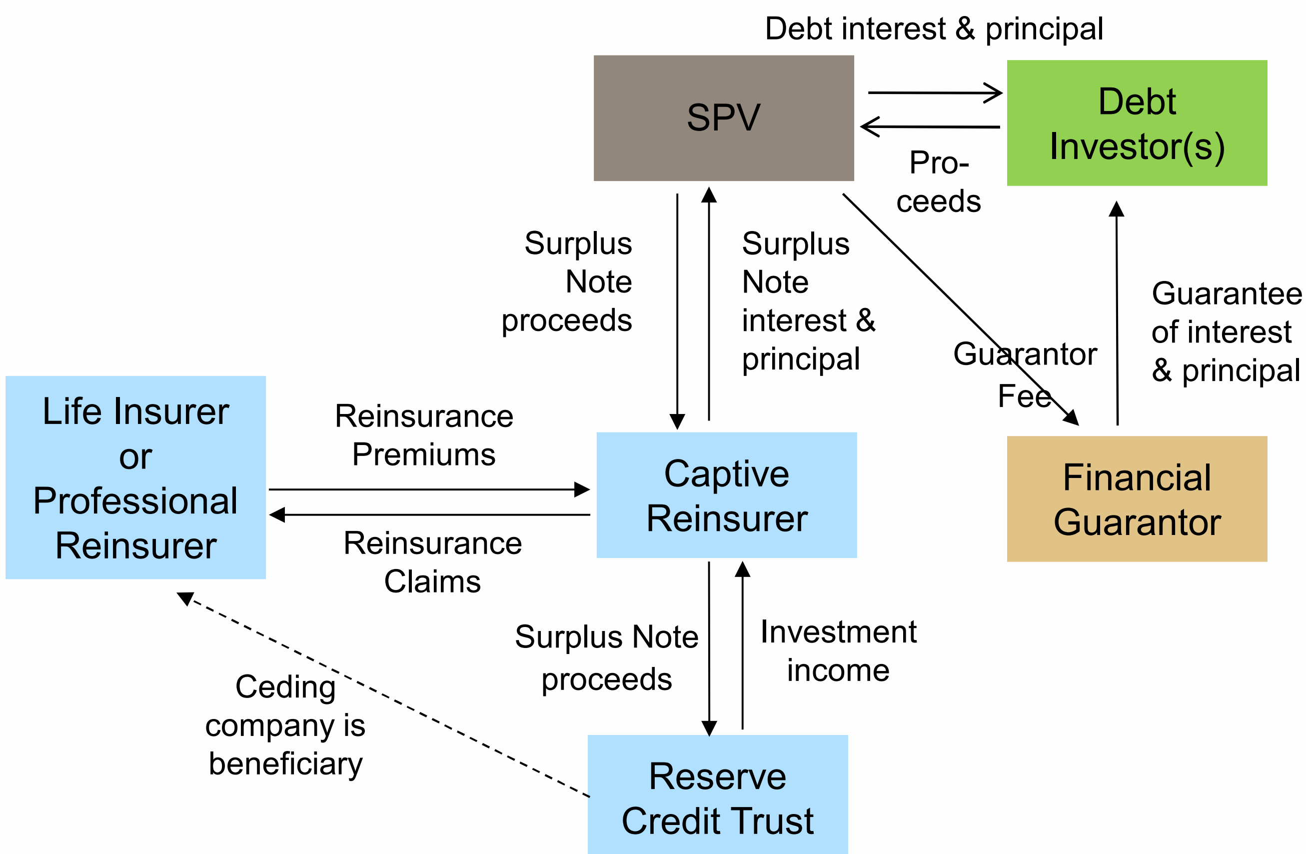
2009-2010 – More activity on wide range of approaches

- Mostly LOC based deals
- Most are recourse, though some non-recourse
- Shorter tenor than in past (commonly 7-15 years, some longer, some shorter)

2011-2012 – More non-recourse

- Many LOC based, but other approaches also being used (e.g. LPS)

Pre – 2008 Common Structure for EV Transaction and Reserve Financing Transaction



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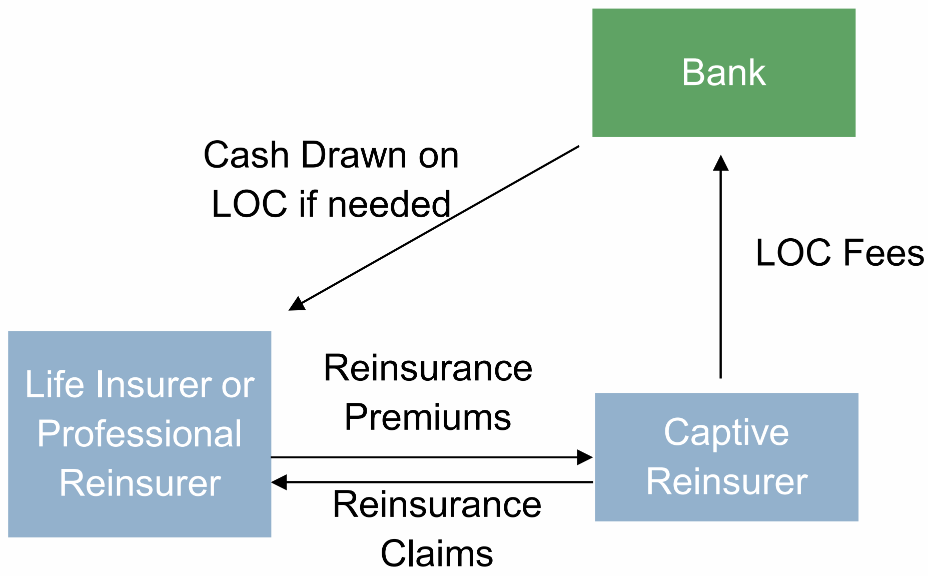
II. The Present

LOC Format Generally Followed Since 2008

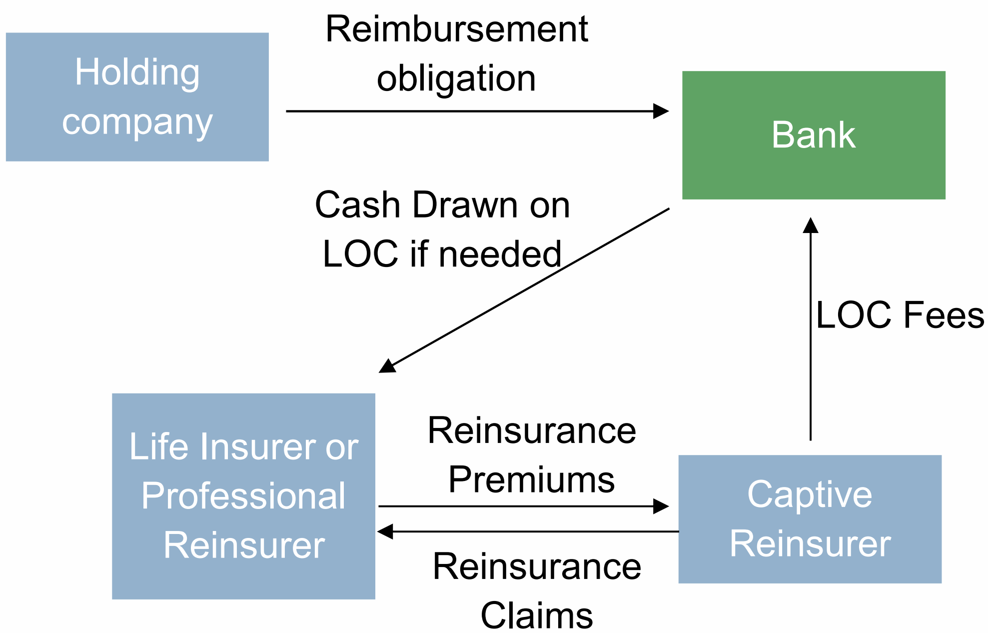
- Insurer cedes a block of term, UL-SG or combo to a captive
- Captive enters into LOC which names ceding insurer as beneficiary
- Cedant capitalizes captive
- Cedant receives credit for reinsurance
- One constant observed by S&P – likelihood of a draw is remote
  - For XXX, typically need extended mortality in excess of 150% per year
  - For AXXX, typically needs combo of extended low interest rates forever and significant mortality and lapse deviations

Source: Standard & Poor's "The Changing Landscape of XXX/AXXX Reserve Requirements Will Challenge U.S. Insurers", Feb 29, 2012

Common Non-Recourse LOC Structure



Common LOC Structure with Recourse



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Solutions Other Than LOC

- ~~Widely Distributed Securitizations wrapped by Monolines~~
- Internal funded solutions usually with HoldCo Senior Debt Financing
- Structured Reinsurance
- Other forms of collateral acceptable to the cedant’s regulator

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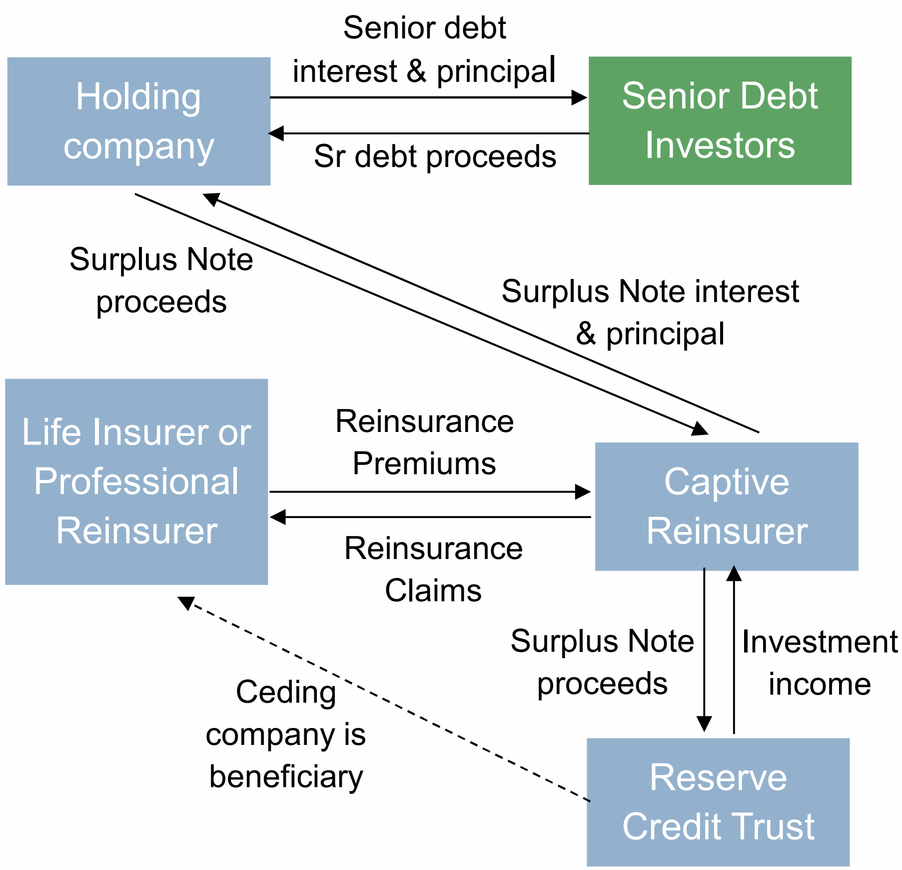
Internal Funded Solution with HoldCo Senior Debt



III. The Future

NAIC Captives & SPV Use Subgroup Background

- NY Times Article, May 2011

- NAIC "E" Committee – regulator-only calls, June – October, 2011, plus public discussion at June and September NAIC meetings

- NAIC Charge to E Committee (October, 2011):

  "study insurers' use of captives and special purpose vehicles … in relation to existing state laws and regulations and establish appropriate regulatory requirements to address concerns identified in this study"

- May lead to modifications to existing NAIC Model laws / regs or new NAIC Models

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NAIC Captives & SPV Use Subgroup Background

- Formed in October, 2011
- Two members each from:
  - Financial Analysis (E) Working Group
  - Life Actuarial (A) Task Force
  - Reinsurance (E) Task Force
- Started regular meetings at end of January, 2012

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NAIC Captives & SPV Use Subgroup
2012 Activities

- During 2012, the Subgroup covered a range of topics:
  - Scope
  - State authority
  - Transparency and confidentiality
  - Types of business and risks
  - Capitalization
  - Accounting and reporting
  - Credit for reinsurance
  - Holding company considerations
- Significant number of public and private conference calls
- Surveyed Insurance Departments -- big challenge was limited access to information
- White Paper Discussion Draft released on October 17
- Comments Due by November 16

NAIC Captives & SPV Use Subgroup White Paper Discussion Draft Survey Results on Reserve Financing

- Vast majority of the transactions between a commercial insurer and a captive insurer are a means of dealing with perceived XXX and AXXX reserve redundancies
- All of the regulators that have been involved in these types of transactions indicated that they review such proposed transactions in detail to ascertain at a minimum that the transaction does in fact match its intent, to transfer the redundant/non-economic reserves to the captive/SPV
- Most states also determine and require that the transaction meets the credit for reinsurance requirements
  - To do so, the assuming captive or SPV assumes the full statutory reserve liability and secures those reserves in various manners (e.g., LOC)
  - Common to use as collateral "any other form of security that is acceptable to the commissioner"

NAIC Captives & SPV Use Subgroup White Paper Discussion Draft Consensus View Points

- Transparency and Confidentiality
  - Subgroup found differing thoughts and particularly differing legal requirements, which prevented any consensus on the subject
  - Some felt that confidentiality is needed and even required in some states, especially because of the single transaction nature of these captives
  - Others felt that, at a minimum, financial statements should be publicly available
  - Despite these differences, Subgroup felt that there is a need for all states to have the ability to understand the transactions, and the information sharing sections in the captive laws and regulator confidentiality agreements should be utilized as needed to address this

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NAIC Captives & SPV Use Subgroup
White Paper Discussion Draft
Consensus View Points

- Accounting and Reporting
  - Subgroup held a consensus view that it was <u>inappropriate</u> for <u>captive insurers</u> to be <u>used</u> as a means <u>to avoid statutory accounting</u>
  - Subgroup held a consensus view that a <u>more appropriate accounting treatment</u> of XXX and AXXX reserves <u>should be pursued</u> as opposed to the use of captive insurers thereby eliminating the need for the separate transaction outside of the commercial insurer simply to address these perceived reserve redundancies
  - Subgroup held a consensus view that the Financial Condition (E) Committee should form a <u>separate subgroup</u> to <u>develop possible solutions</u> for addressing the remaining XXX and AXXX perceived redundancies

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NAIC Captives & SPV Use Subgroup White Paper Discussion Draft Consensus View Points

- Credit for Reinsurance
  - Subgroup held a consensus view that these types of transactions [conditional LOCs or parental guarantees] were not consistent with the NAIC credit for reinsurance requirements
  - Subgroup felt a more appropriate way to address such concerns regarding redundancy in reserves ➔ accounting for the underlying business at the primary insurer level -- eliminates need for the separate reinsurance transaction
  - Subgroup expressed its support for the use of solutions designed to shift risk to the capital markets or provide alternative forms of business financing ➔ NAIC should consider developing a uniform framework for the implementation of such alternative market solutions
  - Subgroup recommends enhanced disclosure [with regard to existing transactions] in ceding company statements regarding the impact of the transactions on the financial position of the ceding insurer

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NAIC Captives & SPV Use Subgroup
White Paper Discussion Draft
My Reactions to Discussion Draft

- Emphasis on “My”
- Purpose of these transactions – are companies trying to avoid statutory accounting requirements?
- Can’t we just fix the reserving mechanism?
- Why not just issue debt?
- Why use a captive; can’t this financing be done within the insurer?
- Are these transactions thinly capitalized?
- Is there a shadow insurance industry developing?
- Are companies meeting the Credit for Reinsurance model requirements?
- Is more disclosure / transparency needed?

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