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Focus on restructuring*

Innovative financing: life insurance securitisation

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Insurance Services M&A

Overview

- Securitisation of life insurance portfolios could provide a valuable source of financing for acquisitions and other strategic investments by releasing the embedded value from blocks of business.

- Securitisation of mortgages and credit card receipts is already commonplace. Recent placements have helped to demystify and highlight securitisation's potential within life insurance.

- Almost any asset or liability and its underlying cash flows could potentially be marketed for securitisation including premiums, charges, commissions and reserves.

- Investors in life insurance securitisation have been attracted by competitive yields and the opportunity to diversify their asset-backed portfolio away from the current concentration on consumer credit.

- The use of credit wraps backed by third-party guarantors is helping to limit risk to investors and enhance market confidence.

- The development of securitisation is significantly increasing the life insurance sector's access to the financial markets. This could eventually create a liquid market in life portfolios, which could in turn have a far-reaching impact on financing arrangements and the cost of capital.

- Securitisation could potentially facilitate a fundamental shift in life insurance business models, with manufacturers taking on the role of intermediaries that underwrite and package risks before transferring them to the financial markets.

Opportunities

Raising capital through securitisation is gradually gaining acceptance within the life insurance sector, opening up opportunities to enhance returns, improve capital flexibility and provide new sources of funding for acquisition.

Like most financial innovations, securitisation initially attracted a certain amount of bewilderment, even suspicion. Fundamentally, however, it is nothing more than the separation of a portfolio of assets or rights to a set of cash flows, followed by their packaging into securities placed and traded in the capital markets.

> **'Securitisation has the ability to address the long payback periods of life products – one of the key investor concerns about the life industry.'**
>
> **Morgan Stanley**
>
> Broker note – UK Life Insurance, 30th March 2005

While securitisation has primarily centred on mortgages and credit card receivables, the development of increasingly sophisticated debt markets is now bringing an ever-broader range of assets onto the securitisation radar. In relation to life insurance, this includes the potential securitisation of premiums, charges, commissions and reserves.

The deployment of capital within the life insurance sector is under the spotlight in the face of new prudential regulation and pressure from investors for faster and more competitive returns. Securitisation helps life companies to punch their weight by releasing some of the embedded value in their business. The potential benefits include increased liquidity, lower cost of capital and improvements in key performance indicators such as return on equity.

Acquisition funding

At a time when merger and acquisition (M&A) is moving up the life insurance agenda, securitisation could prove especially valuable as a source of funding and an opportunity to enhance capital flexibility. Companies can release capital from their own portfolios or free funds tied up in an acquired entity, for example through the securitisation of a closed book of business. Securitisation is being considered by predatory buyers as a potential opportunity to leverage the assets and enhance the balance sheet of companies making limited or inefficient use of capital.

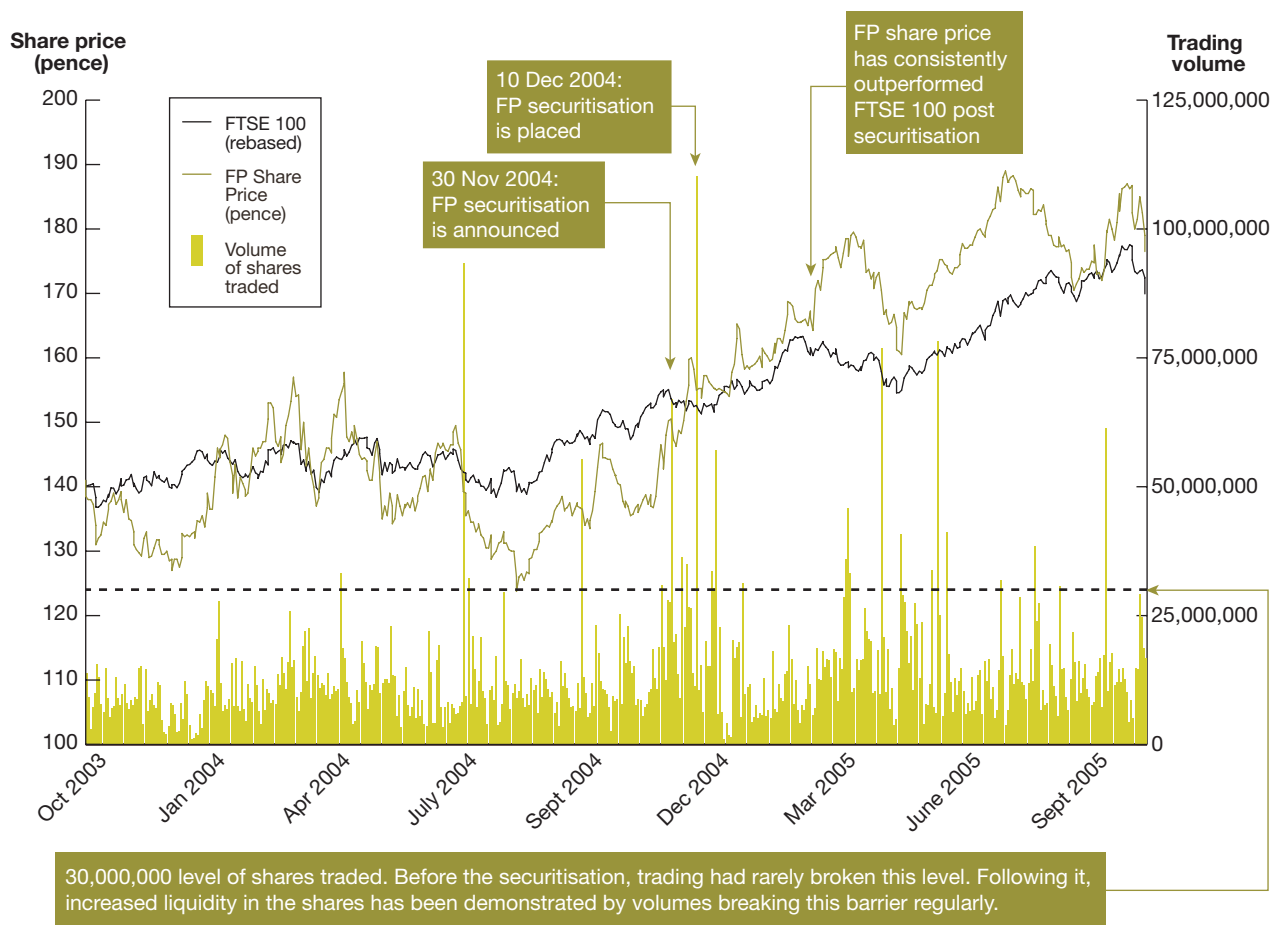
Smoothing returns

Securitisation has recently tended to be more cost competitive than straight equity, subordinated debt or hybrid products. Further, securitisation has the potential to transfer risk off the balance sheet, which can help to protect against adverse shifts in interest rate, mortality, lapse and counterparty risk. Securitisation has the advantage of providing access to the funding potential of the capital markets. In contrast, financial reinsurance remains relatively expensive and comparatively limited in its availability.

Freeing regulatory capital

As more territories move to Basel II-type prudential regimes, life insurers could find that more of their capital is tied up in the business. In particular, companies are increasingly reaching the ceiling for the amount of subordinated debt they can use to demonstrate solvency. Securitisation could offer a solution as the funds raised can potentially be counted as core Tier I solvency capital.

Figure 1: Friends Provident trading performance



Sources: PricewaterhouseCoopers, Factiva

Understanding the business

The originators of a securitisation need to be able to provide potential guarantors and investors with credible in-depth projections of the risk / reward profile of the business being placed. Therefore, preparing for placement has the important spin-off benefit of helping companies to improve their understanding of the value drivers within their business. In turn, securitisation can enhance market credibility by making the value of assets and future earnings more explicit to analysts, investors and rating agencies. It is notable that after the Friends Provident placement, trading in the company's shares and its share price rose sharply (see Figure 1). Securitisation can send a powerful message to the markets that management is prepared to take decisive steps to optimise returns and the use of capital.

Motivations for recent life securitisations

- To monetise the value-of-in-force (VIF) of a defined book of business
- To provide relief from statutory capital requirements and bolster solvency
- To assist in financing new business
- To provide capital to fund acquisition activity
- As a hedging strategy in transferring extreme mortality risk

Hurdles

While life securitisation remains complex, a template for successful placement is beginning to emerge. The key to further development is greater market understanding of how life insurers generate revenues.

Preparation for life insurance securitisation tends to be more taxing than the mortgage or credit card equivalents. This includes a detailed assessment of capital needs, the cash-flow profile of the block of business to be placed and the risk appetite of potential investors. The placement itself requires a considerable amount of coordination and commitment from a range of parties including bankers, lawyers, actuaries, accountants, tax advisers, regulators and rating agencies. Clearly, companies need to take full account of the potential time, expense and demands on management resources.

> ‘Advisors need to make life securitisation simpler and more flexible.’
>
> **Lehman Brothers**

It is also essential to ensure that securitisation is appropriate for the specific capital profile and strategic objectives of the company. The mechanisms for reducing exposure, for example, can be very different from those designed to accelerate earnings. Indeed, it appears that several placements have recently been shelved at a late stage because it transpired that the planned securitisation was not the right mechanism for achieving the desired business goal.

In marketing the placement, companies need to bear in mind that while securitisation in the banking industry is commonplace, it is still a relatively novel concept in the life insurance sector. It can lack market transparency, especially in relation to pricing. Effective explanation and assurance are therefore essential. Credit guarantees have helped to nurture confidence and are giving investors time to build up a better understanding of the cash-flow dynamics of life insurance business.

The success of securitisation relies to a great extent on being able to deliver clearly defined and reliably quantifiable cash flows to the market. Ensuring such clarity and reliability can be more of a challenge when securitising open life portfolios, though recent placements have shown that it is certainly possible to overcome this.

> ‘Securitisation is akin to project financing. Companies need to do their homework by examining their specific circumstances and what they want to achieve.’
>
> **JPMorgan**

The regulatory, accounting and taxation treatment of life securitisations requires detailed planning and structuring. This includes taking into account the differences in approach to securitisation between regulatory and accounting bases. Key considerations include recognition or derecognition of securitised assets, the consolidation of special purpose vehicles and the timing of income recognition.

Winning regulatory backing is clearly critical. Are policyholders’ interests being protected? How watertight is the risk transfer or allocation of regulatory capital? Although supervisors have so far proved reasonably supportive, there appears to be little consensus or standardisation in the

way they assess such deals. This could actually provide an opportunity for companies keen to pioneer best practice. Ultimately, securitisation could be seen as good for the health of the sector by improving capitalisation and transferring solvency and default risk from individual companies to the financial markets.

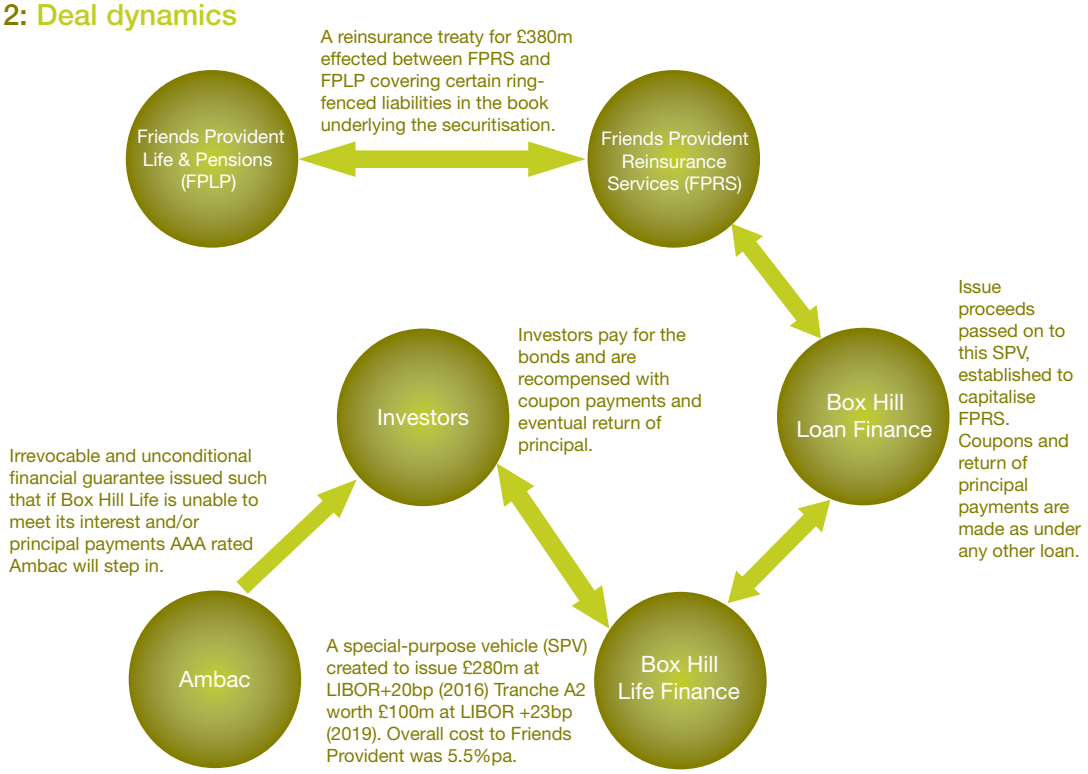
Some commentators believe that the complexities and specific circumstances of securitisation defy standardisation. However, others argue that while each fresh placement has broken new ground, certain common techniques are beginning to emerge, which could help to cut costs and make placements more straightforward. In particular, the recent Friends Provident offering in the UK is seen by some as providing something approaching a template for VIF business securitisation and could act as a trigger for others to follow suit (see Figure 2).

Case study: Friends Provident / Box Hill Life Finance

The structure of Friends Provident's demutualisation split the company's assets and liabilities into a shareholders' fund and a long-term business fund. A sizeable proportion of non profit business was 'trapped' within its with-profits fund. Securitisation enabled Friends Provident to release the future emerging surplus from this business and raise around £380 million of core Tier I regulatory capital. The deal has helped to increase the quality of its capital and generated funds to write new business.

Figure 2 outlines the dynamics of the transaction in more detail.

Figure 2: Deal dynamics



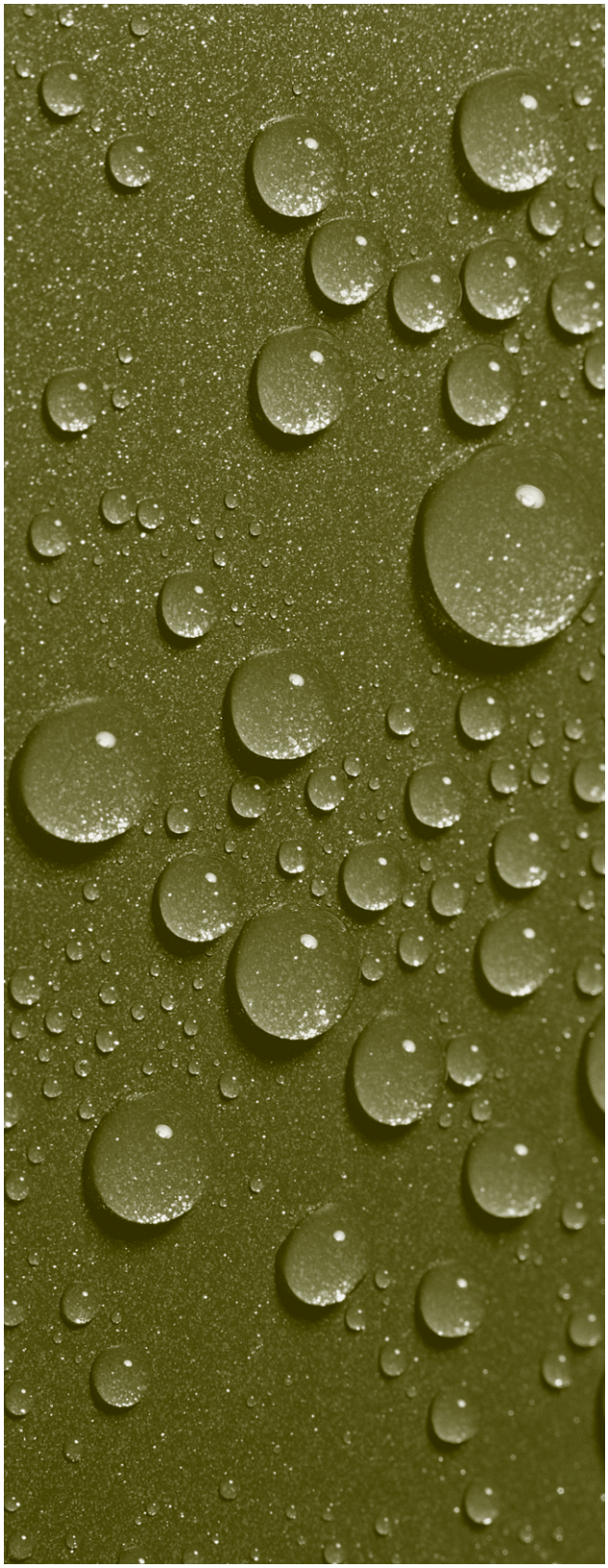
Sources: PricewaterhouseCoopers, Factiva

Recent transaction history

Transaction	Date	Value	Purpose and salient features of transaction
Swiss Re / Admin Re	Feb. 2005	$245M	VIF monetisation from closed block of business • Securities issued in three tranches paying an average coupon of 6.96% • Capital released is to be used to fund acquisitions of closed life businesses in US and UK
Friends Provident Life & Pensions (FPLP) / Box Hill Finance	Dec. 2004	£380M ($735M)*	VIF monetisation of emerging surplus from a block of conventional, unit-linked, and unitised life and pensions business • Improved the quality of solvency held by FPLP by boosting core Tier I capital • Two tranches of floating rate notes (FRNs) issued with average cost of funding of 5.5% • Credit enhancement provided by AMBAC raised rating to AAA
Norwich Union Life & Pensions (NULAP) / Anglia Funding	Oct. 2004	£200M ($356M)*	Set a precedent in UK for using securitisation of premium and commission claw-backs to finance new business activity • Loan secured by two distinct cash flows – protection premiums from policyholders and commission clawbacks from independent financial advisors
Swiss Re. / Vita Capital	Dec. 2003	$400M	Securitisation of extreme mortality risk • Vita Capital is to provide up to $400M to Swiss Re in certain extreme mortality risk scenarios as defined by specified movements in a combined mortality index • Funded by Vita Capital through issuing $400M principal at-risk variable notes over a three year term
Barclays Life / Gracechurch Life Financial	Oct. 2003	£400M ($679M)*	VIF monetisation of entire Barclays Life closed book • As a result of the credit wrap from AMBAC and the involvement of Barclays Bank, which faced high reputational risk if the deal had failed, the issued notes were AAA rated • An innovative transaction partially fuelled by the drive for more cost-efficient financing methods
Genworth I / River Lake & Genworth II (2 tranches)	Jul. 2003 and Dec. 2004	$1,150M and $850M	Regulation XXX securitisation • Provided significant regulatory capital relief on term assurance reserves
Prudential Financial	Dec. 2001	$1,750M	US closed block securitisation, implemented in tandem with its demutualisation • Three tranches, limited recourse security offering • High level of over-collateralisation and guarantees to protect bondholders • Securitisation provided access to surplus that was difficult to utilise due to closed block regulations associated with the company's demutualisation
NPI / Mutual Securitisation	Apr. 1998	£250M ($420M)*	First public traded VIF monetisation in the UK • Open block of policies • Two sequential tranches issued with an overall A-rating
American Skandia	1996 – 2001	$1,100M	Liquidity and securitisation of mortality and expense fees • Provided financing for variable annuities acquisition costs • Securities collateralised by mortality and expense fee income and deferred sales charges on unit linked pensions

Sources: PricewaterhouseCoopers, Factiva

* Exchange rate is taken as at transaction date.



Market trends

Analysis of recent life securitisations in the UK and US offers some valuable insights into the possible development and future direction of such transactions.

Strong yields and good credit ratings have helped to make life securitisation increasingly popular with investors. The risk / reward profile of life insurance also provides an attractive alternative to assets backed by consumer credit, such as mortgages and credit card receivables.

Life securitisation was pioneered in the US. Groundbreaking deals such as Prudential Financial's $1.75 billion closed block securitisation in 2001 highlight that the primary driver there has been regulation. More recently in the US, securitisation has been used to free capital from the 'XXX' solvency reserves relating to term insurance. There are opportunities to apply securitisation to other aspects of insurance business and release funds to help support the growing consolidation within the US sector.

The primary aim of life securitisations in the UK has been the acceleration of emerging surplus, largely through the monetisation of the VIF business.

The NPI securitisation in 1998 was the first public offering in the UK. While the structure was relatively simple, the securitised portfolio was still open and therefore the cash flows relied in part on new business, some of which failed to materialise. As a result, the emerging surpluses failed to meet the original forecasts. The company also experienced wider problems including a credit downgrade.

The experience of NPI led to some reservations about securitisation and it was several years before a fresh placement was undertaken. However, the success of the Barclays Life securitisation appears to have dispelled many of the earlier concerns and renewed interest in such financing techniques.

The Barclays Life placement was able to draw on an entire book of closed business, rather than relying on the surplus emerging from a specific book of unit-linked and unitised with-profit policies, as with NPI. However, the wide spectrum of products involved, which included annuities, term assurance, investment bonds and critical illness cover, required far greater analysis. The subsequent Friends Provident securitisation drew on an open book of both conventional and unit-linked contracts. This indicates that the business does not necessarily need to be homogeneous or even closed to be successfully securitised, as some have suggested.

'Some 80% of securitisation is now standard practice. The remaining 20% is where we can improve on what went before and optimise the benefits of the transaction.'

Lehman Brothers

The popularity of these placements was underpinned by the deployment of credit guarantees that effectively raised the credit rating to AAA. This involved a combination of internal credit enhancement through the establishment of reserve funds or over-collateralising, and external credit wraps backed by third-party guarantors. While some believe that reliance on guarantors may create potential capacity issues, there may be some transfer from more mature areas of the asset-backed market, where the demand for credit wraps and returns generated are decreasing. In time, investors' understanding of life insurance could also reach a point where such guarantees may no longer be necessary.

The securities were divided into tranches within many of these offerings, which enhanced the marketability of the product offering by attracting a wider investor base with varying degrees of risk aversion. Other important developments have included the use of a fully funded reinsurance structure. This offers regulatory and accounting benefits over unfunded financial reinsurance and collateralised loans. Not only is it a more flexible method of drawing out the cash flow, it also has the advantage of easing the insurer's regulatory liabilities.

Future developments

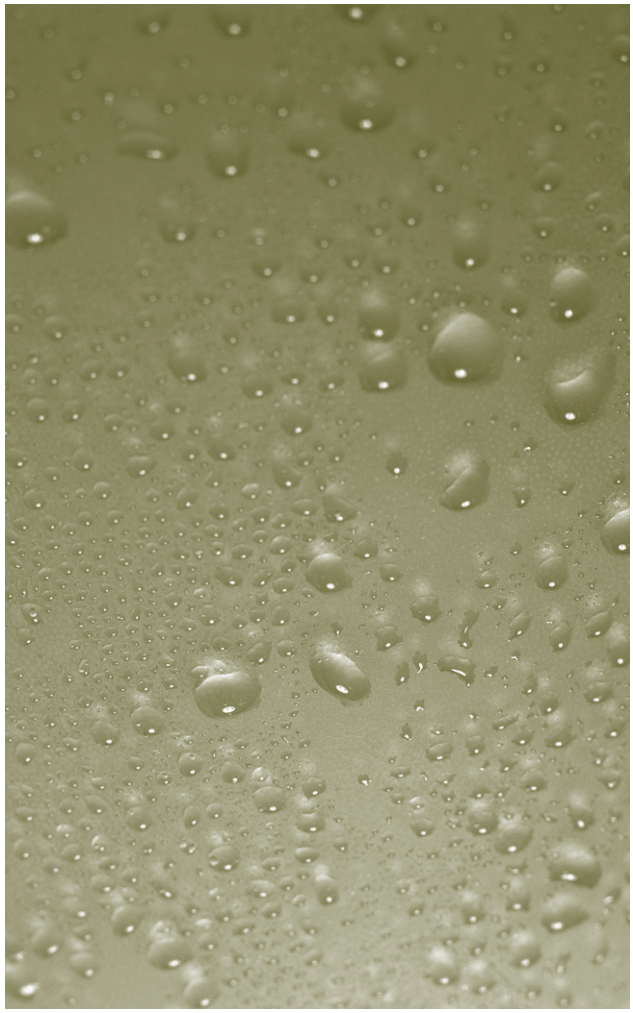
The full potential of securitisation, including its use in transaction financing, is only just beginning to emerge.

Securitisation's capital raising potential is set to grow at a time when spreads are tight and investors are looking for new asset classes. Other openings include the development of securitisation as a hedging tool for life insurers through such instruments as mortality index bonds, which could be structured along the lines of catastrophe (CAT) bonds. Examples already include Swiss Re's issue of some US$ 400 million of mortality index bonds in 2003.

> 'Non-equity financing is becoming an ever more important part of insurance M&A thinking. Securitisation is likely to become a key part of this package.'
>
> **JPMorgan**

In choosing what business to securitise, life insurers may wish to look beyond the basic cash flow to view the embedded value of each portfolio as an asset that needs to be judged against the same risk / reward criteria as a comparable equity or property investment. Companies can then judge whether they wish to hold the 'asset' on their books or transfer its cash-flow characteristics to the financial markets through securitisation. The proceeds could then be used to fund investment that better supports the company's goals. This could include acquisition, business expansion, asset-liability management or other such strategic objectives.

In time, better information and greater investor understanding are likely to lead to a more mature life securitisation market. It is then conceivable that asset-backed investors could become the arbiters of the fair valuation of life insurance contracts, which could in turn lead to the creation of a liquid market in life portfolios. Eventually, we could see the emergence of a business model similar to the mortgage market in the US, in which insurance contracts are sold and then quickly packaged for securitised capitalisation in the financial markets.



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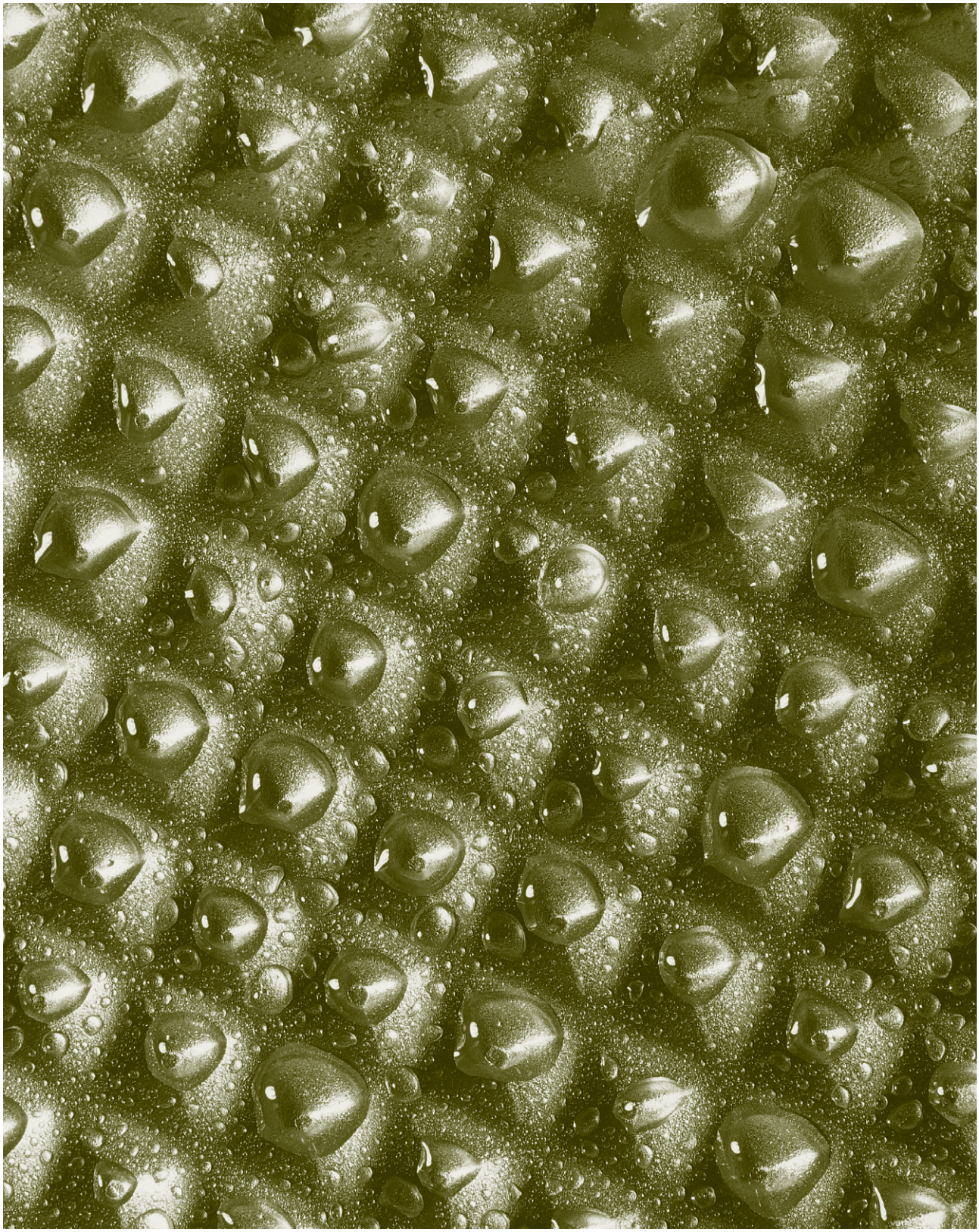

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