

# A new age: life insurance securitisation

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**In the past five years, the United States life insurance industry has begun a new phase in its management of risk. The industry has adopted and developed securitisation techniques to address challenges raised by its regulatory regime and strengthen return on equity. At the same time, securitisation has provided investors the ability to receive exposure to risks uncorrelated with traditional investments. To date the life insurance industry has utilised three basic securitisation transaction types: redundant reserve, embedded value and catastrophic mortality.**



Redundant reserve securitisations have grown most rapidly in recent years, in response to the adoption in the United States of Regulation XXX and Actuarial Guideline AXXX. From the insurers' perspective, these regulations have substantially increased the reserves that life insurers are required to maintain in connection with level-premium term life insurance policies and 'no lapse' or 'secondary' guarantees for universal life insurance policies. These additional reserves are considered redundant to the reserves that insurers believe will be required economically to fulfill the actual policy liabilities. As the redundant reserves are substantial in size (as compared to the amount of the anticipated economic reserves), these reserves have created an immense drag on the working capital of a life insurer selling term policies and 'no lapse' or 'secondary' guarantee riders.

Typical solutions could not provide the complete answer to this problem: as traditional reinsurance with a US regulated reinsurer simply shifted the redundant reserves to the assuming reinsurer and reinsurance with a foreign reinsurer would require the assuming reinsurer to post collateral to support its reinsurance obligations, including the redundant reserves. Letters of credit were generally used to fulfill insurers' needs for funding such reserves; however, traditional forms of letters of credit generally provided a temporary solution that did not match the long term nature of the redundant reserves. (Long-term letters of credit are currently used to provide an 'unfunded' redundant reserve solution in some cases.) A confluence of these factors caused insurers to turn to alternative risk transfer methods to address the redundant reserve problem.

Insurers found a solution in securitisation. Applying securitisation principles, life insurers have used affiliated special purpose reinsurers to segregate the policies for which redundant reserves are required and have funded such reserves with cash received from third-

party investors. In a typical XXX or AXXX securitisation, the insurer cedes, through reinsurance, the risks related to an identifiable pool of insurance policies to a special purpose vehicle that is usually licensed as a captive reinsurer. This reinsurer is financed through its sale of securities. The securities may be in the form of true equity sold to an intermediary holding company which issues debt to investors or in the form of surplus notes directly issued to investors or issued to a trust which then issues debt securities. (A surplus note is a hybrid instrument.) Like a debt instrument, a surplus note requires scheduled payments of principal and interest. However, such payments may be paid only if the reinsurer's insurance regulator determines that the reinsurer has sufficient funds to support its future insurance obligations and, therefore, the surplus notes proceeds are treated as surplus capital by the regulator. The proceeds of the sale of the notes are sized to equal the amount of redundant reserves related to the applicable policies and will be deposited in a trust for the benefit of the ceding insurer. For XXX securitisations, the scheduled maturity date of the notes is usually 30 years while notes issued in connection with a AXXX securitisation have a longer scheduled maturity. The ceding insurer may either transfer to the reinsurer cash and securities with a value equal to the economic reserve amounts or withhold such funds in order to secure the payment of the reinsurer's obligations. Maintaining the assets either in trust or in a funds withheld account allows the ceding insurer to receive credit for reinsurance for purposes of its statutory accounting statements.

Interest on the notes is paid from the net premium received under the reinsurance agreement and investment income from the reserves. Principal is repaid as reserves decrease on the reinsured policies. The notes are structured in a manner that allows them to be treated as debt for US taxation purposes.

Also, the notes are distributed into the 'I44A' or 'qualified institutional buyer' market (that is, institutional investors generally that own and invest over US\$100m in assets) and, under certain circumstances are sold to investors that are also 'qualified purchasers' (that is, institutions generally that own and invest over US\$25m in assets). Similar transactions to date have included third-party guarantees from bond insurers, recourse to an affiliate of the ceding insurer and/or capital maintenance guarantees for the reinsurer by an affiliate of the ceding insurer.

Redundant reserves securitisation transactions are subject to the approval of regulators in both the jurisdiction of the ceding insurer and the jurisdiction of the reinsurer. Regulators for both jurisdictions will look closely at these transactions to ensure first, in the case of the ceding insurer, that the transaction is fair to the ceding company and its policy holders and that the assets supporting the reserves will be available to the ceding insurer without restriction when required and second, in the case of the reinsurer, that the reinsurer will have sufficient capital to pay its possible liabilities.

This review will require both legal and actuarial analyses of the relevant transaction and close coordination among the ceding company, the reinsurer and each regulator to explain the goals and principles of the transaction. The reinsurer usually is a special purpose captive insurance company that is typically formed in a US jurisdiction, such as South Carolina or Vermont, so that the captive reinsurer can be consolidated with the ceding company for tax purposes and the insurance family can retain the tax benefits associated with the redundant reserve requirements. The captive reinsurer is licensed and regulated as an insurer which subjects the activities of the captive reinsurer to the supervision of a state insurance regulatory body.

However, before deciding whether to incorporate the captive as a US or foreign insurer, careful consideration of the tax aspects of the transaction to the ceding company should be undertaken. Among the items to be considered is whether the captive can be consolidated into the tax filings of the cedent and its parent; any taxable income, loss, loss carry-back or carry-forward positions of the cedent and its parent; and if a foreign jurisdiction is chosen the impact of excise taxes and the general level of taxes of the foreign jurisdiction.

One of the most significant regulatory hurdles in redundant reserve transactions has been the requirement that the ceding insurer have unfettered access to the assets supporting the redundant reserves. Regulators of ceding insurers may enforce very stringent restrictions on the amount of control that a reinsurer and its investors have over the

reinsurance trust and the reinsurance relationship in general. This may result in reinsurance trusts not having any limitations on the ability of the ceding company to make withdrawals, including little or no prior notice of withdrawals to the reinsurer.

Investors in insurance securitisations have addressed this risk by delineating the proper purposes and priority for trust withdrawals in the reinsurance agreement and requiring that improper withdrawals be maintained in trust for the benefit of the reinsurer. In addition, other transaction documents will generally contain covenants which prevent the captive reinsurer from agreeing to take actions that could change the intended purpose of the transaction, including covenants with regard to amending transaction documents, calculations of reserves, management of trust assets (including investment guidelines) and withdrawals of trust assets, including withdrawals to repay the principal on surplus notes.

Embedded value securitisation uses techniques similar to those used in redundant reserve securitisations but the purposes diverge significantly. In a redundant reserve transaction, the ceding insurer uses securitisation as a means of financing redundant reserves. The offering proceeds received that are used to collateralise the captive reinsurer's obligations under the reinsurance agreement are generally intended to be used as repayment of the principal amount of the notes issued to investors. Many redundant reserve transactions have been completed with recourse to an affiliate of the cedent. This feature allows investors to seek recourse from an affiliate of the cedent if certain adverse developments occur with respect to the reinsured block. In an embedded value securitisation, the offering proceeds are used by the captive reinsurer to pay a ceding commission to the cedent. The cedent (or its parent) deploys the proceeds to other business initiatives. The notes issued to investors are repaid through the profits generated by the reinsurance agreement. In addition, a transaction of this type does not provide investors with recourse to an affiliate of the cedent. As a result, investors in an embedded value securitisation are more sensitive to the cash flows generated by the reinsurance agreement and, therefore, ultimately the performance of the underlying insurance block.

From the cedent's perspective, embedded value securitisation allows the cedent to monetise a substantial portion of the value of a particular block of business which otherwise would emerge only over that block's life. Embedded value securitisations were first used in connection with the closed blocks of participating life insurance policies created in connection with demutualisation transactions but are now also used for other blocks of business, including

disability, interest sensitive, term, BOLI/COLI, industrial life insurance and annuity blocks. In the same fashion as redundant reserve transactions, embedded value securitisations typically require an affiliate of the ceding company to maintain a significant equity investment in the captive reinsurer.

This serves two purposes. First, it assures tax consolidation between the cedent and the captive reinsurer, and offset between the cedent's ceding commission income and the captive's ceding commission deduction. This offset of income and deduction keeps the initial transaction tax neutral. Second, since the cedent is monetising the block, investors could be concerned that the cedent is divesting itself of a substandard block of business. Through a significant equity contribution by an affiliate of the cedent in the captive reinsurer, which serves as a first loss to help buffer the investors' holdings, an alignment of interests is maintained between cedent and reinsurer.

Embedded value transactions involve important regulatory issues. Many regulatory concerns are similar to redundant reserve transactions, such as approval of the transaction by the relevant regulatory

bodies, licensure of the captive reinsurer; control rights of investors and taxation issues dependent on the ownership structure of the captive reinsurer.

In addition, insurance insolvency issues are just as acute. Unlike redundant reserve transactions, the offering proceeds in an embedded value transaction are deployed to unrelated business lines. Typically the economic reserves remain with the cedent as assets in a funds withheld account and these assets represent the prepayment by the captive of its future reinsurance obligations. (The captive reinsurer does not maintain a reinsurance trust because there are no redundant reserves attendant to the transaction.) In fact, the captive reinsurer's capital consists primarily of the equity contribution made by an affiliate.

In the event of the cedent's insolvency, the reinsurer must ensure that the funds withheld assets are not used for purposes unrelated to the reinsurance agreement. Also, the reinsurer may be able to assert that any claims made against the reinsurer by the cedent are subject to offset or recoupment defenses by the reinsurer as the funds withheld assets represent the prepayment of the reinsurer's reinsurance obligations.

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Catastrophic mortality securitisation addresses low probability/high loss events in a similar fashion as transactions completed in the traditional property and casualty bond market. The structure of a catastrophic mortality bond transaction borrows from traditional property and casualty catastrophe bonds. In a typical mortality cat bond transaction, an offshore special purpose vehicle is established which issues notes to institutional investors that are both 'qualified institutional buyers' and 'qualified purchasers'. The vehicle enters into a swap or similar contract with the relevant insurance company. Like redundant reserve transactions, the offering proceeds are posted in an account as collateral for the vehicle's obligations under its agreement with the insurance company. The insurer will pay premiums to the vehicle and in the event that certain mortality triggers are met, the vehicle will pay the insurer a lump sum payment based on the severity of the increase in mortality. The vehicle applies the investment returns from invested assets and the premiums paid by the insurer to pay interest on the notes. However, if a triggering event occurs, the principal amount of the notes is decreased in an amount equal to the lump sum paid by the vehicle under its contract with the insurer. If the notes are not entirely written down due to mortality events, the remaining amounts are repaid to the investors upon the maturity of the bonds.

Mortality cat bonds allow the insurer to receive a cash infusion at a time that mortality rates rise by significant levels. The formulas for determining loss amounts for mortality cat bonds may be adjusted to weight specific age and gender groups and may be tied to one or more countries to better match an insurer's portfolio of risk. To date, transactions have tied the determination of loss amounts to objective triggers (such as mortality reporting by the US Centres for Disease Control and Prevention) and not to actual losses by the insurer. Although this creates basis risk for the insurer, it has also resulted in the view that the transaction between the insurer and the vehicle is not a contract of insurance or reinsurance. If an insurer desired indemnity protection against catastrophic mortality, it would be necessary to reassess this issue.

For investors, mortality cat bonds offer direct exposure to extreme mortality risk in contrast to redundant reserve and embedded value transactions, which include a blend of mortality, lapse, underwriting and investment risks. However, investors purchasing catastrophic mortality bonds should be cognizant of the permitted jurisdiction restrictions imposed on purchasers of the bonds. As these transactions typically do not include a sizable equity tranche, and given the close tie between losses by investors and

mortality, there is a risk that investors may be viewed as conducting an insurance business by some insurance regulators. To avoid this result, the jurisdictions in which mortality cat bonds may be purchased are limited to a set of jurisdictions for which the issuer has received advice that the bonds will not be treated as insurance. In addition, investors should be aware that mortality cat bonds are usually treated as equity for US income tax purposes, unlike the traditional debt treatment in redundant reserve and embedded value securitisations.

Over the past five years, the life insurance industry has implemented important changes in its management of capital. Securitisation has become an important tool in this regard. Not only has it appealed to insurers but investors have considered these products a type of investment that is not correlated with other investments. As more insurers and investors become comfortable with these transactions, securitisation should become even more prevalent in the industry.

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