Insurance Securitizations: Coping With Excess Reserve Requirements Under Regulation XXX

Insurance securitizations are emerging as a financial tool that can provide regulatory capital relief.

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The use of insurance securitizations – a broadly defined class of transactions involving insurance companies that have emerged during the past decade – has increased substantially since February 2001, when Regulation XXX became effective on a rolling basis in 37 States. Regulation XXX imposes conservative assumptions and valuation methodologies for determining the level of statutory reserves, which insurers are required to hold under statutory accounting principles for term life insurance policies with long-term guarantees of premium rates. These conservative assumptions result in significantly higher reserve levels for term life insurance business than were previously maintained and limit the financial flexibility of direct issuers of term life insurance and reinsurers of such business.

More recently, the National Association of Insurance Commissioners promulgated Guideline AXXX, an actuarial standard analogous to Regulation XXX that requires higher reserves for secondary guarantees on whole life insurance policies. Since the inception of Regulation XXX, more than $20 billion face amount of securities have been issued to fund Regulation XXX reserves, and industry professionals estimate that within the next ten years, additional reserves required by Regulation XXX and Guideline AXXX will exceed $150 billion.

This article examines the impact of Regulation XXX on the reinsurance market, typical structures in Regulation XXX reserve funding securitizations, and some of the key issues arising with respect to such insurance securitizations.

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REGULATION XXX: MARKET EFFECTS OF CHANGES IN RESERVE REQUIREMENTS

Under Regulation XXX, a life insurer that issues term life insurance policies with guarantees of premium rates is required to hold statutory reserves equal to the greater of (1) the amount determined under a method in which each policy is considered a set of contiguous segments (the "segmented valuation method"), and (2) the amount determined under a method whereby each policy is considered a single segment (the "unitary valuation method"). Prior to implementation of Regulation XXX, statutory reserves were determined solely under the unitary valuation method.

Many underwriters, actuaries and accountants would argue that the additional reserving requirements imposed by Regulation XXX under the segmented valuation method are unnecessary and, in fact, redundant. This is because life insurers typically price guaranteed premium term life insurance policies to accommodate the fluctuating risk profile of the products, i.e., the guaranteed premiums for the early years essentially amount to overpayments (on an actuarial basis) that subsidize underpayments in later years. The cash flows under these products are anticipated by their underwriters to mimic, on an aggregated basis, the performance of products with a yearly adjustable premium. Unfortunately for life insurance companies subject to Regulation XXX, the more conservative valuation methodology required by Regulation XXX can significantly restrict capital that otherwise would be available for such companies to engage in new business generation and diversification and consolidation transactions.

The impact of Regulation XXX's regulatory capital requirements is not limited to direct writers of term life insurance. Reinsurers also may be subject to Regulation XXX's reserving requirements, to the extent that such reinsurers are either U.S. regulated companies or are otherwise subject to mirror reserving requirements, i.e., required to maintain reserves equal to those maintained by their ceding companies. Therefore, reinsuring policies subject to Regulation XXX may impose significant burdens on reinsurers as well. Further, Regulation XXX has materially affected the process by which offshore reinsurers satisfy (as well as the cost of satisfying) the significant collateral requirements to which they are subject.

Offshore reinsurers generally address their collateral requirements through letters of credit issued by banks (a statutorily approved method of collateralization preferred by U.S. domestic insurers for ordinary course reinsurance), which are obtained by the offshore reinsurers to provide their U.S. customers with financial statement credit and security for the reinsurance. However, the magnitude of the collateral requirements arising in respect of Regulation XXX-related reinsurance has posed considerable problems for offshore reinsurers. First, letters of credit typically are written for a one-year renewable term, although recently, facilities have been offered for five- to ten-year terms, subjecting reinsurers to pricing volatility upon renewal. Second, due to the promulgation of Regulation XXX and Guideline AXXX and other developments in the insurance industry, demand for letters of credit has increased. This heightened demand has brought reinsurers to the brink of their credit limits extended by banks, and has caused concern that demand may ultimately outstrip the ability of banks to provide letters of credit. Third, despite the accelerating demand for letters of credit and the pricing and capacity problems associated with providing them, reinsurers typically are expected to provide consistent premium rates from year-to-year during the term of a reinsurance contract.

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EMERGENCE OF REGULATION XXX SECURITIZATION STRUCTURES

Increased reserve requirements tie up insurers' and reinsurers' capital and, consequently limit their financial flexibility for a long period of time. The "level term" period[1] of a term life insurance policy, during which Regulation XXX imposes significant excess reserve requirements, typically is between 20 and 30 years. As a result, after Regulation XXX went into effect, insurers searched for techniques that would free up capital and be both longer-term and more cost-effective than traditional reinsurance supported by letters of credit. The result of this search was the emergence of the various Regulation XXX reserve funding securitization structures.

Reserve funding securitizations have been completed by First Colony Life Insurance Company, a large primary insurer or direct writer of life insurance, in 2003 and 2004, Scottish Re (U.S.), a large reinsurer, in 2005, and UnumProvident, a life insurer specializing in disability income protection, life insurance and supplemental benefits, in 2006. The UnumProvident transaction was the first successful Guideline AXXX securitization. As with many complex securitization structures in the early years of their development, the transaction costs associated with implementing a reserve funding securitization program for an insurance or reinsurance company are substantial. This is one reason why reserve funding securitizations have thus far been consummated only by large insurance companies. We suspect that as bankers, rating

[1] The "level term" period refers to the period during which the death benefit is level and the premium paid by the policyholder does not rise above the initial rate.

agencies and investors become more comfortable with reserve securitizations, their structures will become commoditized and therefore available to smaller life insurance companies in need of reserve relief.

Typical Structure. A reserve funding securitization undertaken for Regulation XXX regulatory capital relief typically involves an insurer or reinsurer ceding to a captive reinsurer all policy liabilities under an identified pool of term life policies subject to Regulation XXX (the "ceded business"), and paying a reinsurance premium to the captive as compensation for assuming those term life policy liabilities. Under such a reinsurance arrangement, the captive reinsurer will receive, as of the effective date of the transaction, an initial reinsurance premium in an amount at least equal to the portion of statutory reserves associated with the ceded business determined to be economically necessary ("economic reserves") under the actuarial model developed for the transaction. In addition, during the term of the transaction, the captive will receive ongoing premium payments on the reinsured policies, which are typically paid net of expense allowances, loss expenses paid and similar obligations.

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Concurrent with the receipt by the captive of the initial reinsurance premium sufficient to fund the economic reserves, a special purpose entity ("SPE"), which may be independent of, or an affiliate or subsidiary of, the sponsoring insurer/reinsurer, will issue securities in the capital markets to finance the amount by which the statutory reserve requirement exceeds such economic reserves. Net proceeds from such issuance of securities are used either to purchase surplus notes issued by the captive reinsurer or to make a capital contribution to the captive reinsurer where the captive is formed as a subsidiary of the SPE.

Regulatory Approvals. Transactions entered into in connection with Regulation XXX or Guideline AXXX securitizations — such as reinsurance, retrocession and/or the issuance of surplus notes — generally require the approval of the insurance regulator(s) of the domiciliary state(s) of the originating insurer or reinsurer and the captive reinsurer. In addition, regulatory approval has been required on an ongoing basis, for each payment by the captive reinsurer of, as applicable, principal of and/or interest on its surplus notes and each payment of dividends on its equity securities. The need for regulatory approval could potentially delay any such payment to the SPE, which in turn could trigger, among other things, a payment default by the SPE under the capital markets securities issued by the SPE and/or, for transactions in which the securities issued by the SPE are insured by a financial guarantee insurance company, a claim under the related financial guaranty insurance policy. Consequently, some transactions involve the creation of a liquidity facility or debt service coverage account sufficient to fund any shortfall created by a short-term delay in obtaining regulatory approval for a payment or dividend by the captive insurer. These devices can be critical to obtaining financial guaranty insurance coverage and the desired rating, as discussed below. Considering that these transactions can have durations of 20 years or more, the possibility, or at least the perception, of adverse future regulatory intervention plays a significant role in the development of deal structures.

Ratings and Wraps. Due in part to the novelty of life insurance reserve funding securitizations, sponsors and investors have almost always demanded that the securities issued to the capital markets receive the highest or next highest available ratings by the major rating agencies. Thus far, this has been accomplished only by using financial guaranty insurance to guarantee or "wrap" those securities. Financial guaranty insurance is written by only a small number of companies that specialize in this type of coverage. With a few exceptions, financial guaranty insurers themselves carry triple-"A" ratings, which they are capable of passing along to the securities that they guarantee. In the event that an SPE is unable to make timely payments on its securities, the indenture trustee of those securities makes a claim on the financial guaranty insurance policy and the financial guaranty insurer steps into the shoes of the SPE issuer and makes payments to security holders.

Ironically, the participation of financial guaranty insurers contributes to the complexity of the structures discussed above. For example, the structure involving the back-to-back issuance of securities (surplus notes funded by capital market securities) was motivated in part by the financial guaranty insurer's inability, from a regulatory perspective, to guarantee surplus notes.[2]

Reinsurance Trusts. The obligations of the captive reinsurer to the originating insurer or reinsurer are

[2] For regulatory purposes, surplus notes are considered equity rather than debt.

typically secured by a reinsurance trust. Like letters of credit, reinsurance trusts are a form of security that enables the ceding company (i.e., the originating insurer or reinsurer in the Regulation XXX securitization) to take financial statement credit for reinsurance from a reinsurer that is not licensed in its jurisdiction of domicile. (In most cases, a captive reinsurer will be licensed in only one state, which often is not the domiciliary state of the originating insurer or reinsurer.) The captive reinsurer will be the "grantor" of the reinsurance trust and the ceding company will be the "beneficiary."

The trustee of a reinsurance trust must be a qualified financial institution under the law of the ceding company's state of domicile. Under New York law, for example, the trustee must either be a member of the Federal Reserve System or a New York State-chartered bank or trust company, and may not be a parent, subsidiary, or affiliate of the grantor or the beneficiary. In addition, the assets held in the reinsurance trust must meet certain eligibility criteria (which generally require the assets to be held in the form of cash, U.S. Treasury securities, or highly-rated fixed income securities).

A key feature of a reinsurance trust is that the beneficiary may withdraw the assets held in the trust at any time, without notice to the grantor. Although the grantor may later claim that the withdrawal was improper, or not used to pay reinsured obligations or for any of the other limited permissible purposes described in the reinsurance trust agreement, the terms of the reinsurance trust agreement will not prevent the beneficiary (or a receiver of the beneficiary) from withdrawing all or any portion of the assets.

Assets held in the reinsurance trust agreement may not be released to the grantor and, consequently, will not be available for payment of principal to investors, until the aggregate fair market value of the trust assets exceeds 102% of the grantor's "entire obligations" (defined to approximate the aggregate statutory reserve requirements under the reinsurance agreement. Depending on the terms of the reinsurance trust agreement, investment income may be released to the grantor (for any purpose including payments to investors) at any time.

TAX BENEFITS

Tax Deductions. A life insurance company normally is eligible to receive a federal income tax deduction for an increase in its statutory reserves. In connection with a Regulation XXX securitization, a captive reinsurer is required to establish a large statutory reserve. This produces a large tax deduction in the early years of the transaction, as reserves build up. This tax deduction is likely to be offset by income in later years, as reserves decline, unless mortality significantly exceeds the projections of the ceding company's actuaries and causes losses for the captive reinsurer in excess of the economic reserves.

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Although the captive reinsurer will not have significant income in its early years against which to apply its tax deductions, the ceding company and other members of the ceding company's consolidated group are likely to have such income. It is therefore important, if possible, for the captive reinsurer to be in the same consolidated group as the ceding company, so that members of the consolidated group can, during the early years, offset their income against the tax deduction generated by Regulation XXX reserving requirements. It may also be important for the security holders in a Regulation XXX securitization to have the benefit of all or some of the tax savings as additional collateral. This collateral feature generally is implemented through a tax sharing agreement between the ceding company (and other members of its consolidated group) and the captive reinsurer.

Tax Sharing Agreements. There are several ways in which tax sharing agreements can allocate the benefits and risks relating to the tax savings that may result from the captive reinsurer's losses. Key considerations in crafting a tax sharing agreement include:

1. Possible changes of tax rates after the transaction closes.
2. The possibility that the income of the ceding company or other members of its consolidated group will be insufficient income to offset the tax losses.
3. The possibility that consolidated return regulations relating to the life-nonlife groups will not permit the captive reinsurer to be a member of the same consolidated group as the ceding company or its affiliates.
4. Possible post-closing acquisitions of the current consolidated group by another corporation, resulting in the creation of a new consolidated group.

5. More than 50% changes in the ownership of the captive reinsurer (either directly or indirectly through changes in ownership of the ceding company parent) that could limit the use of the ceding company's net operating losses.
6. Possible credit problems of the ceding company, which could interfere with its ability to fulfill its obligation to make tax savings payments to the captive reinsurer.

If the captive reinsurer is incorporated outside the United States (even if it makes the special 953(d) election to be treated as a U.S. insurance company), its net operating losses cannot be used by the ceding company parent.

CONCLUSION

The use of insurance securitization as a financial tool to provide regulatory capital relief is but one element of a notable trend: Over the last several years, and indeed over the last decade, securitization has been used by insurers and reinsurers with greater frequency, and by increasingly varied means, to transfer risk and provide regulatory capital relief. This trend has been fueled in large part by legal, economic, and other developments that periodically have created risk categories and/or regulatory capital burdens that the insurance industry has sought to disperse to the capital markets. With each development has come a growing familiarity and sophistication of insurers and reinsurers with respect to structured finance techniques, and the steady intertwining of the securitization and derivatives markets with those of the insurance world. These phenomena are likely to continue and to result in new insurance structures even more closely calibrated to the needs of the insurance and reinsurance industries. ■

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