Insurers Adjusting Practices To Tap Capital Markets

As some of the larger primary insurers go to the capital markets for reserve financing, it has become apparent that the investment community has business expectations that can be quite different from those to which they are accustomed. Insurers have always recognized contracts to be controlling documents, but bankers and investors treat contract language as binding to the letter. They have placed pressure on companies approaching the capital markets to conform more closely to their literal interpretation of agreements.

Otto Lowe, Second Vice President of Capital & Liquidity Management for Transamerica Reinsurance, spoke with Scott Avitabile, Partner at Dewey & Leboeuf, LLP about these converging differences of perspective. Scott has advised insurers and investment banks in life insurance-related transactions totaling more than $7 billion. He holds a law degree from Fordham University and a bachelor of music degree from the Berklee School of Music.

Otto Lowe: Before we get into the nature of business expectations and contracts, I’d like to ask you about current market conditions. What factors other than concerns about monolines might account for the drop off in non-recourse deals?

Scott Avitabile: The perceived effects of the sub-prime crisis have certainly caused some disruption for the capital markets. By capital markets I mean the sources of funding (lines of credit) that insurers are approaching for these deals, i.e., commercial and investment banks and the monoline financial guarantors. However, even before the monoline issue surfaced, we were seeing fewer wrapped (non-recourse) securitizations and more private recourse transactions with investment and commercial banks.

I think two things were driving this. First, banks like diversification of collateral in their loan portfolios and insurance policies are attractive for this reason. So they have been willing to hold the risk on their own books or find ways to syndicate it to other investors. Second, insurers like the simpler deal structures which are available in private recourse transactions with investment and commercial banks.

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Second, insurers like the simpler deal structures which are available in private transactions. They are often faster and cheaper to execute than the non-recourse route. There is often less negotiation because you don’t have to bring in a monoline to get the notes wrapped. Also, you don’t need to prepare a formal offering memorandum, which can be a very large undertaking for insurance companies that aren’t doing repeated offerings.

Since private recourse deals do not require the monoline wrapper, they have not been affected directly by recent monoline problems.

OL: The monoline financial guarantors have a reputation for being particular about contract language. In going the recourse route, do insurers face less pressure to conform to capital markets practices?

SA: That is not necessarily the case. The widely-held view throughout the capital markets is that deals are expressed through contracts, they should be followed to the letter, and rights should be enforced diligently.
OL: Can you comment generally on “business culture” differences between life insurers and the capital markets?

SA: I don’t think it’s a difference in culture as much as in business goals. Insurers want guaranteed long-term reserve funding that is economical, efficient and results in appropriate capital and rating agency treatment. They also want to limit the number of conditions under which the lending facility could be accelerated.

The capital markets want to have securities that they can sell quickly and easily. They want the transaction to be easy to understand and without credit risk. In most non-recourse deals, this means going to a financial guarantor that is willing to assume what is essentially the true risk of the business by guaranteeing timely payment on the policy-backed securities. A parent or affiliate provides similar protection to the lender in recourse deals.

OL: How do these different objectives affect the execution of deals?

SA: The guarantors really have one goal in mind – to underwrite the bond and the security for its repayment (the insurance policies) to a zero loss ratio. To do so they tend to really dig deep, not only into the block of business but also into the underlying terms of the policies and the performance and administration of the policies. They expect remedies in the event of default, require consent to any amendments and insist on copies of all notices that go back and forth under a transaction. Some of this can be quite onerous to an insurance company that is not used to being told how to run its business by another institution.

A guarantor sees this transaction as a loan and says, “We’re lending you money backed by your ability to make these policies perform like you say they will.” And the insurance company responds, “Look, we know our business. We can’t have you interfering (for lack of a better word) in our day-to-day operations. Just look at the modeling and you’ll be fine.”

The biggest challenge to this type of financing is negotiating so that the lender feels that they are getting what they need without the insurer feeling that its ability to manage its business could be hampered.

OL: Would you say that the capital markets generally rely more on the literal expression in a contract to define the risks, whereas in the past insurers and reinsurers were more interested in preserving the relationship – either with the policyholder or the distributor or cedant?

SA: Yes, absolutely. The capital markets rely heavily on the terms in documents and scrutinize those terms carefully. But, this again goes to the basic business being run here. In the life insurance world, everyone knows you are going to pay claims. Policyholders die, but they usually live a long time first. Over time their insurance needs change, and life insurers want to be there to capitalize on those needs. Thus, there is an emphasis on preserving the relationship that might motivate an insurer to grant exceptions or accept amendments to agreements in instances where a bank or a third-party guarantor probably would not.

The capital markets’ goal is to devise a structured finance deal that will get the principal and interest paid on time. They are taking credit risk; only catastrophic mortality risk should threaten cash flow to the lender. For a guarantor, having to pay any claim, in any amount, at any time, can represent a failure in its primary business model.

OL: What diligence documentation do lenders ask for in order to be comfortable with the insurer’s business conduct?

SA: It’s a long list. Both guarantors and banks conduct exhaustive due diligence on the insurer as well as the block of business.

First is a physical documentary diligence, which consists of an onsite visit where the lender’s lawyers review a lengthy list of materials provided by the insurer. This list includes correspondence with regulators, statutory and tax reporting, underwriting guidelines, policyholder forms and complaints. They are particularly
interested in seeing documentation related to the subject block. The lender will also conduct oral diligence by interviewing senior leadership to learn what the general practices, operations and controls are for the issuing company.

The lenders want to understand how the insurer operates, how the block of business is expected to perform, and be assured that the insurer will do business in the same capable manner going forward. They do not expect the insurer to change anything about policy administration or terms that might adversely affect the performance of the deal.

**OL:** Transaction documents contain representations (assurances of current fitness) and covenants (promises to do/not do certain things) from the insurer. Which ones give insurers the most difficulty?

**SA:** Some lenders want a guarantee that the actuarial projections are accurate or they ask insurers to commit not to change current business practices on the deal block without the lender’s consent. They also ask insurers to limit exceptions and waivers to terms on the deal block of business. Sometimes lenders ask for timely notice of all events and communications having anything to do with the deal block. Finally, some lenders request special reports, in addition to the regular quarterly and annual financials. Insurers often find these additional requests excessive and try to limit their scope.

**OL:** Can a life company assume that a private recourse transaction will have fewer and/or easier covenants?

**SA:** It depends on the bank. Some lenders have less stringent requirements than those in the usual public non-recourse deal, but other banks follow the financial guaranty underwriting model, asking for the same reports, representations and covenants as a guarantor. Banks benefiting from deal experience and/or sound outside counsel advice generally know the risks better and negotiate accordingly.

**OL:** How should an insurer present its case in order to get the best priced deal?

**SA:** The capital markets want a block of easily understood policies with fairly consistent policy forms and span of years. In almost every case, they will want to see clear, concise modeling, vetted by a nationally-recognized, unaffiliated actuarial firm.

As for getting the best price, the cedant’s reputation in the marketplace carries significant weight. A large insurer with good brand recognition is more likely to get terms to its liking than smaller firms. The more reliable your information and your ability to represent that you have run a tight ship and your contract terms and controls have been in place as you put the block together, the better. That can only be helpful in negotiating a price for the deal.

**OL:** When a reinsurer coinsures a block of business, it receives a higher rate of return if mortality is less than expected. When a lender underwrites a deal, its best outcome is getting principal and interest. How does the absence of upside exposure affect the capital markets’ thinking?

**SA:** Again, different business goals drive behavior. Historically, reinsurers have acquired and managed policy risk, only asking for limited conditions and granting leeway to the client as a part of the traditional insurer-reinsurer relationship. For the capital markets, it’s a loan; they want to be paid on time and protect their principal. They ask for many conditions and expect little deviation from the literal interpretation of the contract. If they become uncomfortable you can expect them to aggressively exercise remedies to mitigate losses. Reinsurers must adopt many of these capital market practices in order to take advantage of reserve financing opportunities.

**OL:** How is completing a securitization deal different for a reinsurer?

**SA:** Reinsurer securitizations are more
complex, largely because when reinsurers present a block of insurance policies, the block is not from one but from a pool of direct writers. But doing business with reinsurers offers diversification benefits by spreading out the mortality and operational risk on the underlying policies. The difficulty arises because the lender can’t review the business as thoroughly as they can when working with one insurer, because the personnel involved and the supporting documentation are elsewhere. But reinsurers who can demonstrate that they are enforcing their contracts and monitoring the deal block’s performance closely are well-positioned to close deals at good prices, because there is less likelihood of surprises and the transaction is more likely to work as designed. And the same practices that can make reinsurers successful in the capital markets should benefit their retail clients through lower costs, enhanced controls and better mortality selection.

**OL:** In what cases would you advise clients to forgo securitizations?

**SA:** Some insurers can’t assemble a large enough block of business to warrant the cost of a securitization. Others lack the resources needed to handle the complexity of a deal without impairing their everyday operations. And some insurers present exotic or difficult-to-model blocks of business that just aren’t suited for this market. Working with a reinsurer to obtain scale might be an option to consider.

**OL:** What does Transamerica Reinsurance think of the convergence of insurance risk and capital markets financing?

**SA:** While the current financial environment is having a significant pricing impact on reserve financing deals, it likely will not alter the inevitable course toward the convergence of insurance risk and capital markets financing. Life insurers large and small will have to learn how to take advantage of a new way of doing business – whether that means developing financing solutions on their own, or, alternatively, working with a reinsurance partner.

Transamerica Reinsurance’s experience in executing complex financial structures enables us to develop “next generation” reinsurance solutions that extend the benefits of new financing programs to companies that may not be able to develop and execute them on their own.

Transamerica Reinsurance sees the convergence of life insurance and capital markets as an opportunity to strengthen client partnerships with high value solutions. We have made a significant capital investment – both financial and intellectual – in meeting the needs of our clients, and we look forward to sharing the details of our new reserve financing program.