Securitization remains a hot topic as life insurers and reinsurers examine potential benefits and costs associated with capital markets financing solutions. Is securitization a realistic alternative or just wishful thinking? Is serious exploration worth the time and effort? What are the big show stoppers?

William Wellnitz, Vice President of Transamerica Reinsurance’s Capital & Liquidity Management, talked about this subject with Donald Callahan, Managing Director at Morgan Stanley. The benefits can be attractive, but Don cautions that securitization deals demand considerable time and resources and, in most cases, much more transparency than has ever been required of the issuing company.

Don brings more than 20 years of investment experience to Morgan Stanley’s Global Capital Markets group, where he co-heads the team responsible for financial institution clients. Much of his time is concentrated on balance sheet optimization, investment and capital management issues for insurance companies. A graduate of the University of Michigan, Don received his MBA from Cornell University.

William Wellnitz: How do life insurance securitizations compare to other more developed securitizations?

Donald Callahan: To date, most life insurance structures involve identified collateral pools backed by some type of underlying asset held in a special purpose vehicle. Triple X or embedded-value deals are similar to operating company securitizations that are becoming prevalent in the marketplace. These deals—franchise fees, for example—are typically backed by contractually obligated income streams or operating assets. Recourse in these transactions is limited to the emerging performance of an identifiable block of business. In some cases, like with Triple X, a bit of asset-based risk may be transferred, but the primary recourse is limited to a walled off block of business risk.

W W: What risks are unique to life insurance securitizations?

DC: Execution risk is a key difference. There’s always a steep learning curve when a new asset class goes through the securitization process. Life insurance securitization involves many parties with limited experience with either securitizations or insurance risk. The sponsoring issuers, actuaries, lawyers, monolines, investment bankers, rating agencies and, certainly, regulators—of which there are many—all are going through a learning process.

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Once the structure and process become more standardized and better understood, the gap will close between what’s required to do these deals versus other types of securitizations. However, I don’t see a point in the near future where any of these deals will be nearly as boilerplate as other parts of the securitization market. The nature of the underlying life insurance business will make these transactions incrementally more difficult.

**WW:** How does the interaction of the participants affect deal complexity?

**DC:** Well, everyone involved has a different objective and is looking for different things as far as what they would like the transaction to achieve. It’s also important to remember that the perspectives are often competing. Making sure you come to a framework that meets everyone’s objective is the difficult part.

**Standardization**

**WW:** You cited difficulties related to the nature of the business. Lack of standardization is a big issue for our industry. Can the economics of the capital markets either through financing or other motivations be persuasive enough to encourage life insurers to, for example, adopt a standardized set of underwriting class definitions?

**DC:** It would be a big plus if investors knew exactly what to expect when they saw a pool of risks that are in Class 1, 2, 3 or so on, which is not the case today. By contrast, in the consumer asset market, FICO scores, for example, are well understood and provide one foundation for the capital markets to look at different obligors through the same prism and come up with an answer that they feel compares apples to apples.

As it stands today, I don’t think securitization provides sufficient economic motivation to drive product / process standardization in the life insurance industry. But it is certainly one more reason for life insurance leaders to make standardization an industry-wide goal.

**WW:** How does product design impact securitization?

**DC:** Just consider what’s been accomplished with term business versus other life products. We’ve been able to move towards a very similar series of structures in Triple X deals because term life products are relatively simple. But even with this business, each company is so different – their fact pattern, what they’re trying to achieve – that we may never get to a cookie-cutter approach like you see in the credit card or auto loan market.

Things get much more complicated when you move away from term and consider securitizing universal life or other life products. If everyone’s product design becomes identical, as in the mortgage market, and there’s no differentiation at all, then maybe you could move towards real standardization. But as long as products have slightly different features – and insurers seem to want that as a differentiating factor – it’s hard to believe life insurance securitization will become as standardized as some other markets.

**Transparency**

**WW:** What product or process characteristics make securitization more difficult?

**DC:** First, any product features or benefits outside of the norm raise a degree of modeling and review that will require more effort. If the market’s never seen it before, presume that you’ll pay a price for being first.

Questionable underwriting will, at a minimum, cause delays. A third party’s assessment of the transaction risk will be based on how they – not you – perceive the underwriting practice, especially if you can’t demonstrate a confident assumed-to-actual. So if your underwriting practices don’t have a very strong story, the transaction will be more difficult. Participants will build more uncertainty around the risk than you think is there, because they will believe that you have more information than they do.

Same thing goes for data accuracy and timeliness. If it’s delayed, or if you have to continually correct or explain data to people,
expect both pricing risk and some third party reticence to believe all the assumptions. All the data must be verifiable down to record level before you go out to third parties. That’s critically important. If you wait to find the errors or can’t deliver on certain data requirements as you’re going through the process, you will lose credibility.

**WW:** How does data reporting and the types of information shared in these deals compare to those of more traditional solutions?

**DC:** When you enter into a deal that has third-party capital markets participants in the transaction, assume that you will need to provide outside audit rights to at least the surety provider. Assume also that they will be conducting significant due diligence that’s likely to be above and beyond what you’ve been used to in a traditional reinsurance framework.

The market’s requirements for data, data integrity and ongoing data reporting are important. You’ll need to dedicate resources and deal with the ongoing security-specific issues inherent in a transaction. Once the deal’s in place, it has to be administered. That may or may not fit into your current operational procedures, so you should contemplate what additional operational changes you may need in order to make the whole system work. In most cases, at least some changes will be required.

**Securitization and Reinsurance**

**WW:** Can life insurers expect a similar confidence in the pricing they’ll get from the markets as they currently have with their reinsurance?

**DC:** In highly advanced markets like commercial mortgages, people warehouse business and expect to securitize within about 60-90 days. When the timeline between decision and execution is inside of a quarter, you can predict some band of certainty around market access and the price for that access with some confidence.

But with life insurers you’re dealing with companies that may need two to three years to warehouse enough business. Consequently, there are risks of factoring current market costs into your pricing.

You would have to self insure and use captives with recourse financing, and have to assume some large cushion in your pricing above what you sell at today’s executable level. So from a warehousing perspective, you’d be no better off than other self-help solutions in terms of price certainty – and worse off than had you used a traditional third-party reinsurance arrangement. Price and pricing risk is all about time to market.

**WW:** How can reinsurers help direct companies capitalize on the mortality and reserve relief offered through securitizations?

**DC:** Reinsurers can play a significant role here. Not many primary companies are positioned to address these issues on their own, at least with Triple X. Large reinsurers, on the other hand, have the balance sheet and systems that allow them to aggregate risk, to write reinsurance on inforce blocks and to provide price certainty for future business.

Reinsurers also enjoy scale economies, both in terms of transaction size, which can spread fixed costs, and diversification. These two facts allow them over time to pass through to clients the benefits they gain from securitization, presuming there’s competition among the reinsurers themselves.

Reinsurers can put securitization into a whole set of complementary reserve and risk management approaches. They should have very broad access to capital providers and the solutions available. This can help them optimize what deal type may be most attractive at any point in the market cycle.

So, at the end of the day, if you’re a primary company whose scale and resources limit your alternatives and tradeoffs as business and market conditions evolve, you can still use reinsurers and take advantage of that portfolio of reserve management techniques, only one of which is securitization.
**WW:** What critical success factors do you associate with executing a securitization transaction?

**DC:** First of all, before anything else, you’ve got to have the right motivation. To look at a deal and say, “My competitor’s doing this,” is not the right motivation. It has to make sense for you in terms of overall strategic profile. How important is having a non-recourse term solution within your company’s total capital and reserve management framework? If the answer is, “Not that important,” because of the cost-benefit tradeoff, then you should cross it off the list. These are not deals that you can do once and walk away from. One deal every three or four years is probably not an appropriate use of resources.

If the motivation is right, then you need commitment. If you’re motivated and committed, then I think it comes down to some of the things we’ve already talked about – getting in the weeds. It means understanding the systems and data requirements, creating a strong knowledge of the regulatory, legal, tax and actuarial issues. Again, understand what you’re getting into.

And lastly, you need to create a dedicated internal deal team that has the time and sponsorship of senior management. You should have a team that sees capital markets and other types of transactions happening on a regular basis and therefore is drawing on personal experience around deal structuring. It works best when someone who is transaction-savvy is on point and has senior management’s explicit support.

In theory, the capital markets represent the most efficient source of capital for companies at all stages of development. But this abundant source of financing comes with costs – both operational and economic. To some, securitization may be an ideal path to obtain operational leverage; but for others the effort may be just wishful thinking.

For a number of companies the question of alternative financing through the capital markets has an easy answer: the size of a company’s peak redundant reserves may either be large enough to make a deal efficient or so small as to effectively shut out securitization as a profitable option.

For others, however, the answer is not that cut-and-dry. Insurers and reinsurers that fall into this category need to thoughtfully consider what exactly is accomplished through securitization – at least as it stands today – that cannot be achieved at similar cost, and less effort, through more traditional means.

We at Transamerica Reinsurance stand ready to help you assess your options in a thoughtful manner and develop the mixture of solutions that most effectively meets your company’s current and strategic needs. For many companies, we believe you will find our innovative approaches to mortality and reserve needs to be more than suitable.