VIF monetisation for European life insurers: A re-emerging trend

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July 2013

In November 2012, Milliman published a white paper on VIF monetisation for European life insurance. Since then, market activity in this area has continued at an increased pace and a number of new transactions have been completed. This follow-up paper considers recent developments and provides further thoughts on the possible future direction of VIF monetisation in Europe.

INTRODUCTION

In the past 12 to 18 months, the European life insurance industry has seen an increased interest in various forms of capital solutions. In particular, 'VIF monetisation' transactions[1] are a re-emerging trend.

Recent activity has focused on the Spanish and Portuguese bancassurance sector, driven by pressures from the banking crisis in those markets. However, significant activity is also apparent in other European markets.

Since 2012, the completed (publicised) transactions are:

- July 2012: Santander / Deutsche Bank / Abbey Life (€ 490m,100% quota-share)
- November 2012: CaixaBank / Berkshire Hathaway (€ 600m, 100% quota-share)
- March 2013: BBVA / SCOR (€ 630m, 90% quota-share)
- June 2013: Banco Espirito Santo (BES) / NewRe[2] (40 bps increase to BES' Core Tier 1 ratio, 100% quota-share)

This paper considers these recent developments and provides further thoughts on the possible future direction of this trend.

KEY DRIVERS OF VIF MONETISATION

VIF monetisation has arisen as an attractive option for European insurers (and their parent groups) as a means of raising liquidity and/or Tier 1 capital, either via risk transfer or via recognition of assets which are not otherwise recognised under the accounting regime. Depending on market conditions and specific circumstances, this can be an alternative to other forms of financing, such as debt or equity capital. The implementation is much faster than a full sale, and the issuer maintains control of its clients and the administration of the business.

While such an option clearly has its benefits during times of financial stress, VIF monetisation can also form an important part of a pro-active capital management policy. Through a good understanding of the risk and value drivers, and by adopting a more efficient capital and liquidity structure, alternative strategic opportunities potentially open up and can have a positive effect on market perception, potentially supporting a higher share price.

At the same time, VIF monetisation has generated significant interest from the various counterparties to such transactions, such as reinsurers, investment banks and private equity firms.

[1] VIF: Value of In-Force life insurance portfolios, representing the expected future profits from an in-force block of life insurance contracts.
[2] New Re is part of the Munich Re group.

STRUCTURING THE TRANSACTION

The specific structures used in these transactions can be as simple or complex as the situation requires and will be tailored to the needs of all the parties involved. There are a number of broad structuring options available for a VIF monetisation deal, including:

- Contingent loan structure;
- Quota-share reinsurance structure; or
- Insurance-linked securitisation (ILS).

These broad categories can overlap to some extent, much in the same way as hybrid instruments can combine features of both the debt and equity markets. Furthermore, the structure can vary significantly within these categories, depending on the specific circumstances.

The preferred arrangement for the recent deals in Spain and Portugal was a quota-share reinsurance structure. However, each of the transactions differed significantly in terms of objectives, structure and counterparties.

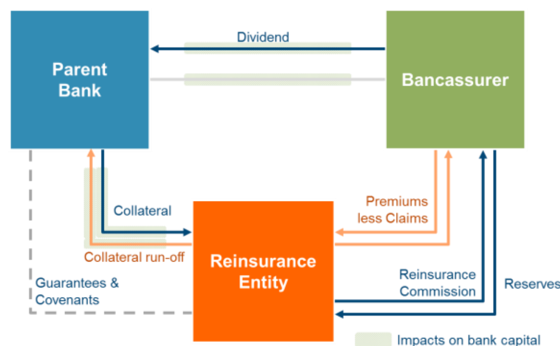

Figure 1: Basic structure of VIF monetisation for bancassurance portfolio

Figure 1 illustrates the basic principles of how a VIF monetisation through reinsurance can benefit the banking parent of a life insurer. The same principles can be applied to more general situations.

Understanding the objectives & implications

Understanding the objectives of all parties to the transaction is critical to the design of the structure and a successful outcome. Areas of focus for all parties include financial reporting implications, generation of profit and/or capital, transfer of risks and rewards, liquidity and/or tax implications.

It is essential to seek the regulator's view at an early stage in the process to ensure that the desired balance sheet or capital objectives are feasible under the current structure and regulation. It is also important to understand the auditor's opinion on the accounting implications of the deal.

Scenario testing and volatility analysis is a key step to ensure the robustness of a proposed structure and to avoid certain unintended consequences.

Defining the portfolio

A natural prerequisite to a successful VIF monetisation is that a sufficiently large amount of VIF is available to be structured into a deal. Beyond this, the possibilities are relatively broad. As an early step in a transaction process, insurers might perform an assessment of their portfolios to identify which are strong candidates to meet the objectives of the transaction.

Deal sizes vary, but there are currently quite a number of counterparties with appetites for different deal sizes.

The nature and risk profile of the portfolio influences the attractiveness of the deal because counterparty appetite for different risk types can vary.

Defining the transferred cash flows

Cash transfers between the issuer and the counterparty will not necessarily be the actual profit stream emerging from the defined portfolio. For example, cash transfers arising from a contingent loan structure may not be reflective of the actual profit stream, although the profit stream will act as a security to the loan.

In general the contract terms and conditions should objectively define the cash flows

transferred, so that they can be verified independently and reconciled back to audited accounts and administration systems.

The definition of the cash transfers must also produce the intended transfer of risk and rewards under the transaction.

Understanding the risks

Parties to the transaction will be exposed to a number of risks and these will depend on the specific circumstances. A thorough due diligence process should be undertaken to fully understand the risk implications of the proposed structure. All risks should be either appropriately mitigated via the structure or allowed for in the deal pricing.

The underlying risks associated with the defined portfolio, such as mortality, persistency or market-related risks, will be a feature of any deal to some extent. Other transaction-related risks will also arise, such as counterparty, legal or country-related risks. The various risks can potentially be separated and shared between multiple counterparties.

An earn-out, or profit-sharing, clause is one of many structural features that might be considered by parties as an attractive risk-sharing mechanism and used to align the interests of the parties. In all cases such features need to be fully reviewed and tested in order to analyse the resulting emergence of cash flows. Auditors and regulators will take a keen interest in the results of this testing.

The role of collateral

Collateral arrangements play an important role in reducing counterparty risk and protecting policyholders. A wide range of options are available for structuring these arrangements, and it is important to understand their impact as they can significantly influence the deal economics.

POSSIBLE FUTURE DEVELOPMENTS

As the entire European insurance industry moves towards a more transparent risk-based capital and value framework, we expect activity in this area to increase and VIF monetisation to become a more prevalent and natural mechanism for life insurers to employ, not only as one-off events but also as an integral part of on-going business strategy. We anticipate that the ongoing financial crisis in Europe will continue to accelerate the process for some insurers.

CONCLUSIONS

VIF monetisation can be a viable solution to consider for life insurance business. Transaction drivers can range from solvency or liquidity reasons to a pro-active capital management solution under a broader strategy program.

Transaction structure is critical to a successful outcome and this relies on a thorough understanding of the key objectives, risks arising and the financial implications.

We expect momentum in this area to continue, given the numerous possible advantages to both originating insurers and counterparties.

HOW MILLIMAN CAN HELP

Milliman is a leading global advisor on ILS, reinsurance and insurance M&A transactions. We have advised on approximately 100 global ILS deals since 2001, totalling approximately US$ 47 billion of financing and an average deal size of US$ 510 million. Our clients include the world’s leading insurance companies, reinsurers, banks and private equity firms.

Milliman has been at the forefront of recent developments on European VIF monetisation deals, acting as advisor to BES and BBVA on the monetisations of their risk portfolios in Portugal and Spain respectively. Milliman also advised a number of investors on other recent European VIF transactions and non-completed deals.

Milliman offers a full service to all counterparties on VIF monetisation assignments. Our support areas include:

- Deal analysis: Economics, structure and risk
- Experience analyses, e.g. persistency, mortality
- Due diligence
- Contract review
- Seller's report and valuation
- Management support
- Support for discussions with investors, auditors, regulators

ABOUT MILLIMAN

Milliman is among the world's largest providers of actuarial and related products and services. The firm has consulting practices in life insurance and financial services, property & casualty insurance, healthcare and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe.

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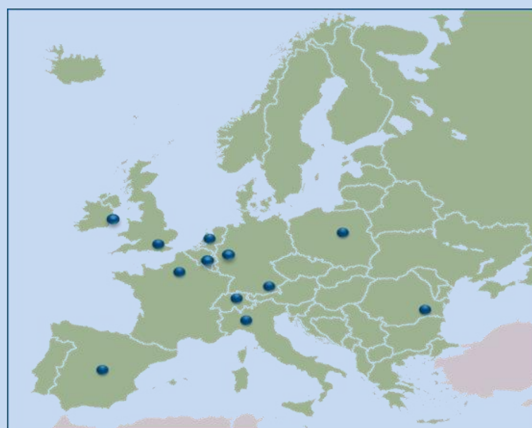

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