Life ILS: 2010 Year in Review and Looking Ahead to 2011

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Very quietly, more than US$7 billion in transactions related to life insurance-linked securities (life ILS) were completed in 2010. Most of these transactions involved the financing of redundant reserves for U.S. life insurers selling level premium term subject to Regulation XXX or universal life products with secondary guarantees (UL-SG) subject to Actuarial Guideline 38 (AXXX), with many of these transactions involving the use of bank-issued letters of credit to finance the redundant reserves. In addition to the private redundant reserve transactions, the market saw a range of additional life capital market transactions.

FIGURE 1: XXX AND AXXX TRANSACTIONS (US$ MILLIONS)

COMPANY	TYPE	AMOUNT	BANK
ING	XXX	US$ 615	CREDIT SUISSE
PROTECTIVE	XXX	US$ 790	UBS
RGA RE	XXX	US$ 300	NOMURA
AVIVA	XXX/AXXX	US$ 325	CREDIT AGRICOLE
PROTECTIVE	XXX	US$ 610	UBS
MUTUAL OF OMAHA	XXX	US$ 150	CREDIT AGRICOLE

THE YEAR OF THE LIFE ILS COMEBACK

Starting with the first Regulation XXX redundant reserve transaction in 2003, a large percentage of the XXX redundant reserve financing through 2007 involved broadly marketed capital market securitization transactions structured by financial guarantors, with the guarantors bringing their Aaa/AAA ratings to the transactions. Some of the financing during that time period involved banks providing long-dated private-funded or letter-of-credit (LOC) solutions, with such transactions being the preferred approach for AXXX financing. But the financial crisis brought a halt to all of these structures, as investors lost confidence in financial guarantors and the securitization market and banks lost balance sheet capacity.

This market freeze lasted about a year, but starting in the fall of 2008, the redundant reserve financing market restructured itself, moving away from guarantor-wrapped securitizations and bank private-funded solutions to private LOC solutions. Many of the transactions involved recourse, though some banks offered non-recourse structures.

While most of the recent activity has involved XXX financings, in 2010 there have been several AXXX transactions completed. Figure 1 shows a list of publicly disclosed XXX and AXXX transactions completed in 2010 for which Milliman served as consultant.

Based on transactions we have worked on, together with other transactions that were publicly disclosed, we are aware of 14 redundant reserve transactions in 2010 that provided more than US$6.5 billion of financing. Reflecting additional transactions we did not work on and for which public information is not available would push that number even higher.

During 2010, we saw more banks entering the marketplace, each providing a unique transaction structure. As supply increases, structures continue to evolve, including more non-recourse transactions and transactions with longer tenor. While the cost of financing likely will not return to 2007 levels, the increase in supply has contributed to some reduction in financing cost. We have also seen several self-financed transactions, where the holding company or affiliates of an insurer have purchased surplus notes issued by a wholly owned captive to provide financing for XXX and AXXX reserves.

OTHER 2010 TRANSACTIONS

While most of the 2010 ILS transactions involved redundant reserve financing, there were several other innovative transactions in 2010, all of which involved the issuance of notes to capital market investors.

Aetna, through its Vitality Re special purpose vehicle, raised US$150 million to provide excess of loss protection on a portion of Aetna's group commercial health insurance business.

Goldman Sachs, through its Signum Finance special purpose vehicle, raised US$200 million and receives protection if actual mortality experience on a defined block of life insurance exceeds a specified trigger level.

In addition to additional issuance under its Vita IV mortality catastrophe bond structure, Swiss Re also entered into a US$50 million longevity trend risk transaction. Structured like a catastrophe bond, the payments to Swiss Re would be triggered in the event there is a large divergence in the mortality improvements experienced between male lives of ages 75-85 in England and Wales and male lives of ages 55-65 in the United States.

One area where there was a lot of discussion, but not, we believe, too much activity, involved secondary market trading of outstanding wrapped securitizations. Many of the outstanding bonds are trading at fairly steep discounts. This is not necessarily because of the underlying insurance risk, but rather we believe because of the lack of information available to investors to evaluate the risk of existing transactions. In order to see movement from the current private structure on redundant reserve transactions back to capital market financing, we believe the transactions need to be much more transparent. They must also provide investors with useful ongoing information, including detailed experience studies and updated deal modeling.

LOOKING AHEAD TO 2011

We expect that redundant reserve financings will continue to drive the life ILS market in 2011. With the redundancies growing at US$10 billion-US$15 billion per year, the life industry will continue to be open to solutions to help unlock surplus that is tied up in funding redundant reserves. Through 2010, we saw banks staffing up to provide redundant reserve solutions and we expect to see several new banks enter the marketplace in 2011. This continued increase in supply will likely lead to better terms for insurers, with a possible movement to more non-recourse transactions and possibly a longer tenor for the transactions.

Some other key factors to watch in 2011 include:

- **Principles-based reserves (PBR)**: Many in the industry had been hoping that PBR would be the *fix* to eliminate the redundant reserve problem. But after almost five years of progress, with the industry and the regulators working together to replace the century-old rules-based valuation structure with a principles-based structure that would be more responsive to newer, more flexible products, the industry has raised concerns about the principles-based structure that was emerging. In mid-2010, it expressed concern that what was intended to be a truly principles-based structure may be turning into a more complex rules-based structure. As a result, the industry asked the National Association of Insurance Commissioners (NAIC) to field test the current proposals so both the companies and regulators can assess how the current proposal would work in practice. Those field tests are currently under way, with an original goal of reporting back to the NAIC in March 2011. The industry and the NAIC will then need to digest the results of the field tests to decide how to move forward with PBR. Even after agreement is reached, it may take several more years for state valuation laws to be revised to allow for the new PBR structure.

- **Term UL**: Several companies have started issuing a level term coverage in a UL-SG product to reduce the amount of redundant reserves needed to be held if the product was a standalone level term product. More companies are considering development of Term UL-like products but some regulatory concerns were raised late in the year relating to reserving for these products. Companies need to monitor this development closely.

- **Iowa collateral**: In 2010, Iowa adopted legislation and regulations that allow Iowa-domiciled life insurers to use a guarantee from a parent with sufficient capital to cover the redundant XXX and AXXX reserves. This is another issue that companies should actively monitor.

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