

Securitization of Annuities

Overview:

Annuities have been securitized in asset-backed transactions since 1997 by factoring companies that purchase structured settlements from tort claimants. Annuities also have been included in securitizations involving the purchase of life settlements since 2003. In transactions involving life settlements and annuities, the annuities are designed to pay the premiums of the life settlements thereby taking advantage of the arbitrage associated with the differences between the mortality tables used to price the annuities and the mortality tables used to price the premiums of the life settlements. A.M. Best is seeing more transactions in which investors analyze whether they can benefit from perceived mispricing of annuities when such investors have concluded that insurance companies have used higher mortality rates than are warranted to price annuities.

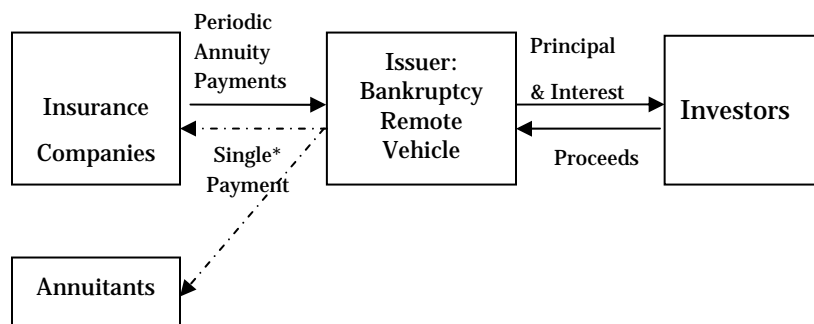
In general, there are two varieties of annuities: a) a period-certain annuity that generates guaranteed, periodic payments to the annuitant that can be fixed or can escalate based on a specified compounding rate and/or inflation rate; and b) a life-contingent annuity in which specified payments are made to the annuitant until he or she dies. There also are annuities that combine period-certain and life-contingent features.

The most important risks associated with annuities (no matter if the annuities arise from structured settlement transactions or from annuity/life insurance arbitrage transactions) are credit risk and mortality risk. This quick reference summarizes how A.M. Best will assess such risks in transactions that include only annuities in their collateral pools, although transactions can contain a combination of annuities, life settlements or any other collateral. Readers interested in an analysis of the risks associated with collateral pools containing life settlements should read this document in conjunction with the A.M. Best methodology, *Life Settlement Securitization*, published March 24, 2008.

Simplified Transaction Structure:

Securitization of annuity cash flows can be achieved through the use of bankruptcy-remote special-purpose vehicles (SPVs). The issuer of securities, the SPV, raises funds from investors that are used to purchase annuity cash flows from insurance companies or annuitants. If these are period-certain annuities, the issuer receives the periodic annuity payments from the insurance companies for a fixed period of time. If the annuities are life-contingent, the issuer receives the periodic annuity payments from the insurance companies until the annuitants die. The cash flows received by the issuer are used primarily to service the principal and interest payments due the investors.

Simplified Transaction Diagram



*For certain transactions such as structured settlements, the single payment effectively goes to annuitants. For other types of transactions, the single payment goes to the insurance companies.



Key Assessment Factors:

- The source of the annuities (to help determine the appropriate mortality tables) – if the annuities are from structured settlements, the annuity table may be derived from structured settlement mortality experience;
- The availability of life expectancies from at least one medical examiner for each life in the annuity pool (See the methodology, *Life Settlement Securitization*, published on March 24, 2008, for the standards for evaluating medical examiners);
- The assumed default and recovery rates for the companies that issued the annuities;
- The assumed default correlations of the insurance companies;
- The definition of what constitutes a default of the payment to investors – default could be defined as an untimely return of principal to investors, an untimely return of principal and interest, or in other ways;
- The number of insurance companies that issued the annuities in the collateral pool – a high concentration of insurance companies is generally not desirable;
- The underwriting guidelines for purchasing the annuities on the lives in the collateral pool;
- The number of lives in the pool (300 recommended) and the granularity of the annuity cash flows in the transaction – the smaller the annuity payments, the better the exposure data gathered for the risk model;
- If the annuities are associated with structured settlements, the observation of all transfer laws in the state in which the annuitant lives;
- Whether the annuity cash flows could be encumbered due to bankruptcy of the annuitant or any liens on such cash flows;
- Whether the annuity cash flows may be challenged by a spouse, relatives and dependents of the annuitant;
- Whether there has been screening for annuitants such as minors or adults that cannot legally enter into contracts;
- The procedures for periodically confirming the annuitant's survival for life-contingent annuity cash flows;
- The existence of legal documents produced for securitizations such as an indenture, true sale opinion, and other documents; and
- The legal and tax issues associated with the annuities – Are the annuities pursuant to a court order? Are there any insurable interest issues associated with the purchase of annuities on the lives in the collateral pool?

Modeling of the Annuity Cash Flows:

To model the risks associated with the annuity cash flows, the following data should be provided:

- a) For period-certain annuities: the fixed annuity cash flows aggregated by each insurance company in the pool;
- b) For life-contingent annuities: the annuity cash flows of each life in the pool with the associated insurance company making the annuity payments; the base mortality table used by the issuer in its analysis; and the mortality ratings and/or life expectancies determined by at least one reputable medical examiner for each life in the pool.

A.M. Best applies the default assumptions (as determined by *Best's Idealized Default Rates of Insurers*) and recoveries associated with each insurance company in the transaction. A.M. Best also applies the appropriate mortality tables to each life in the transaction (for life-contingent annuities) and in some cases, default correlations. The cash flows associated with each annuity are modeled using the Monte Carlo simulation method, aggregated, and applied to the transaction's waterfall to determine the default probability of the securities backed by the annuities. The rating of the securities is partially determined by correlating the tabulated default to the grid in *Best's Idealized Default Matrix*.

Related Reading:

Best's Impairment Rate and Rating Transition Study -1977 to 2007 (April 21, 2008), *Life Settlement Securitization* (March 24, 2008), *A.M. Best's Idealized Default Matrix* (December 5, 2007), *Securitization of Reinsurance Recoverables* (August 20, 2007) and *Best's Ratings & the Treatment of Debt* (October, 11, 2004).

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