

Review of BCAR Treatment for XXX Captives

A Captive Audience

Over the past several years, direct writers have been searching for effective capital solutions to fund reserves for level premium term products subject to the reserve requirements of the Valuation of Life Insurance Policies Model Regulation, more commonly known as Regulation XXX. Since the change in reserving methodologies became effective in 2000, insurers have been struggling with the additional capital requirements, especially since most companies believe that a part of the reserves required under Regulation XXX are redundant.

The change has impacted both direct writers and reinsurers. Term insurance products remain popular, and direct writers are looking to maintain a pricing edge in a highly competitive market, while reinsurers need means to continue to provide coverage while not straining their own capital positions. Whereas reinsurance had been the most common means of providing direct writers capital relief, rising reinsurance rates and capacity issues have led insurers to search for alternative means of funding their growth.

Insurers have developed structures that access the capital markets to provide a XXX solution by funding perceived statutory reserve redundancies through securitization. The amount funded is the excess over what the insurer and investors believe is the true economic reserve required to support the business. A.M. Best believes that securitization of XXX reserves will continue to be utilized as an effective funding vehicle by insurance companies for long-term, guaranteed, preferred risk term insurance products.

A.M. Best has been monitoring the evolution of XXX solutions and its impact on direct writers' capital strength (in terms of operating leverage, etc.). As part of A.M. Best's standard review of an entity's financial strength, an

important tool is Best's Capital Adequacy Ratio (BCAR), which along with other capital ratios is impacted directly by a XXX securitization transaction.

In a typical securitization, the direct writing company reinsures (cedes) statutory reserves related to XXX to a captive company, thereby lowering its C2 mortality risk on the BCAR. From A.M. Best's perspective, the XXX captive often is more thinly capitalized relative to what the direct writer would have reported had it not entered this reinsurance arrangement with its captive (although it is within captive regulatory guidelines). Also, in most cases, the captive's capitalization is supported primarily by surplus notes. The captive (or in most cases the downstream holding company that owns the captive), like any subsidiary, appears on the direct writer's statutory balance sheet as an invested asset (investment in subsidiary) based on its equity position. In many cases, however, the captive holding company may have a "negative" statutory carrying value, resulting in a \$0 carrying value on the statutory balance sheet of the direct writer that owns the captive. As a result, there is no C1 capital charge on the direct writer for ownership of the captive. In effect, the initial capital contribution has been "written off" for statutory purposes, until the captive eventually begins to generate positive earnings. Finally, the removal of the "statutory strain" from the direct writer's balance sheet results in its ability to write more business, which effectively acts like an increase in surplus levels. (See Chart 1 for an illustration. Please note, the examples are for purposes of understanding the BCAR impact and are not intended to be a complete explanation of a XXX securitization. For a complete overview of XXX transactions, please see A.M. Best's special report: "The Triple X Dilemma," Dec. 13, 2004.)

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XXX Securitization

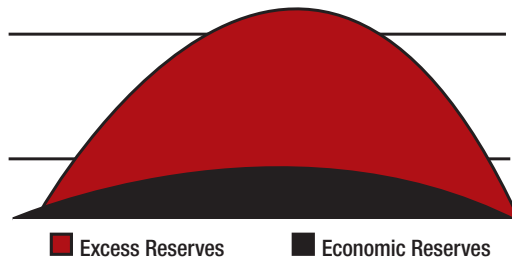
Level premium term products under XXX develop a humpback reserve pattern. As a result, the need for funding grows over time



before leveling off and then declining. The more conservative statutory reserve is consistently higher than the “economic” reserve, the latter of which most companies feel is the more appropriate level of reserves to hold for level term policies. The excess of the statutory reserves over the economic reserves, or redundant reserves, is what is financed in the capital markets.

Statutory Triple X Reserves

Term life writers argue that Triple X causes them to hold redundant reserves on level term products.



To date, these transactions have been company specific. For example, all securitizations that have been done as of this writing have included reserves exclusively on behalf of one direct writer or reinsurer (several reinsurers have been active in securitizations, in addition to direct writers). However, third-party consulting firms are designing pooled XXX securitizations that would warehouse reserves from multiple life insurance companies. These arrangements would make it more economically feasible for smaller companies to participate in such funding arrangements. Reinsurers also would see value in making such an arrangement for their clients.

As this transaction is not a true “sale” like most securitizations, A.M. Best’s analysis of these transactions would include a review of any “claw-back” provisions within the transaction, even from a reputational perspective rather than a legal standpoint. A.M. Best also would consider whether a captive can be unwound under certain conditions — such as if future mortality table changes (some of which are in the process of occurring) or other events give more “relief” to statutory reserves — that could result in sending the reserves back to the ceding company. Regulatory oversight and the “airtight” nature of the risk transfer of the securitization clearly are important elements of the review.

Clearly, adverse mortality is the primary risk in these securitization transactions. As a result, rigorous modeling of mortality is undertaken as part of the securitization process. A.M. Best has noted from its review of various transactions that deterministic and stochastic stress tests are conducted and that with more transactions occurring, documentation and stress tests are becoming more standardized. To alleviate concerns of excess mortality, some insurers also enter stop-loss agreements that are triggered under certain excess mortality events. This extra layer of protection also results in a reduced need for capital at the captive.

Another key component of the structuring of the XXX captive is the tax impact. Because the captive needs to set up a large statutory reserve at the outset, a large loss is incurred (see Chart 1). This tax deduction generated by the captive in the initial years can be used to

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offset gains from the ceding company or other members of the consolidated group. The company “gains” a tax advantage through this structure, as opposed to traditional means of reinsurance with a third party, by retaining the loss within the group.

A.M. Best’s Perspective

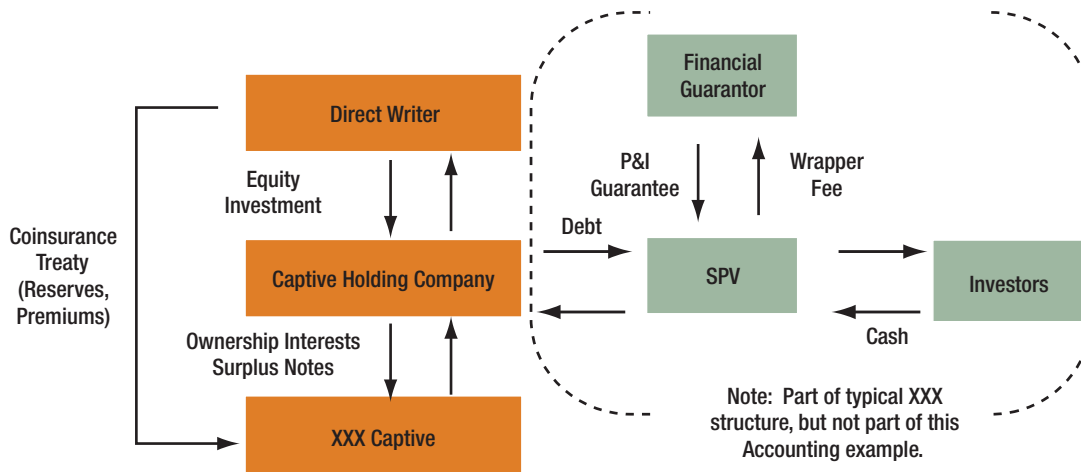
In order for A.M. Best to properly review the relationship between a XXX captive and

the direct writer, and to provide appropriate credit in the Best’s Capital Adequacy Ratio (BCAR) model, A.M. Best has developed a list of items necessary to complete its analysis. The analysis would be the same if the securitization was company specific or if a company was a participant in a XXX pooled securitization. A.M. Best’s analysis includes:

- Review of the structure of the transaction; schematic of the organizational structure/capital

Simplified Statutory Accounting Example

Chart 1 - Statutory Reporting for Captive



Direct writer

	Pre-transaction	Post transaction	BCAR impact	
Reserves	500,000,000	300,000,000	C2, C3	<---- C2, C3 Reduced
Premiums	2,000,000,000	1,000,000,000	C4	No impact
Cash	100,000,000	50,000,000	C1	Seeding of sub happens prior to transaction
Inv in sub (a)	50,000,000	0	C1	<---- C1 Reduced
Unrealized Loss	0	-50,000,000	Capital	Write off of investment due to \$0 carry value of sub
Equity	500,000,000	450,000,000	Capital	Non-admission of subsidiary, lower capital

XXX Captive

	Initial Seeding	Post transaction	
Reserves	0	200,000,000	
Premiums	0	1,000,000,000	
Cash	50,000,000		
Surplus notes (b)	250,000,000		
Equity (c)	300,000,000		
Stat Loss		-200,000,000	
Reported Equity		100,000,000	(a) Note: Carrying value on parent-due to loss-is \$0.

(a) After loss at captive, captive holding company has negative stat carrying value so investment value is \$0

(b) Raised from external debt issuance

(c) Consists of contribution + surplus notes, does not reflect stat loss

NOTE: A captive holding company is normally the direct owner of the insurance captive. The direct writer owns the captive holding company and reports this on its Schedule D.

This chart is simplified for illustrative purposes and does not represent a strict statutory accounting presentation of such a transaction.

Source: A.M. Best Co.

structure of the captive (initial capital costs).

- Audited financial statements of the captive company and/or its immediate holding company. This information should be available on a statutory (and GAAP for the holding company) basis. The captive is commonly domiciled in the state of South Carolina, which has been active in establishing captive companies following the passage of the South Carolina Special Purpose Captive Insurance Company Act in 2002. For these entities, audited financial statements are expected for balance sheet, income statement, statement of changes in financial position and cash flow. Quarterly statutory statements also are required.

- Independent actuarial report to validate assumptions used in the securitization. A.M. Best's review would include an analysis of:

- Mortality assumptions
- Lapse expectations
- Company experience vs. industry data
- Interest rate and investment default assumptions
- Distribution of business by underwriting classes, issue age and duration
- Economic reserve mapping
- Scenario testing: the results of economic reserves under stress scenarios; description of scenarios tested; the number of scenarios tested; and the duration of scenarios

- If security is guaranteed by a financial guarantor, a review of terms and provisions of the guarantee to see if any claw-back provisions exist.

- A full understanding of the "ring fencing" of collateral.

- An understanding of the "non-recourse/bankruptcy remoteness" nature of the Special Purpose Vehicle (SPV). In other words, while the SPV reinsurer can be consolidated for tax and accounting purposes, the perspective is that it is not a legal consolidation.

- A determination of whether any related debt is treated as financial or operating leverage.

A.M. Best will review statutory, GAAP and economic reserves. Unlike GAAP reserves, which are audited, economic reserves are not. Since the amount of GAAP reserves normally is close to economic reserves, A.M. Best would look to the GAAP audit as a proxy for the validity of the economic reserves.

Captive Capitalization

A.M. Best also will include a review of the capitalization of the captive entity on an ongoing

basis. With the statutory data received on the captive, a BCAR is calculated on a stand-alone basis for the captive entity. In the initial seeding of the company, capital in many cases is funded primarily with long-term surplus notes, which are given substantial equity credit in A.M. Best's BCAR model, given their long-term duration.

Assuming A.M. Best is comfortable with the stress testing, the structure and the assumptions used in the transaction, and with the stand-alone BCAR of the captive, no additional charges will be made to the ceding company's published BCAR. A consolidated BCAR, which would be used for internal analytical purposes, also will be reviewed and will factor in the captive's results in the consolidation. This allows A.M. Best to view the consolidated entity's risk-adjusted capital position, assuming no securitization had been completed.

A.M. Best does not anticipate any negative rating impact from securitization activity, which generally has been nonrecourse and has been used as a vehicle for regulatory relief. However, excessive use of securitizations would necessitate a review of the group's overall capital structure, risk appetite and risk-management process. As securitization is viewed as a means to write more business than a company's capital normally would permit, a review is necessary similar to excessive use of reinsurance or other forms of leverage. If the data requested are not received, A.M. Best will take a more conservative view of the direct writer's and the group's risk-adjusted capitalization, which may result in a negative impact on the rating. A.M. Best will monitor the impact of recent proposed changes to reserving that may offer relief to providers of term and universal life insurance, and the possible impact on current and future securitizations.

Conclusion

A.M. Best believes that risk transfer through XXX securitization has given insurance companies a new form of flexibility. It is viewed as

BCAR Methodology

	BCAR Calculated		Discussion at Rating meeting	
	Yes	Published	Yes	Yes
Direct Co	Yes	Yes	Yes	Yes
Captive	Yes	No	No	Yes
Consolidated	Yes	No	No	Yes

a more effective long-term capital solution than the use of short-term letters of credit, which represent a significant mismatch to their longer-term liabilities. However, changes in regulatory treatment of these transactions could impact A.M. Best's view of these securitizations. In addition, high severity (but low probability) mortality events or an error in estimates of mortality, lapses or other key factors would test the assumptions in these transactions. A.M. Best will view companies that have effective asset/liability matching, conservative reserving and demonstrated underwriting acumen most positively. In addition, while not considered financial leverage, an excessive use of debt-funded securitization transactions as a capital-management tool would be considered a negative rating factor.

Also, new flexibility from banks (primarily European) in issuing longer-term letters of credit may make the more complex

securitization process less favorable. Other methods of contingent capital also may become available. Smaller insurers likely will continue to look primarily to reinsurance as their solution for XXX capital relief. However, securitization transactions will likely continue to be utilized in the near term by the larger direct writers and reinsurers as an important tool in managing capital.

While the methodology applies to XXX captives, it is likely that captives will be formed for AXXX reserves (required for universal life products with secondary guarantees under Actuarial Guideline 38) reporting in a similar manner. A.M. Best would take a consistent approach in its analytics and filing requirements. However, since as of this writing, no such transactions have been announced publicly, A.M. Best reserves the right to review these transactions on an individual basis and analyze them accordingly.



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