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Layout & Distribution: Valéria Kozakova

# Securitisation: a tool for improving capital management and risk management in the European Insurance industry

Jean-Christophe Ménioux

## Securitisation: a modern tool to improve risk and capital management

Two key forms of securitisation have developed over the past decade in insurance:

- ▶ **Risk securitisation**, offering an alternative form of risk transfer to capital markets
- ▶ **Value securitisation**, offering an alternative mechanism to release capital and capitalise future profits from selected lines of business

Banks have started to actively use securitisation as a risk management or a capital management tool since the eighties.

- ▶ Securitisation of insurance risk is a recent phenomenon, beginning slowly in the mid-nineties with the issuance of the first catastrophe bonds, and continuing in the 2000's with some securitisations of embedded value.

Most recently, securitisation continued to expand with some innovative transactions:

- ▶ **Mortality risk** (Vita I in 2003 from Swiss Re ; Vita II in 2005 ; Osiris from AXA and Tartan from Scottish Re in 2006 ; Vita III in 2007)
- ▶ **P&C insurance risk** (Sparc in 2005 on AXA's motor portfolio)

→ But **the insurance sector is lagging behind the banking industry** (in Europe, in 2006, € 450bn new issues for ABS/CDO vs around 7bn Insurance Linked securities)



### Key advantages of risk securitisation

- ▶ Capital markets have significantly greater capacity than insurance markets
- ▶ Better pricing in some cases where insurance market has a limited number of providers
- ▶ Increases the diversification of protection sources
- ▶ Removes counterparty credit risk
- ▶ Improves the cost of capital, i.e. the reduction in the cost of capital achieved through securitisation is greater than the cost of servicing the securitisation structure



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### Further growth of Insurance Linked Securities (ILS)...

- ▶ We anticipate that capital markets will be increasingly utilised as an outlet for the transfer of risk
- ▶ The types of risks transferred will take three forms:
  - Portfolio based securitisation characterised by “high frequency, low impact” risks, such as motor insurance
  - Specific event risk securitisation characterised by “low frequency, high impact” risks, eg natural disaster, epidemic...
  - Structural risk securitisation (longevity...)
- ▶ There is a considerable potential market for ILS, as the need for risk transfer from insurance companies matches the desire for diversification from investors.



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## ... needs a favourable regulatory environment

- ▶ From a regulatory perspective, issuers should benefit from a favourable treatment due to the advantages of capital markets solutions, in particular:
  - Greater capacity at a reasonable price
  - Elimination of credit risk
  - Better diversification of protection
- ▶ Education of capital markets to transfer more and more sophisticated risks will take time, so an adapted favourable treatment within Solvency I should be sought without waiting for Solvency II
- ▶ In the context of Solvency II, it is important that the regulations fully take into account these new forms of risk transfer



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## Appendix: Case study: the SPARC transaction



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## SPARC - Objective and outcome

The objective was to securitize the risk of deviation of the cost of claims of AXA France P&C's personal motor insurance portfolio

- € 1.4bn earned premiums
- Approximately 3 million contracts
- Claims characteristics of high frequency, low severity and low volatility
- Around 800 000 claims p.a.

Key outcome for AXA

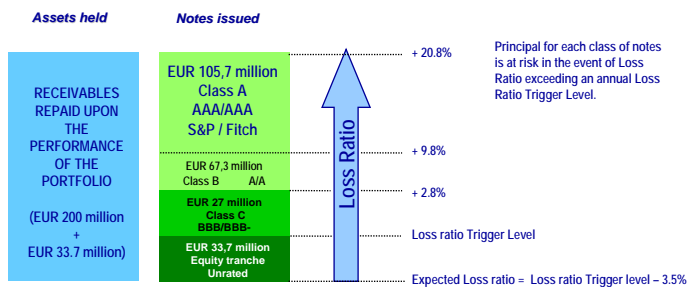
- Transfer of €200 million of risks over four independent cover periods (2005 to 2008)
- Diversification of the sources of reinsurance outside of traditional markets while eliminating counterparty risk
- Improved balance sheet efficiency and capital management
- New asset-class offered to traditional ABS investors
- Average margin of 28bp over Euribor, in line with similarly rated synthetic Asset Backed Securities (ABS) securitizations



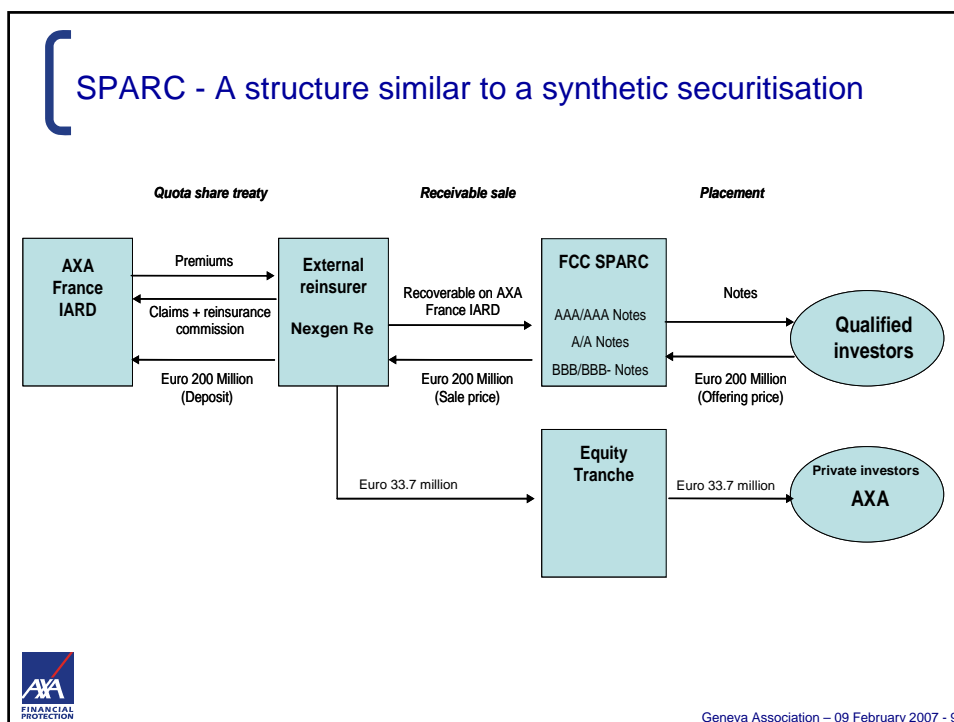
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## SPARC – Deviation of the Loss Ratio

- The transaction, structured via FCC SPARC, a French debt mutual fund, is similar to a synthetic securitisation by which the risk of performance of the securitised motor insurance portfolio is transferred to investors at certain defined levels.
- The risk is measured via the Loss ratio, which is the ratio of:  $\frac{\text{Claims}}{\text{Earned Premiums}}$
- The main risk for investors is the deviation of the Loss ratio above the Expected Loss. External investors are exposed above the Loss ratio Trigger Level.



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### SPARC - A structure similar to a synthetic securitisation

**STEP 1:**

- The risk is transferred through a quota share reinsurance treaty signed with an external reinsurer, which covers 85% of the premiums and claims of the portfolio
- Two deposits for a total amount of €233.7 million are made by the reinsurer to secure its obligations towards AXA France. Should the cost of claims stay below the risk transfer trigger level, the deposit will be totally reimbursed at the end of the transaction

**STEP 2:**

- Transfer of the risk by the reinsurer through a securitization transaction: the reinsurer transfers to a FCC the receivables arising from AXA France's obligation to repay the deposit. The public FCC issues 3 classes of notes subscribed by external qualified investors
- An equity tranche, covering the first losses in the event of a deviation of the loss ratio is subscribed by private investors, including AXA.

**AXA FINANCIAL PROTECTION**

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## SPARC - Why is this transaction innovative\* ?

From a structural aspect, the transaction includes several innovative features such as :

- First ever securitization of a low claim severity, high claim frequency insurance portfolio
- Right to repayment of deposits by the Reinsurer, not a classic receivable, is securitised
- First public securitisation transaction to be based on the European directive on collateral arrangement (EU Financial Collateral Directive, 2002/47/EC).
- AAA rating level without any monoline guarantee, although neither AXA France nor Nexgen Re have AAA ratings
- Yearly review of the rating of the notes: on an annual basis, the ratings of the notes are reassessed by the rating agencies and attachment points are reset by the rating agencies annually.

\* AXA received 5 awards in 2006 for this transaction:

- "ABS deal of the Year" by International Securitization Review
- "Insurance deal of the Year" by Structured Finance International
- "Alternative Risk transfer of the year" by Reactions magazine
- "Reinsurance initiative of the year" by the review Reinsurance Awards
- "Prix de la meilleure opération financière" by Le Club des Trente

