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Layout & Distribution: Valéria Kozakova

Insurance Linked Securities: The Rating Agency Perspective

Rob Jones

Agenda

- **Driving forces**
- **Issuer motivations**
- **Rated ILS**
- **Rating methodology**
- **Changing trends**
- **Capital relief**

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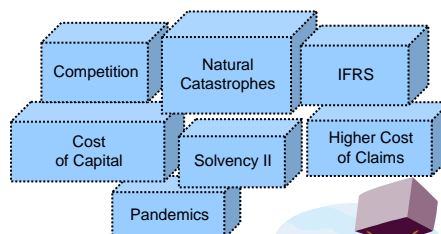
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Driving Forces Behind Insurance Linked Securities

Insurance Industry:

- Capital intensive industry
- Pressures from regulators, rating agencies and shareholders
- Threat of costly catastrophes



Capital Markets today:

- Appetite for high yielding asset classes
- Desire for diversification
- Role of hedge funds and private equity and other sophisticated investors



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Some Issuer Motivations

Risk Transfer

- **Property cat risk**
- **Extreme mortality risk**
- **Motor insurance risk**
- **Credit reinsurance risk**
- **Reinsurance recoverables credit risk**
- **Non-life loss reserve risk?**

Capital Raising

- **Embedded value (monetising VIF)**

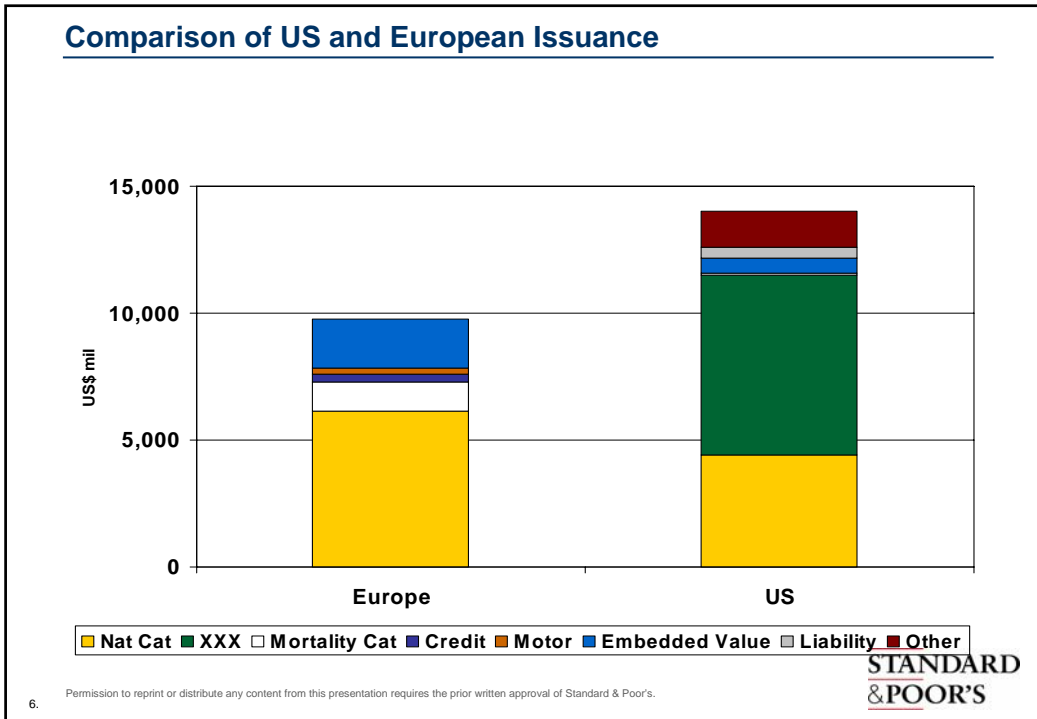
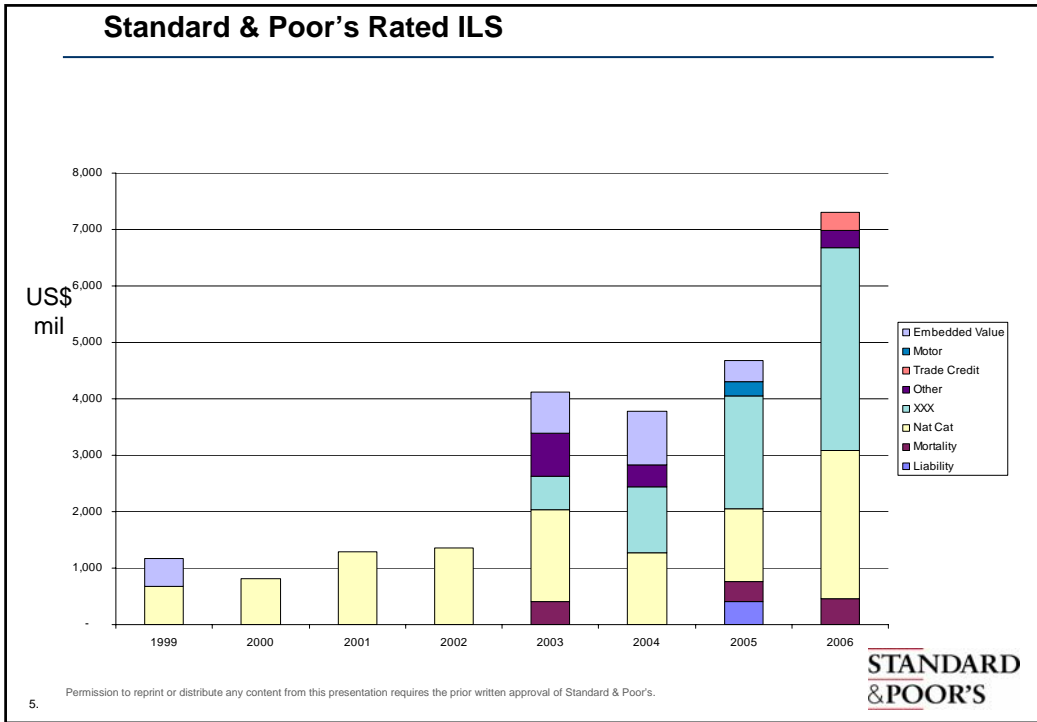
Reserve Funding

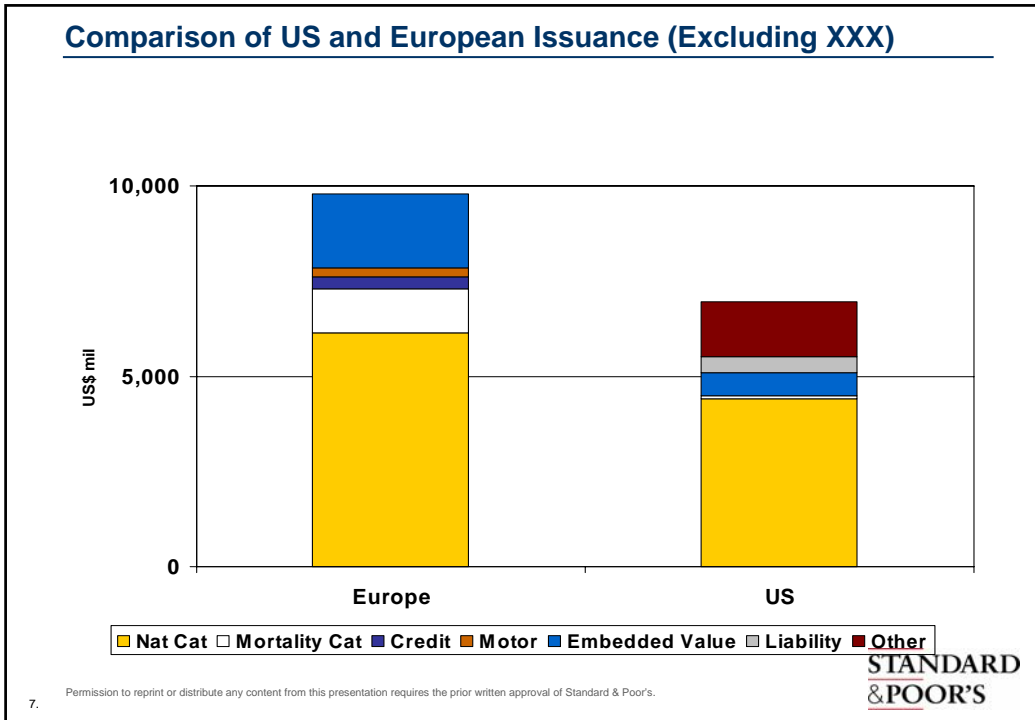
- **Triple X reserve and AXXX reserve requirements for U.S. domiciled life insurers**

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Rating Methodology

Insurance Considerations

- Premium, claims and persistency patterns
- Mortality, morbidity, lapsation, interest rate sensitivities
- Development of stress tests to analyse the vulnerabilities of the insurance blocks being securitised

Structural and Legal Analyses

- Structured Finance criteria regarding:
 - Special purpose entity
 - Indenture trustee and accounts
 - Priority of funds/ flow of funds/ events of default
 - Swaps – No termination for non-credit related events
- Legal opinions on authority, enforceability of agreements, security interest and taxation
- Ratings of cedants, swap counterparties, guarantors
- Servicer evaluations
- Review of investment criteria

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Rating Methodology

Rating Impact

- Additional funding sources can enhance financial flexibility
- Give qualitative credit under relevant rating factors
- Aim to understand the economic benefit of transaction
- Quantitative credit possible

Analytical Team

- Ensure consistency between criteria used and rating assigned
- Joint rating analysis – Structured Finance and Insurance analysts
- Involve sponsor's primary rating analyst
- Able to draw on further expertise where required
 - Actuarial
 - Legal
 - Accounting
- Ongoing surveillance

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Development of US and European Markets

The US and Europe have both witnessed significant growth in the number and sophistication of transactions completed over the last five years

- Cat bond market is global in nature
- Non-cat markets for securitisation are growing largely independently
- Regulation XXX reserve funding remains key asset class in the US
- Embedded Value has greater acceptance as an asset in Europe
- Europe has seen more asset classes than US – with highly bespoke deals being the norm
- CDO technology has been used in both markets to facilitate capital markets access for smaller insurers

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Identify Changing Trends

Catastrophe bonds

- Increased use of parametric and indexed bonds
- Expansion of geographic locations and risk exposures to wind/hurricane/quake/mortality
- Ratings are typically in the 'BB' to 'BBB+' range with the exception of third event bonds that can be rated up to 'A+'
- Evolving models and increasing scrutiny of models

Insurance securitisations

- Bond insurers have provided credit protection to facilitate the issuance of the notes due to complexity of underlying risks
- Issuance expense is fairly high leading to the need that the underlying portfolio have a sufficient critical mass
- Maturity dates have varied widely from 3 to 30 years
- Ratings have been primarily investment grade

Common to all new risks being securitized

- A "novelty" premium is demanded by investors; mitigated if wrapped
- More unwrapped tranching deals

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Capital Relief

- Ad hoc so far, except cat bonds
- Considering globally consistent principles-based approach

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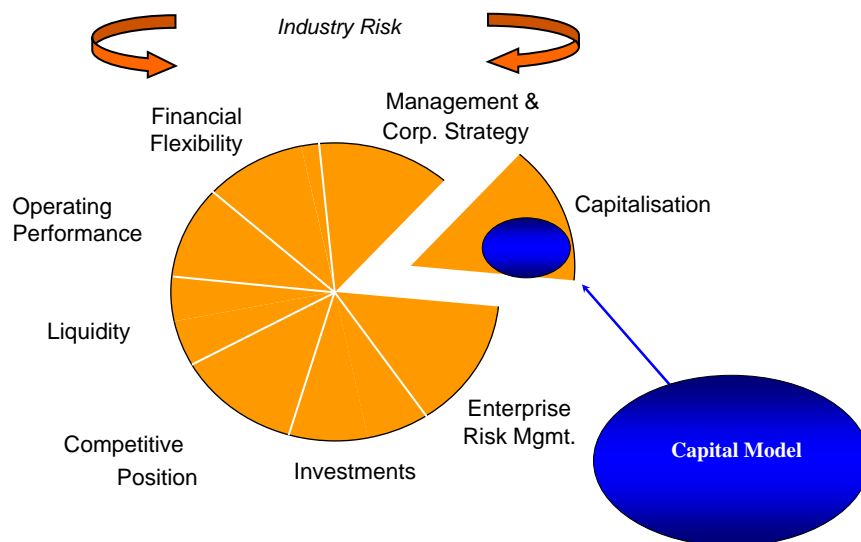
S&P Approach to Capital Adequacy

- Capital adequacy model (updated in 2007)
- Economic capital model analysis (coming in 2008)
 - Final plank of ERM criteria

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S&P Capital Model



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Capital Model and ILS Capital Relief

- **ILS may have a direct and measurable impact on outcome**
- **However**
 - Compare with reinsurance
 - Subject to 'cherry-picking'

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ILS Compared to Reinsurance

- **Basis risk**
- **Permanency**
- **Credit risk**
- **Sponsor motivation**
- **Bankruptcy remoteness/legal risk**
- **Exclusions**
- **Financial flexibility**

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Capital Model: Potential Future Approach

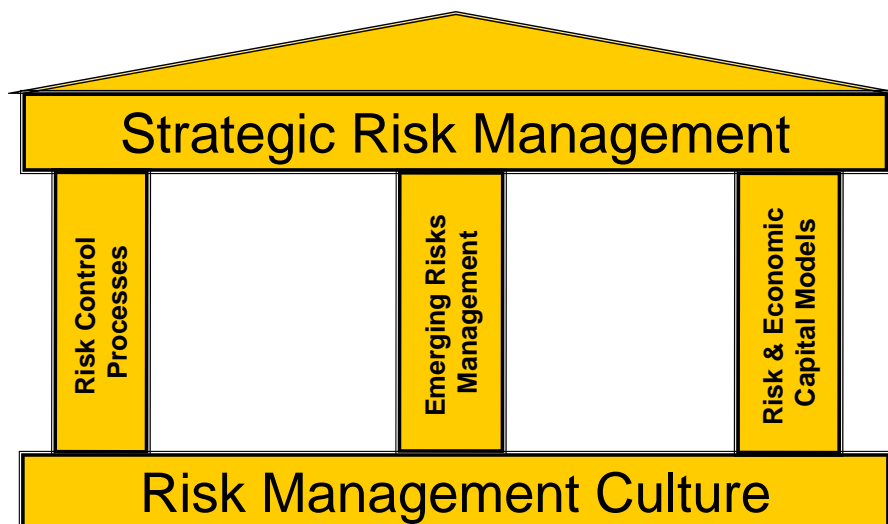
- Place onus on the company/sponsor
- Demonstrate economic benefits
- Limit benefit to economic capital benefit arising from transaction

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S&P's Evaluation of ERM



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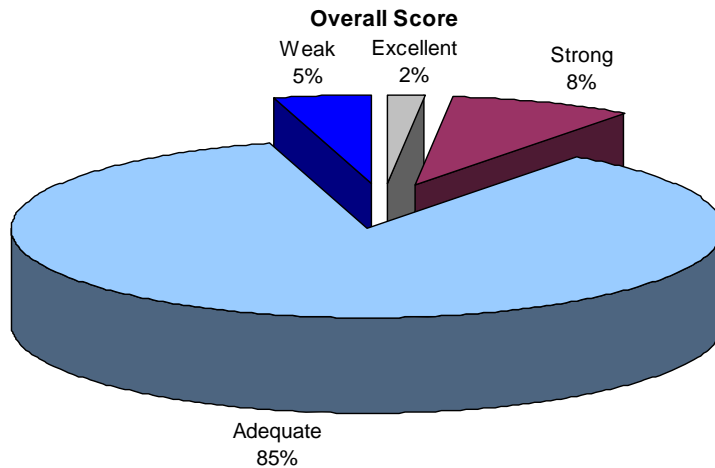
Classification of ERM Quality

Weak	Lacking basic controls for important risk(s).
Adequate	Fully functioning risk controls for all important risks, but performed in silos. No view of overall risk profile and therefore, no strategic risk management. No tracking of emerging risks.
Strong	Risk controls in place for all major risks. Vision of the overall risk profile and tolerance. Risk return considerations embedded in business decisions. Robust processes to identify emerging risks.
Excellent	Same as Strong but more advanced in the development of processes, or in the implementation and the effectiveness of execution.

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Europe, Middle East and Africa



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ERM: The Leaders in Europe

Excellent ERM

- Axa
- ING

Strong ERM

- Allianz
- Aspen
- Friends Provident
- Hannover Re
- Legal & General
- Munich Re
- Prudential
- Swiss Re
- ZFS

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Economic Capital Model Analysis

- **ECM evaluation will be used to inform the rating process regarding capital adequacy so long as:**
 - ✓ Insurer must have a robust ERM process in place (ERM scored 'Excellent' or 'Strong');
 - ✓ Model/model process must generate reliable estimates of the insurer's risks; and
 - ✓ ECM results must be relied upon by the insurer, together with other measures to significantly influence major decisions.
- **Capital impact of ILS reflected in ECMs**
- **Consistent with Solvency II approach to internal models (albeit 2012)**

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