Capital management and financing, including financial reinsurance

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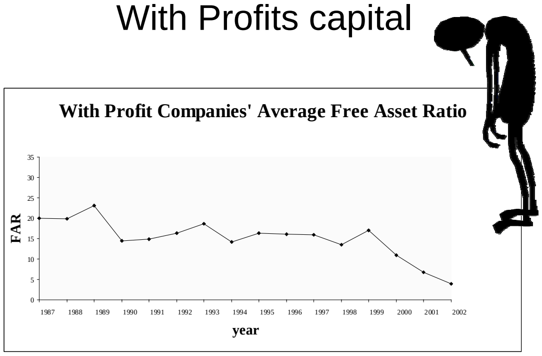
Capital management and financing

Andrew Sanders

With Profits capital



The new regulatory regime for capital

- Statutory solvency (including realistic basis)- PRU
- Individual Capital Assessment (ICA)
- Individual Capital Guidance (ICG)
- CP144
- Financial Groups Directive – CP204
- Basel 2
- IAS
- Solvency II

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CP195

- Set out FSA's approach to enhanced capital requirements and ICAs
- Provided draft PRU text for Capital, Market Risk, and Insurance Risk
- Introduces new capital regime from late 2004

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Regulatory changes

- Changes to statutory reserving, including 'twin peaks' for with profits companies
- ICA from 2005
- Implicit item already reduced and being phased out
- Financing of with profits limited to charges and shareholder transfers
- New capital resources requirements and definitions

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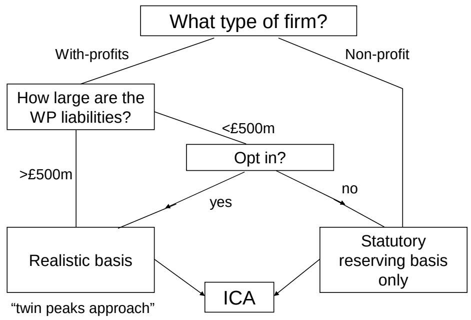
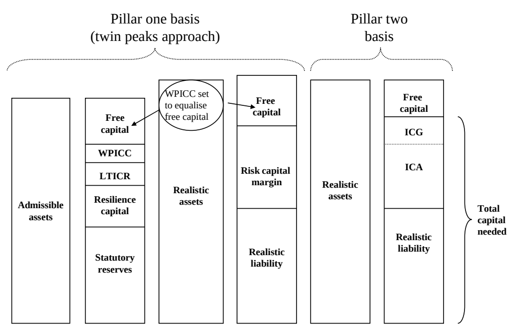
The new prudential regime



 "twin peaks approach"

Summary – realistic basis firms



Changes to statutory reserves

How are the statutory reserves calculated?

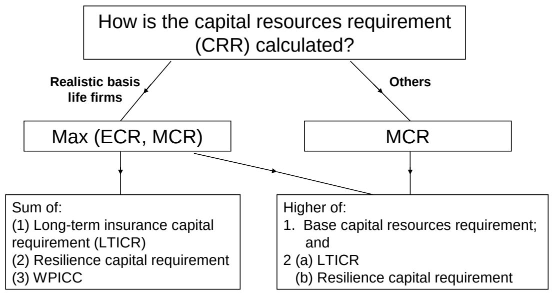
Realistic basis life firms

As currently, but:
- Gross premium valuation for CWP
- Prudent persistency assumption
- Max reinv. rate = gilt forward rate
- More realistic GAO take up
- 2 x div. cap removed on equity yld
- Resilience reserve part of MCR
- Benchmark margins in reserves
- Lower liquidity premium if not HTM

others

As currently, but:
- More realistic GAO take up
- 2 x dividend cap removed on equity yield
- Resilience reserve part of MCR
- Benchmark margins in reserves against market prices for risk transfer
- Lower liquidity premium if not HTM

The new capital requirements



The new capital requirements

LTICR (old RMM)
+ Resilience reserve
= MCR (subject to minimum of base capital resource requirement, €3m)
+ WPICC (RBS companies)
= CRR (ECR for RBS cos, MCR for others)

New capital resources

- Tier 1 – permanent loss absorbing, no fixed costs, ranks after debts/liabilities – Shares, Reserves, Innovative Tier 1
- Upper Tier 2 – Perpetual cumulative preference shares, Perpetual subordinated debt
- Lower Tier 2 – Long term subordinated debt
- Other capital – Implicit Items

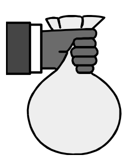
New capital requirements

- Ordinary shares/reserves should make up at least 50% of Tier 1 capital
- 50% of MCR must be met by Core Tier 1 and perpetual non-cumulative preference shares (less deductions) – subject to waiver for Implicit Items
- One-third of LTICR (minimum base capital requirement) must be met by core Tier 1, non-ordinary shares or Tier 2 capital (ie excluding Implicit Items)
- Innovative instruments may meet ECR but not MCR, but are limited to 15% of Tier 1 capital
- Tier 2 capital in excess of Tier 1 capital (after adjustments) does not count, nor does the excess of Lower Tier 2 capital over 50% of Tier 1 Capital

Financial Groups Directive – CP204

- Applicable to financial conglomerates (40% financial and at least 10% or Euro 6 billion in insurance/banking)
- Currently the Insurance Groups Directive requires reporting, but no group capital requirement
- From 2005 group capital adequacy requirement at top EEA parent insurance holding company
- Objective to eliminate double gearing of capital
- ICAS/ICG needs to be considered at group level

Capital management options



- Implicit Item
- Innovative Tier 1 capital
- Subordinated Debt
- Cumulative preference shares
- Contingent Debt
- Embedded value reinsurance financing
- Securitisation
- Derivative and dynamic hedging strategies

Implicit Item for Future Profits

- In 2002 most with profit companies and some unit-linked companies used an Implicit Item
- Lower of retrospective and prospective calculation
- Prospective calculation is a conservative estimate of present value - Guidance Note 2.2 requires maximum of risk free return for risk assets
- Retrospective calculation is bizarre - currently average of last five years profits times 0.5 times average period to run (max 10 years)

Implicit Item for future profits

- EU Solvency I changes implemented from 2004
- One-third (previously one-sixth) of the LTICR has to be met by higher quality capital (with minimum of minimum guarantee fund €3m
- From 2007 restricted to 25% of the lesser of LTICR and capital resources
- Abolished from 2009
- Any waiver application from 2004 must exclude allowance for profits after 2009
- Overall, amounts available much reduced.

Innovative Tier 1 capital

- Capital instrument that pays coupon or is redeemable (unless redeemable solely in cash)
- Perpetual status
- Deferrable coupons with stock settlement
- Limited coupon step-up
- Junior claim in liquidation
- May meet ECR but not MCR, but are limited to 15% of Tier 1 capital
- Friends Provident to issue c £250m

Long Term Subordinated Debt

- Increasing use, but no major changes
- From group company or capital markets (use by holding company for Financial Groups Directive requirement)
- Some new requirements under PRU
  - different restrictions on step-up of interest
  - amortisation in final five years at 20% per annum
- Some change in impact (eg Sub debt could meet 50% of MCR plus 100% WPICC, which is higher than 50% of RMM; also difference in impact of dated sub debt)

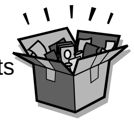
Contingent Debt

- Debt where interest and capital payments can only be made if appropriate solvency criteria are met, or dependent on future profits
- Much used as shareholder support for with profits fund
- Avoids tax and other disadvantages of shareholder transfer to long term fund
- Is normally recognised as a debt under GAAP in Companies Act accounts, as expected to be paid
- Capital support mechanisms offer ability to draw down contingent debt
- Impact of twin peaks valuation and restrictions on with profit financing (embedded value financing and securitisation also)

Embedded value reinsurance financing/securitisation

- Loan secured on future profits
- Can provide cash as well as solvency support
- Genuine transfer of risk
- Liability to pay interest/capital can be 'ignored' as outflow offset by surplus
- Or more correctly liability for outflows is valued but either outflow does not exist on valuation basis or is offset by surpluses, giving no additional liability
- Not all the risks may be transferred - lender may not be prepared to take on some risks
- Effective for non profit companies and for statutory peak, but impact for RBS companies reduced as credit available for value of non profit business (although there will be an impact on the Risk Capital Margin)

Securitisation

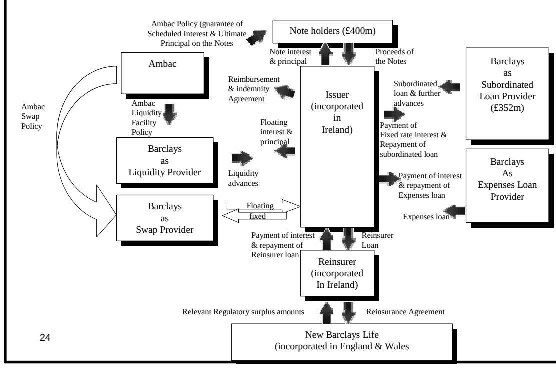


- Loan provided by capital markets
- Genuine risk transfer
- Reduces company's investment in closed business
- NPI (1998) and Barclays (2003) transactions
- Two US examples - Prudential and MONY
- Large size/complex/limited flexibility
- Interest cost low
- High set up expenses – minimum size

Securitisation transactions

Mony	Prudential	NPI	Barclays
$450m	$1,750m 3 Tranches	£260m 2 Tranches	£400m
AAA	AAA/AAA/A	A-	AAA
Floating	Floating/Fixed/Fixed	Fixed	Floating notes/Fixed to New Barclays Life (via swap)
15 years	17 and 22 years	15 and 25 years	Expected under 5 years - repaid as fast as surplus emerges
3m LIBOR	3m LIBOR + 0.875% US Treasury + 1.75% US Treasury + 3.2%	Govt stocks + c1.5%	3m LIBOR + 0.4%
Credit enhanced (Ambac)	2 Tranches credit enhanced (FSA) 1 Tranche no third party	No third party guarantee Reserve account mechanism	Credit enhanced (Ambac)

Barclays Structure



Developments of Life Reinsurance
John Cliff

- Regulatory changes affecting reinsurance and other financial engineering
- Issue raised by CP195
- Reinsurance and realistic valuation
- Reinsurance which does not work
- Reinsurance which does work
- Longer term future

Regulatory Changes Affecting Reinsurance & Other Financial Engineering - CP144

Financial engineering should be assessed on the following criteria:

- Not introduce undue risk to policyholders or potential policyholders, notably credit, market and legal risk
- Pay due regard to interests of customers and treat them fairly
- Should not be designed to mislead policyholders or FSA, particularly on financial strength
- Costs/benefits/overall effect should be adequately reflected in regulatory return

Regulatory Changes Affecting Reinsurance & Other Financial Engineering - CP144

- There should be adequate documentation of procedures and purpose
- Credit risk on reinsurance, and other risks, should be reflected in reserving and regulatory reporting
- Requirement for legitimate commercial purpose and effect e.g. risk transfer or enabling access to economic reserves, assessed on a prudent basis, within technical provisions
- Must not leave inappropriately thin prudential margins

Regulatory Changes Affecting Reinsurance & Other Financial Engineering - CP195

- PRU 7.3.30 requires amounts to be paid or received under insurance or reinsurance or analogous financing arrangements to be valued
- PRU 7.3.79(2) Reinsurance cash outflows unambiguously linked to surplus can be ignored, but PRU 7.3.86 restricts this to non profit surplus or charges or shareholder transfers on with-profits business (consistent with PRE)
- PRU 7.3.79(3) Reinsurance cash inflows contingent on factors other than insurance risks must not be valued (PRU 7.3.85 explicitly includes the contingencies of winding-up or closure)
- This is also applicable to non-reinsurance financing

Issues Raised by CP195

- Silent on transitional arrangements
- Property linked reinsurance?
- Reinsurance may only be repaid from non-profit surpluses

Transition

- Transitioning timetable for implicit items clear - 2009
- Potential scope for specific agreements on existing arrangements with FSA
- Scope to lobby for more formal transition
- But some treaties may be unnecessary under the realistic valuation

Reinsurance and the Realistic Valuation

- Realistic value of most Fin Re treaties is nil
- Role of these treaties is then potentially
  - for the regulatory peak
  - where real assets do not meet Minimum Capital Requirements
- Imposes prescriptive approach to credit risk

Regulatory Changes Affecting Reinsurance & Other Financial Engineering

- ABI SORP
- Finance Act 2003
- The Insurance Companies (Taxation of Reinsurance Business) Regulations 2003

Reinsurance Which Does Not Work

- Purpose is to mis-represent the company's financial position **X**
- To facilitate a dividend which leaves the life fund too weak ignoring reinsurance effect **X**
- Reinsurance can require payment from sources other than emerging surplus **X**
- No legitimate purpose - (e.g. risk transfer or access economic reserves) **X**
- Life business involving transfer of investment risk **X**
- Property-linked reinsurance?

So, What Can We Do?

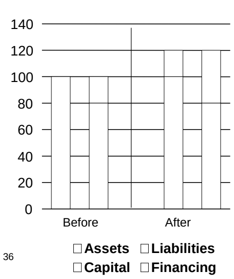
- Finance new business strain
- “Securitise” value in force e.g. management charges and reserve margins

Basic Reinsurance Structures

- Cash
- Funds Withheld
- Reinsurance of Liabilities

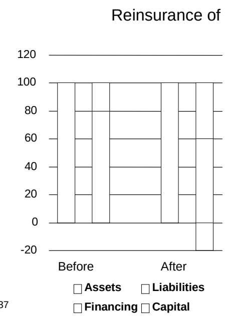
Basic Reinsurance Structure

Cash & Funds Withheld



- Cash financing provides a reinsurance advance which is repaid with interest from future regulatory surplus
- Repayment is directly contingent on future surplus actually emerging
- No liability to repay is established
- Regulatory Capital is increased by the amount of the cash payment

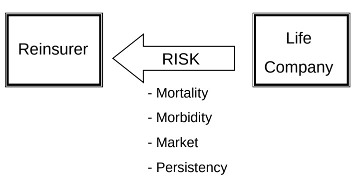
Basic Reinsurance Structure



- Cashless financing reduces liabilities without requiring an initial premium
- Liabilities are recaptured over time from emerging surplus
- No liability to recapture is established
- Regulatory Capital is increased by the amount of the release

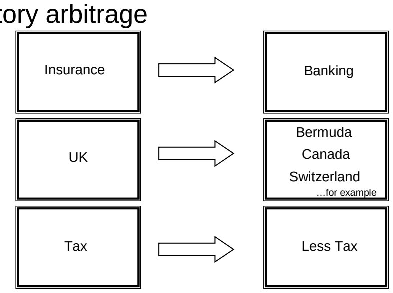
Longer Term Future

- With material risk transfer



Longer Term Future

- Without material risk transfer - if there is regulatory arbitrage



Conclusion

- Capital is scarce, but balance sheets being rebuilt
- Higher capital requirements under the new regime
- For large with profit companies the realistic balance sheet approach gives credit for the embedded value of non profit business, making financing less useful
- Implicit Items being phased out
- CP144 provides the ground rules for financial engineering
- Existing arrangements need review
- Need to consider impact of new regime
- Care needed for new arrangements

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