Insurance Securitisation - Another Method of Risk Management

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January 2008
## Agenda

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<th>Overview of Insurance Securitisation Market</th>
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<td>Examples of Transaction Types</td>
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Driving Forces in the Insurance Securitisation Market

> Regulatory development
  - Regulation XXX in the USA. Allows insurers to fund redundant reserve requirements
  - EU Reinsurance Directive, which allows member states the option to introduce regulatory framework for Insurance Special Purpose Vehicles (ISPVs)
  - Singapore’s recently proposed regulatory framework for insurance securitisation

> Solvency II (possible credits assigned)

> Growing institutional investor appetite for insurance risks
  - Diversification value / non-correlative relative to traditional capital market exposures, and relative high yield
  - Non-investment grade with virtually no credit risk but replaces with catastrophe risk
  - Proceeds secured in collateral account and invested in high quality fixed-income securities achieved by total return swap from a highly-rated counterparty

> Consistent retrocession capacity
  - Multi-year coverage depending on the structure (3 yrs is common, but seen longer)
  - Provide instant liquidity to sponsors (depend on loss trigger on payment upon confirmation of event), especially when need it the most
  - Able to tap on vast capital market
Comparative Overview of Insurance Securitisation and Reinsurance

Reinsurers raise capital from the capital market, either through equity, debt, hybrid capital, or their own Cat bonds.

Reinsurers allocate capacity and set pricing subject to their loss experiences and demand for capacity worldwide.

Reinsurers are the intermediaries between the insurance market and the capital market.

Direct access to capital market

Global excess liquidity chasing non-correlated risk exposure

A new asset class offering structural feature and secondary market liquidity

3 – 5 year coverage & pricing for Cat bond

10 years or more for life insurance deals

SPV* invests in low-risk fixed income investment and arranged a total return swap with basis consistent with stated interest rate of the note

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Insurance-Linked Securities — Transaction Structure

- Premiums (Expenses + Swap Spread + Note Spread + Dividend Spread)
- Collateral Account Directed Investments (e.g., U.S. Govt. Obligations, Commercial Paper, AAA Bonds)
- Swap Counterparty
- Sponsor
- Special Purpose Vehicle
- Noteholders
- LIBOR + Swap Spread
- Face Value
- Total Return on Directed Investments
- Swap Counterparty
- LIBOR + Swap Spread
- Face Value

*Investment income, realized gains and losses.

Source: Fitch.
Overview

- Market has grown well above trend in both 2005 and 2006 to reach in excess of EUR25bn by end of 2006

- Estimate substantially understates reality (ie. private placements and etc)

- Also excludes weather and property risk futures traded on the exchanges (NYMEX and CME)

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Insurance Securitisation Issues Split
December 2006

- Property Cat Bonds 41%
- Non-Property Cat Bonds 4%
- EV/VIF Securitisation 20%
- XXX Securitisation 22%
- Motor & Credit Securitisation 2%
- Others (Pre-Funding, etc.) 13%

Source: Fitch, Sigma, Guy Carpenter
Developments

> Although growing the market remains small;
  – €25bn of insurance securitisation compared to
  – €6.7trn of European life reserves and
  – €1.5trn of global non-life premiums

> Insurance securitisations suffer from
  – Challenging regulatory framework
  – Potential difficulties in aligning interests of investors and insurance issuers
  – Complex structures that can make pricing challenging and take a long time to put together
  – Limited investor confidence due to limited size of market and reliance on industry not noted for transparency
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Type of Loss Triggers

> 4 basic types of loss triggers – parametric and index are more commonly used

> Indemnity
  – No basis risk but moral hazard risk (coinsurance percentage is normally advisable)
  – Treated as normal reinsurance such as excess of loss reinsurance with an aggregate limit
  – Suitable for cedents receive coverage exactly matching their portfolio

> Parametric
  – Wide variety of parameters, including wind speed or earthquake magnitude
  – Basis risk exists between actual vs recoveries from the securitization
  – Net exposure will be estimated using combination of modelling agency’s estimates and the output of Prism, a stochastic capital model of Fitch Ratings

> Index
  – Industry loss exceeding a threshold. Suitable for cedents whose portfolio resembles that of the index
  – Basis risk

> Hybrid
  – Payment subject to running actual loss event parameters through pre-agreed models. Recoveries depend on ‘notional portfolio’ to reflect the actual portfolios, given a peril’s parameter
  – Basis risk
  – This form of trigger is rapidly evolving
Examples

Insurance Risk

- Severity Risk (Earthquake) – Cascadia 2 (low frequency high impact)
- Frequency Risk (Motor Insurance) – FCC Sparc (high frequency low impact)
- Catastrophe Frequency Risk – Fremantle (low frequency high impact)

Insurance Credit Risk

- Trust Preferred Securities - Dekania
Earthquake Risk – Cascadia II (1)

> In August 2006 Factory Mutual Insurance Co. (FM Global - AA IFS rating) issued a cat bond through a structure called Cascadia II

> USD300m of protection against earthquake in N.W. USA and portions of British Columbia

> Investors lose (FM Global is compensated) if earthquake exceeds certain magnitude

> Depth of hypocentre must not exceed 200km

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Source: Cascadia II Limited
Earthquake Risk – Cascadia II (2)

Cascadia II Limited Transaction Structure

FM Global

Counterparty Payment

Counterparty Contract

Cascadia II Limited

Collateral Account

3-mo. LIBOR
minus Bank Fee

US$ 300 Mil. Face Value

Deposit Bank

3-mo. LIBOR plus Note Spread

US$ 300 Mil. Face Value

Noteholders

LIBOR – London Interbank Offered Rate.
Earthquake Risk – Cascadia II (3)

- Modelling firm performed certain services for the sponsor – namely the determination if an event has occurred, the calculation of any event loss amount, loss payments and principle reductions;

- Bank deposit agreement established with bank with high credit quality (ie. collateral account);

- Fitch further stressed test the base-case modelled of EQECAT and to evaluates the transaction’s first-dollar loss and expected loss;
  - First-dollar loss relates to the likelihood that security holder will incur any loss on the notes;
  - Expected loss measures the average loss noteholders can expect to incur, and is a function of loss severity and event frequency;

- After stress testing, the risk-adjusted loss statistics are compared with Fitch’s catastrophe bond rating grid (ie. from our internal insurance capitalisation model) to determine the implied rating;

- Cascadia II Notes (US$300m) rated BB+ by Fitch, parametric structure;
Earthquake Risk – Cascadia II (4)

> Benefits

- Relative simple and well established
- Non-indemnity transactions can be quickly and accurately determined in terms of losses to investor
- Limited moral hazard
- Multi-year protection
- No credit risk for (re)insurer (ie. originator)

> Issues

- Basis Risk: Losses suffered by the (re)insurer directly will not be sufficiently covered through a non-indemnity protection
- Can take much longer to implement compared to traditional reinsurance covers
Motor risk securitisation – FCC SPARC (1)

> AXA’s 1st transaction (FCC SPARC) raised up to €200m in protection in three tranches (notes). Following its success, the 2nd transaction was arranged in 2007 – involves 4 quota share reinsurance treaties.

> First securitisation of motor quota share reinsurance treaty in Europe

> 3 million policy reference portfolio from AXA’s French motor book

> Structured as an 85% quota share via

  – Fonds Commun de Créances (FCC); French securitisation vehicle
  – Nexgen; a reinsurer

> FCC supports losses above predefined yearly loss ratio trigger threshold and up to total amount of notes issued

> Trigger level set annually by Fitch following analysis of AXA’s budget

> Tranches were rated AAA, A and BBB- by Fitch
Motor risk securitisation – FCC SPARC (1st transaction)

Structure Diagram

AXA France IARD

Quota Share Treaty

Premiums +
Claims + Reinsurance Commission

EUR200m (Deposit)

Reinsurer

Sale of Receivable

Receivable

EUR200m

FCC SPARC
‘AAA’ Notes
‘A’ Notes
‘BBB-’ Notes

Placement

Notes

EUR200m

Investors

Equity Tranche

AXA

Source: Transaction documents
Motor risk securitisation – FCC SPARC (2)

> Benefits
  – Alternative source of cover of traditional reinsurance
  – Multi-year protection (4 years but covers only 1-year on rolling basis)
  – Indemnity protection
  – No credit risk (fully collateralised)
  – Payment timing risk minimised

> Issues
  – Exclude natural disasters, hail, snow and wind related losses
  – Only individual risks. Fleet business priced differently
  – Individual losses capped at EUR5m to avoid skewing loss distribution
Catastrophe Frequency Risk – Fremantle (1)

> Issued by Brit insurance, raised USD 200m to protect against catastrophic events.
> Issued in three tranches and protection lasts for 3 years.
> Triggers are for industry losses in the US, parametric triggers outside.
> Loss of principle only occurs after multiple events. Brit will be paid by Fremantle for each of fourth to ninth events.
> Perils covered: UK Windstorm, Europe Windstorm, Japan Typhoon, Japan Earthquake, California Earthquake, New Madrid Earthquake, Florida Hurricane, Gulf Hurricane, East Coast Hurricane, Bypassing Hurricane.
> Tranches were rated AAA, BBB+, BB- by Fitch
Catastrophe Frequency Risk – Fremantle (2)

Fremantle Ltd Structure Chart

- Custodial Account
- TR Swap Counterparty
- Actual Cash Flows from Custodial Account
- Investment Yield
- Counterparty Contract
- USD200m Custodial Arrangement
- USD200m Note Proceeds
- LIBOR – 10bps

Investors
- LIBOR + Risk Period Spread
- Net Outstanding Principal at Redemption

Source: Offering documentation

Counterparty
- Contract Payments

Source: Transaction documents

Tranching

- Class A
  - Loss Event 9 – USD30m
  - Loss Event 8 – USD30m

- Class B
  - Loss Event 7 – USD30m
  - Loss Event 6 – USD30m

- Class C
  - Loss Event 5 – USD40m
  - Loss Event 4 – USD40m
  - Loss Event 3
  - Loss Event 2
  - Loss Event 1

Protected Event

Unprotected Event
Credit Risk – Dekania 2 (1)

> Pool credit risks from several insurers
  - Ability for smaller insurers to issue debt and therefore improves financial flexibility
  - Costs benefits as the issuer benefits from the economics from the pooling
    > Economic of scale
    > Tranching
  - Subordinated bond can be issued – equity credit from rating agency and regulators
  - Broadens the sources of financing from the company prospective

> Issues – Cost of funding not systematically lower since higher structuring and managing costs than bank loan

> Five Dekania Transactions have been issued to date
Credit Risk – Dekania 2 (2)

**Transaction Structure**

- **Target Portfolio**
  - EUR300m
  - Subordinated Hybrid Capital

  **DEKANIA Europe CDO II plc**
  - Bankruptcy Remote Ireland Based SPV

  **HSBC Trustee (C.I) Ltd**
  - (“Trustee”)

  **Dekania Capital Management, LLC**
  - (“Collateral Manager”)

- **Class A-1 Notes**
  - EUR165m
  - CE: 45.0%
  - Floating

- **Class A-2A Notes**
  - EUR25m
  - CE: 35.0%
  - Floating

- **Class A-2B Notes**
  - EUR5m
  - CE: 35.0%
  - Fixed

- **Class B Notes**
  - EUR26m
  - CE: 26.3%
  - Floating

- **Class C Notes**
  - EUR28m
  - CE: 17.0%
  - Floating

- **Class D1 Notes**
  - EUR12.5m
  - CE: 12.2%
  - Fixed

- **Class D2 Notes**
  - EUR2m
  - CE: 12.2%
  - Floating

- **Class E Notes**
  - EUR12m
  - CE: 8.2%
  - Floating

- **Class F Notes**
  - EUR24.5m
  - CE: 0.0%
  - Floating

*Source: Transaction Documents*
Agenda

Overview of Insurance Securitisation Market

Examples of Transaction Types

Rating Methodology
Fitch’s Approach to Rating Insurance-linked Securities

> Fitch employs a multi-disciplinary approach to rating insurance securitisation
  – Insurance risk
  – Structured finance (analysis of structure)
  – Legal
  – Other groups (e.g., public finance and sovereign) available as needed

> True international ratings capabilities
  – Assign the best available team of analysts
  – Global presence of insurance securitisation team members
    > Chicago, London, New York, Paris, Tokyo, Singapore, Hong Kong, Brisbane and Taipei
  – Multi-lingual capabilities
Insurance-linked Securities Rating Methodology (1)

- 3 Main Steps in Insurance Analysis
  - Estimate the probability of loss
  - Compare the estimated probability of loss to Fitch’s idealized default rate grid to determine the implied rating (usually based modeled experience after a period of time) and
  - Analyze the risk of the sponsor (i.e., generally insurer)
- Probability of loss => To evaluate probability that SPV will fail to make a principle or interest payment as scheduled
  - Use stochastic modeling to derive estimated loss statistics: Fitch’s stochastic insurance capital model (Prism) or Fitch Default Vector Model (Vector)
  - Models built by qualified third-party modelers (such as AIR, EQE and major actuarial consultants) or
  - Combination of both
Insurance-linked Securities Rating Methodology (2)

> Insurer / Sponsor analysis (standard counterparty criteria)
  - Insurer financial strength and issuer default ratings
  - Underwriting, reserving and claim handling abilities, Company’s historical performance

> Structural Review
  - Completeness, legality and enforceability of the contracts, including any security given the ranking of such security
  - Isolation of the bonds from a sponsor, or other counterparty’s, insolvency
  - Qualified investment
  - Swaps, if any
  - Evaluation of key counterparts, which may include:
    > Third-party modelers
    > Third-party claims evaluators
    > Services and back-up services and etc
  - Credit enhancement facility and any special requirements unique to SPV’s domicile
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### Selected Insurance-Linked Securities Rated by Fitch

- Fremantle Ltd.
- Atlantic & Western Re
- Atlas Re
- Avalon Re
- Ballantyne Re
- Cascadia I and II
- Champlain Ltd.
- Circle Maihama Ltd.
- Concentric Ltd.
- FCC SPARC
- Gold Eagle Capital Ltd.
- Halyard Re
- Juno Re
- Mosaic Re
- Namazu Re
- NeHi Inc.
- Pacific Re
- Parametric Re
- Prime Capital
- Residential Re I and II
- Tailwind Holdings
- Trinity Re
- Trinom Ltd.
- Mediterranean Re
Conclusions

> Fitch welcomes the development of insurance securitisation
> Aids financial flexibility
> Can enhance liquidity, risk management and regulatory/economic capital
> Use of proceeds is key consideration
> Challenges remain in aligning interests of investors and sponsoring companies
> Other challenges include regulatory barriers and relatively nascent stage of market which impedes broadening of market
> Securitisation faces competition from reinsurance, derivatives, hybrid debt, sidecars, etc.
About Fitch Ratings
Corporate Overview and Structure

> One of three global rating agencies with expertise and critical mass across the credit spectrum.
> The only European owned rating agency
> Dual headquartered in New York and London
> Over 7,000 subscribers globally
> 2,215 employees (including over 700 analysts) in 49 offices worldwide

![Diagram showing ownership structure of Fitch Ratings and Algorithmics](image)
Fitch Ratings: Presence in Asia Pacific

Subsidiaries, branches and affiliates:-

1. Fitch Ratings (Australia) Pty Ltd
2. Fitch Ratings (Beijing) Limited
3. Fitch Ratings (Hong Kong) Limited
4. Fitch Ratings India Private Limited
5. PT Fitch Ratings Indonesia
6. Fitch Ratings Japan
7. Fitch Ratings Limited, Korea Liaison Office
8. Fitch Ratings Singapore Pte Ltd
9. Fitch Ratings Lanka Ltd
10. Fitch Ratings Taiwan
11. Fitch Ratings (Thailand) Limited
12. China Lianhe Credit Rating Co.
13. Korea Ratings
Fitch Ratings at a Glance

> One of only 3 global rating agencies with expertise and critical mass across the capital market

> The only European owned rating agency
  - Fimalac – Business services group listed in Paris

> Dual headquartered in London and New York

> Global rating coverage

> 6,012 Financial Institutions
  > 3,178 banks
  > 2,435 insurance companies
  > 243 managed funds
  > 62 finance & leasing companies
  > 32 broker-dealers
  > 62 covered bonds

> 1,661 Corporate ratings

> 10,402 structured finance transactions under surveillance, including 366 in Asia

> 103 Sovereign ratings

> 93,109 U.S. municipal transactions

> 162 sub-sovereign ratings

> 7,600+ active subscribers globally

> 2,215 employees in 49 countries worldwide
  (S&P 7,500 in 25 countries, Moody’s 2,400 in 22 countries and A.M. Best 450 in 3 countries)
### Ratings Coverage in Asia-Pacific

*In Asia Pacific, Fitch has assigned over 1,400 ratings to a broad cross section of issuers which represents in depth coverage across the credit spectrum.*

<table>
<thead>
<tr>
<th>Category</th>
<th>Number of ratings assigned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sovereigns</td>
<td>17</td>
</tr>
<tr>
<td>Banks, Securities &amp; Finance companies</td>
<td>415</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>53</td>
</tr>
<tr>
<td>Corporates</td>
<td>425</td>
</tr>
<tr>
<td>CDOs</td>
<td>188</td>
</tr>
<tr>
<td>ABS/MBS</td>
<td>305</td>
</tr>
<tr>
<td>Public Finance &amp; Public Finance entities</td>
<td>64</td>
</tr>
<tr>
<td>Bond Funds &amp; Asset Management</td>
<td>17</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,484</strong></td>
</tr>
</tbody>
</table>

As of 30 September 2007
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For trial access to our research database, please contact asi aclient.services@fitchratings.com or +852 2263-9999

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> Bermuda Reinsurers – What a Difference a Year Makes
> Insurance Securitisation – Coming of Age
> The Pyramid of CEIOPS: Solvency II – An Update
> Enterprise Risk Management for Insurers and Prism’s Role
> In Pursuit of Diversification: Treatment in Economic Capital Models and Prism
> Russian Insurance Sector: Key Challenges
> Turkish Insurance Sector
> Japanese Life & Non-Life Insurance Companies
> Earthquake Insurance in Japan
> Hong-Kong Non-Life Market: Competitive Pressure Intensifying
> Taiwan Life Insurance – Issues & Structures
> Asia Quarterly
> Australian General Insurers
> The Indian Insurance Sector
> Sri Lankan Insurance Market Report
> Global Credit Derivatives Survey
Thank You