An increasing number of life assurance companies are using securitisation to cover their liabilities under the Financial Services Authority and other regulations. Jennifer Donohue and Peter Hoye report

# Work your assets

A survey of recent structures being developed in the life assurance market might suggest that you have stepped back into the Renaissance period, with alchemists seeking to turn debt into capital, or even the period of the flat-earthers, moaning that travelling too far can only result in falling off the edge of the world.

However, the Financial Groups Directive, the Basel II reforms and the decline in equity values have produced seekers of regulatory capital and seekers of Linnaean nomenclature to define the solutions emanating from the laboratory.

The Directive, among other things, introduced arrangements that preclude the double use of the same capital to cover risks in an insurer and its related undertakings. Basel II is the international initiative that requires financial services companies to have a more risk sensitive framework for the assessment of regulatory capital. Both of these involve increasing the amount of capital. Added to this is the fall in the equity markets over the past few years, which has eroded the existing capital base of life assurance companies.

Life assurance companies are required to maintain a minimum level of regulatory capital against the risks to which their businesses are subject, to ensure that they are always able to meet their liabilities to policyholders as they fall due. The Financial Services Authority (FSA) regulations lay down detailed rules about the amount and quality of capital that such companies must maintain, based in large part on the developing rules for banks following Basel II.

In particular, the capital requirements for life assurance companies involve the stratification of capital in terms of tier one (broadly equivalent to equity capital) and tier two (broadly equivalent to long-term debt) in much the same way as that approach has been used by banks since Basel I. The rules require that at least 50% of the capital is made up of tier one capital. However, equity capital is an expensive form of capital and the increasing demand for this has led life assurance companies to look for cheaper alternatives that nonetheless retain enough of the characteristics of equity for them to rank as equity for regulatory purposes.

For similar reasons, many banks have in the past succeeded in devising debt instruments that have had some equity characteristics and a number have raised some so-called innovative tier one or hybrid capital. However, there is a significant limitation in the regulations for both banks and life assurance companies in the extent to which such instruments can be treated as equity capital for regulatory purposes. No more than 15% of the equity capital requirement for such companies can be made up of hybrid capital. So we have seen in the last two years the very successful rehabilitation of an idea first tried (rather less successfully) by NPI in the late 1990s, the so-called securitisation of embedded value.

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What has been done is to take advantage of a little-known provision in the regulations that enables life assurance companies to treat as equity capital borrowings that are limited recourse to future profits from their existing policies (referred to as the value of in force or VIF). Although popularly referred to as securitisations, transactions of this sort do not involve the giving of security over third-party obligations in the way that mortgage book securitisations do. In effect, there is merely a pledge by the life assurance company that its profits from its existing business, as realised each year over the term of the debt, will be used to service the debt obligations. Monetisation of the value of in-force business might be a more accurate (if less catchy) way of describing these transactions.

Two recent instances where monetisation of a defined book of life policies have been successful are the Gracechurch and Box Hill transactions. Gracechurch, which closed in November 2003, involved the monetisation of the VIF of the entire book of life policies of Barclays Life, providing equity capital of £400m. The VIF was reinsured with a Dublin-based captive insurance company, which used it to back a limited recourse loan from a finance vehicle, which itself used that to back the notes of £400m issued to the capital markets. A similar structure was adopted more recently in Box Hill where the VIF of a defined book of life policies, held by Friends Provident, was monetised to provide capital of £380m. In both cases the notes issued to the markets were wrapped by a monoline to provide an AAA rating.

Both these transactions related to a closed book of life policies which has made documenting the arrangements relatively easy to achieve. This is particularly true in the case of Gracechurch where the policies were largely unit-linked, so that the insurer retained no significant investment risk. Nevertheless, opportunities abound for more innovative monetisations involving new business, potentially volatile types of business such as annuities and even with profits business. The reduction or elimination of risk in such books of business, but in a way that retains the principle of equity capital, is the next goal to which the alchemists should turn their attention.

This is a new and complex area, not only for the market and for advisers, but also for the FSA. It took many years to develop the regulatory framework which now applies to the securitisation of mortgage books and other asset-backed debt issues. Currently there is nothing directly in the rule book dealing with monetisation of VIF. Understandably, the FSA is being extremely cautious. Early and detailed explanation to the body of what is proposed in order to demonstrate that it falls squarely within the underlying principles that apply to capital generally and to the significant risk transfer concepts encapsulated in the existing rules on securitisations of mortgage books is crucial to any successful deal. Much of the structural complexity of the two transactions that have already taken place was driven by the sometimes conflicting requirements of the FSA, the monolines, the ratings agencies and the Inland Revenue. One objective of any future transaction must be to satisfy all the requirements of all these parties but in a simpler format.

What is the role for lawyers in this uncharted new world? One of the Harvard Business School models has always suggested strategy, implementation, documentation and troubleshooting as the true destiny for lawyers. The role for lawyers must therefore be to engage in the design of transactions. These solutions are bespoke, highly innovative and depend upon sound and sophisticated understanding of the rules to assist in the continuous experimentation until a proof is established. Documentation follows almost as a write-up of the proof.

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