VIF monetisation for life insurers– key drivers & considerations

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There are numerous potential benefits of VIF monetisation for life insurers, and in recent months there has been an increase in the interest for such arrangements in some countries. There is a varied approach to structuring these transactions and this is driven by the specific objectives of the parties involved. These objectives are important to understand prior to embarking on such an arrangement. This short paper explores the topic in a practical context and considers the potential benefits for life insurers.

VALUE OF IN-FORCE BUSINESS (VIF)

The value-of-in-force business (VIF) is a concept used within insurance that essentially refers to the future profits expected to emerge from a particular life insurance portfolio.

There can be variations around chosen definitions for specific details (e.g. exactly how "profits" are defined, and how these are timed to emerge) but the overriding concept is of the total amount of cash expected to be generated in the future by a specific set of policies in force now, taking into account their expected future premiums, claims and expenses.

Estimations of VIF can be made by performing actuarial projections of the future cashflows expected to emerge from a portfolio of in-force policies based on a particular set of assumptions (e.g. lapse, mortality and expenses).

MONETISATION

In the general sense, a "VIF monetisation" allows an insurer to exchange this expectation of future cashflows for an upfront amount of capital. The insurer can negotiate such a transaction with a reinsurer or investment bank (or possibly a combination of both).

Again, specific details may vary (e.g. the agreed scope of exchanged cashflows; the future period of cashflows to be covered by the deal; the allocation of the portfolio's risks between the various parties to the transaction) but the concept is the same.

SECURITISATION

A "VIF securitisation" is a specific type of VIF monetisation whereby securities are created, each with the right to a slice of expected future VIF cashflows, and issued to raise the capital for the transaction. The purchaser of each security therefore exchanges the purchase price for an expectation of future cashflows to be received as they emerge from the covered insurance portfolio. A special purpose vehicle (SPV) is often created as part of the mechanism for facilitating a securitisation.

KEY DRIVERS OF MONETISATION

VIF monetisation can be attractive to insurers (and their parent groups) as a means of raising cash and/or Tier 1 capital in times of tight liquidity and/or elevated cost of financing. It can also be a source of capital relief in certain circumstances, either via risk transfer away from the insurer (usually at the expense of expected future profitability) or via recognition of assets which are not otherwise recognized under the accounting regime. Solvency II and Basel III also bring specific reasons why certain types of insurance portfolios might be ripe for VIF monetisation.

At the same time, monetisation is of interest to the counterparties to the transaction due to the

potential for non-correlated returns and potential excess profits. In particular, in times of depressed returns generally, a VIF monetisation might offer the opportunity of investing at higher expected yields.

These and other reasons make up the main drivers underlying VIF monetisation, and we look in turn at each of these below.

Improving solvency

Under Solvency I, Solvency II and Swiss Solvency Test (SST), VIF monetisation can offer potential solvency relief.

Under Solvency I, VIF can be an intangible asset held off the balance sheet. Monetisation allows the VIF to be recognized as a cash asset on the balance sheet, and without creating a corresponding liability (due to it being contingent on the emergence of future profits).

For Solvency II and SST, VIF is already recognized as an asset on the balance sheet and (as of the time of writing) contributes towards Tier 1 capital. In the context of these regimes, there is perhaps less incentive to monetise, as this could reduce Own Funds (given that the transaction will involve some cost). While the SCR should also fall due to the reduced risk, there may also be a lower diversification benefit. In the general case it may be unclear whether the net effect would increase or reduce the solvency ratio.

However there may be other more subtle effects that can lead to a clear improvement in the solvency ratio from monetisation:

- The current definition of “contract boundaries” under Solvency II and SST can restrict the reported VIF component for certain products by not making full allowance for projection of future premiums, and the associated profits, in the calculation of the Best Estimate Liability (BEL). In this case the Solvency II balance sheet will imply a “VIF” that is lower than the ‘true’ economic VIF. Monetisation might be a way of transforming the balance sheet to explicitly recognise the additional VIF, subject to regulatory approval and an appropriate reinsurance structure.
- There remains a possibility that “Expected Profits In Future Premiums” (EPIFP) under Solvency II (a concept similar to VIF) may eventually be re-classified as Tier 3 capital, as had been proposed in the draft technical specification for QIS5. In this case VIF monetisation could be a way of ensuring that VIF continues to count fully toward Tier 1 capital.

The overall effect will depend on the specific deal structure, and in particular how the new asset is offset within the balance sheet, e.g. via a reduced reinsurance asset and/or a new liability.

Basel III considerations for bancassurers

Under Basel III, banks will be subject to more onerous capital requirements (compared to Basel II) with respect to any majority stakeholdings in insurance companies, with the consolidation treatment being re-defined under Basel III to reduce the risk of ‘double-gearing’.

Under Basel II, the capital deduction for majority stakeholdings could be limited to the minimum capital requirement (with free surplus available to the parent bank). Under Basel III however, full capital deductions will apply for significant stakeholdings, and these will mainly be deducted from Tier 1 capital.

VIF monetisation can therefore potentially enhance Tier 1 capital under Basel III for banks with significant stakeholdings in insurers. The transaction will involve a release of the bancassurer’s VIF into liquid funds, and then payment of a dividend to the parent banking group to support Tier 1 bank capital. This will be subject to the bancassurance subsidiary maintaining sufficient solvency for on-going management.

Such a strategy might be considered a good alternative to divestment of the insurance

subsidiary, as part of a broader strategic program.

We note that the current need for recapitalization of Spain's banking sector has driven recent VIF monetisation activity in that country, with parent banking groups considering the monetisation of relatively healthy levels of VIF present in the life risk portfolios of their bancassurance subsidiaries. A good example of this is the Santander deal announced in July 2012, in which the bank achieved VIF monetisation of some EUR 490 million.

Unlocking capital for other uses

Apart from solvency considerations, the unlocking of capital via VIF monetisation into liquid funds can prepare the ground for more efficient uses of that capital. For example, shareholder returns might be enhanced through share buy-back and/ or dividend payment, thus reducing excess equity and enhancing returns on equity.

Similarly, alternative investment opportunities can be pursued, for example the writing of new business, or potential acquisitions. VIF monetisation might be more attractive when it is more difficult or expensive to raise funds via more traditional channels, e.g. during times of illiquidity and/or elevated cost of financing.

Risk transfer

Exchanging uncertain VIF cashflows for an upfront amount of capital can transfer certain risks to the counterparties to the transaction. This can bring less volatile and more secure returns to the originating insurer, though this will have a cost and may also give away the right to any future excess profitability.

For certain categories of 'adverse' risk this can be attractive, e.g. lapse risk, especially given current uncertainties linked to the EU Gender Directive, and there can be specific counterparty appetite for taking on these risks (see section below).

In order to gain regulatory approval for reinsurance deals, it will be necessary to demonstrate sufficient risk transfer.

Enhanced market perception

The main drivers of VIF monetisation all demonstrate a pro-active approach to capital management on the part of the originating insurer. VIF monetisation also shows a commitment on the part of the insurer to understanding the key value and risk drivers underlying its business. If the objectives of the monetisation are achieved then this improved use of capital should lead to enhanced solvency and/or more stable performance. Returns may also be increased via accelerated release of excess capital.

This should all be perceived positively by stakeholders and the market more widely, and can bring more certainty to shareholder value, thereby potentially supporting a higher share price.

Counterparty appetite

Of course, any transaction requires two or more willing parties and there are key reasons why a VIF monetisation is also attractive to the counterparties of the deal.

Reinsurers are typically less exposed than direct insurers to certain classes of risk (e.g. lapse risk) and might therefore find some relative advantage in taking on such risks and so enhance diversification benefits. This could potentially lead to something of a 'win-win' situation, whereby both insurer and reinsurer see the price agreed for transfer of (for example) lapse risk as particularly advantageous in each case.

Counterparty appetite for VIF monetisation deals can also come through the opportunities presented for investing in non-correlated instruments and/or at higher expected yields. The originating insurer's relinquishing of the right to future excess profitability, and the price set for this, is where counterparties may have a more optimistic view of the future prospects for the

portfolio and hence see potential for enhanced returns.

STRUCTURING VIF MONETISATION

There are a variety of ways to structure VIF monetisation deals, and each will depend on the exact objectives of each of the parties to the transaction. Specific components of the deal can be separated out and assigned to distinct parties, for example:

- Who provides the finance? (e.g. investment bank, reinsurer)
- Who takes on the insurance risk? (e.g. reinsurer)
- Who takes the credit risk attaching to the financing? (e.g. credit insurer, investment bank, reinsurer)
- Is there a need for a swap counterparty?

A key factor influencing transaction structure will be the regulatory view (e.g. is there sufficient risk transfer) and whether the desired balance sheet or capital objectives are feasible under the current structure and regulation. It is important to seek the regulator's view at an early stage in the process. It will also be important to understand the auditor's view and the likely tax impact.

In general, contract terms and conditions should be prepared carefully to ensure that the VIF cashflows are based on as objective a basis as possible, to avoid subjectivity influencing the outcome of future cash transfers, and also to allow full reconciliation of the figures produced by the insurer from underlying audited accounting information. For example, to avoid subjectivity from expense allocation influencing the cash transfers, it might be preferable to parameterise expenses in the calculation.

Similarly, it is possible that the insurer could benefit from increasing lapse rates if those policyholders are then encouraged to take out a new policy with the same insurer outside the monetisation. In this case the contract governing the monetisation will need to ensure that the insurer is bound to avoiding any form of incentivizing lapses beyond 'natural' attrition rates.

Generally, the specific structures used in these transactions can be as simple or complex as the situation requires and will be tailored to the needs of all the parties involved.

CANDIDATE PORTFOLIOS FOR VIF MONETISATION

For a VIF monetisation to be feasible a natural prerequisite is that a sufficiently large amount of VIF is available to be structured into a deal. Beyond this, the possibilities are broad and companies that are possible candidates for carrying out a VIF monetisation might meet some or all of the following characteristics:

- Capital relief on a Solvency I basis may be important in the short-term, especially if the Solvency II timetable is further delayed. This can be achieved through a VIF monetisation.
- The company has a need for liquidity, for example:
  - Companies may be over-capitalised on a Solvency II basis, but the excess capital is 'locked-into' a large VIF component (i.e. backing assets less BEL). Certain types of product portfolio may be more likely to be in this position, for example risk or protection business.
  - To pursue investment opportunities or write new business
  - The company belongs to a banking group where there is a need for liquidity, e.g. as Tier 1 capital to demonstrate solvency under Basel III.
  - Other sources of financing are limited, restrictive or only available at a higher cost.
- The company is under solvency pressure under Solvency II and can potentially use VIF monetisation to address any contract boundary restrictions, or potentially restrictive EPIFP tiering effects (if applicable in the final regulations).
- The company is interested in de-risking certain parts of its portfolio, particularly if this is in respect of risks that are less amenable to traditional reinsurance (e.g. lapse risk) or

there are new areas of uncertainty (e.g. EU Gender Directive).

CONCLUSIONS

VIF monetisation is interesting in the current regulatory environment as it can be driven by several important and diverse drivers that can act in concert. These range from solvency or liquidity drivers to a pro-active capital management solution under a broader strategy program. Each transaction can therefore bring potentially multiple advantages simultaneously to both originating insurers and counterparties.

As the entire European insurance industry moves towards a more transparent risk-based capital and value framework, we expect activity in this area to increase and VIF monetisation to become a more prevalent and natural mechanism for life insurers to employ, not only as one-off events but also as an integral part of on-going business strategy.

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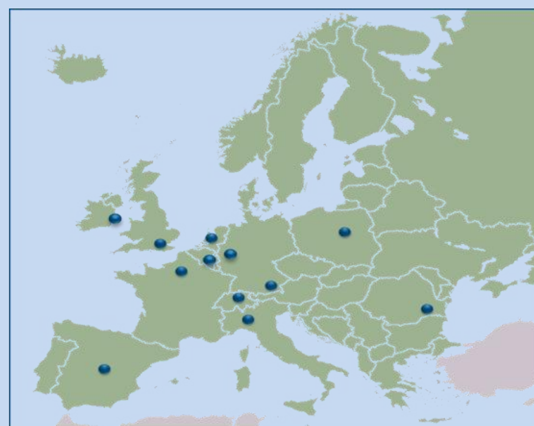

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