

September 18, 2024

Best's Methodology and Criteria

Securitization of Annuities



Wai Tang
908 882 2388
Wai.Tang@ambest.com

Emmanuel Modu
908 882 2128
Emmanuel.Modu@ambest.com

George Hansen
908 882 1815
George.Hansen@ambest.com



Our Insight, Your Advantage™

Securitization of Annuities

Outline

- A. Market Overview
- B. Rating Considerations
- C. The Assignment of a Rating

The following criteria procedure should be read in conjunction with *Best's Insurance-Linked Securities & Structures Methodology (BILSM)* and all other related BILSM-associated criteria procedures. The BILSM provides a comprehensive explanation of AM Best's rating process for insurance-linked securities and insurance-linked structures.

A. Market Overview

Annuities are securitized into asset-backed transactions by factoring companies that purchase structured settlements from tort claimants. Annuities are also included in securitizations involving the purchase of life settlements. In transactions involving life settlements and annuities, the annuities are designed to pay the premiums of the life settlements, thereby helping to de-risk the transaction and taking advantage of the arbitrage associated with the differences between mortality tables used to price annuities for the subject lives at the time of the transaction and the mortality tables used to price the premiums for the underlying policies of the life settlements.

In general, there are two varieties of annuities: a) a period-certain annuity that generates guaranteed periodic payments to the annuitant that can be fixed or can escalate based on a specified compounding rate and/or inflation rate; and b) a life-contingent annuity in which specified payments are made until the annuitant dies. There are also annuities that combine period-certain and life-contingent features.

The most important risks associated with annuities (regardless of whether the annuities arise from structured settlement transactions or from annuity/life insurance arbitrage transactions) are credit risk and mortality risk. While transactions can contain a combination of annuities, life settlements or any other collateral, this criteria procedure summarizes how AM Best will assess such risks in transactions that only include annuities in their collateral pools.

B. Rating Considerations

Securitization of Annuity Cash Flows

Securitization of annuity cash flows can be achieved through the use of bankruptcy-remote special purpose vehicles (SPVs). The issuer of securities, the SPV, raises funds from investors. These proceeds are used to purchase annuity cash flows from insurance companies or annuitants. If these are period-certain annuities, the issuer receives the periodic annuity payments from the insurance companies for

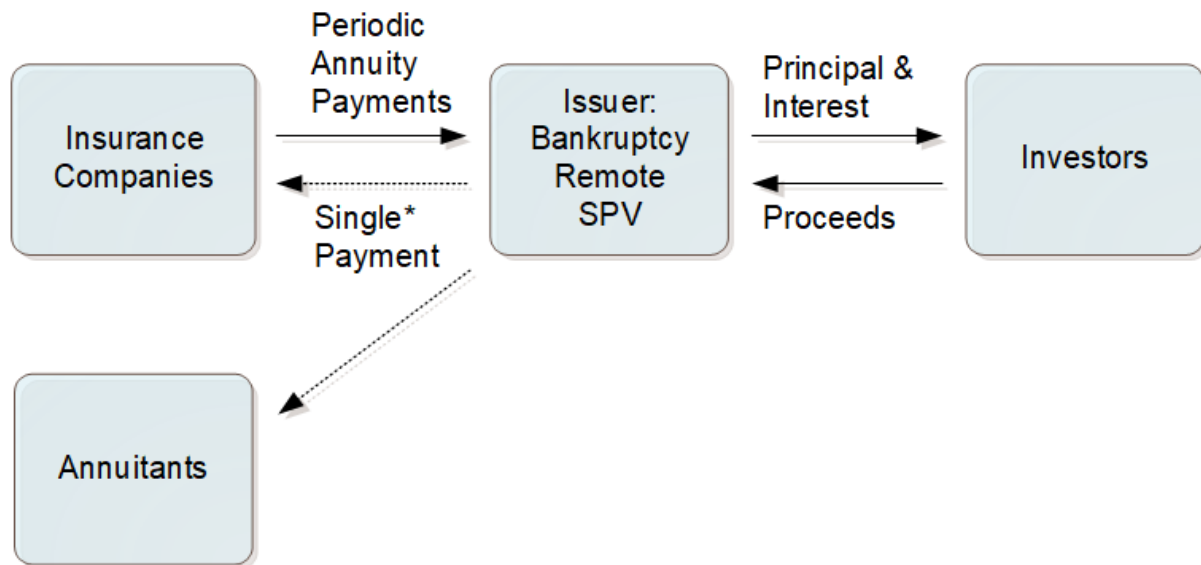


Copyright © 2024 A.M. Best Company, Inc. and/or its affiliates. ALL RIGHTS RESERVED. No portion of the content may be reproduced, distributed, or stored in a database or retrieval system, or transmitted, or uploaded into any external applications, bots, or websites, including those using artificial intelligence technologies such as large language models and generative Artificial Intelligence in any form or by any means without the prior written permission of AM Best. AM Best does not warrant the accuracy, completeness, or timeliness of the AM Best content. While the content was obtained from sources believed to be reliable, its accuracy is not guaranteed. **You specifically acknowledge that neither AM Best nor the content gives any investment, financial, tax, insurance, or legal advice.** You are solely responsible for seeking competent professional advice before making any investment, financial, tax or insurance decision. For additional details, refer to our Terms of Use available at the AM Best website: www.ambest.com/terms.

Securitization of Annuities

a fixed period of time. If the annuities are life-contingent, the issuer receives the periodic annuity payments from the insurance companies until the annuitants die. The cash flows received by the issuer are used primarily to service the principal and interest payments due to the investors.

Exhibit B1: Simplified Transaction Diagram



*For certain transactions such as structured settlements, the single payment effectively goes to annuitants. For other types of transactions, the single payment goes to the insurance companies.

Key Assessment Factors

Key assessment factors in the rating of a securitization of annuities may include:

- The source of the annuities to determine the appropriate mortality tables for use in modeling. For example, if the annuities are from structured settlements, the annuity table may be derived from structured settlement mortality experience
- Life expectancy data from at least one medical underwriter for each life in the annuity pool
- The assumed default and recovery rates for the companies that issued the annuities
- The assumed default correlations of the insurance companies
- The definition of what constitutes a default on the payment to investors. For example, default could be defined as a missed interest payment or an untimely return of principal to investors
- The number of insurance companies that issued the annuities in the collateral pool to determine the risk of concentration. For example, a high concentration of insurance companies generally is a negative rating factor
- The underwriting guidelines of the originator for purchasing the annuities on the lives in the collateral pool

Securitization of Annuities

- The number of lives in the pool and the granularity of the annuity cash flows in the transaction
- If the annuities are associated with structured settlements, proof of the observation of all transfer laws in the state in which the annuitant lives
- Documentation to determine whether the annuity cash flows can be encumbered through the bankruptcy of the annuitant or if any liens on such cash flows are present
- Annuity documentation to determine whether cash flows may be challenged by a spouse, relatives or dependents of the annuitant
- Proof of screening of annuitants to determine that the parties were legally able to enter such contracts
- The procedures for periodically confirming the annuitant's survival for life-contingent annuity cash flows
- Legal documents associated with the securitization such as an indenture, true sale opinion and other related documents
- The legal and tax issues associated with the annuities, e.g., the annuities are the result of a "court-ordered" settlement or a "non-court-ordered" settlement, which differ significantly in their legal risks, and/or any insurable interest issues associated with the purchase of annuities on the lives in the collateral pool.

Modeling of the Annuity Cash Flows

AM Best's Life Contingent Simulation Model (LCSM) includes the use of Monte Carlo simulations to model the risks associated with the annuity cash flows. AM Best expects to review the following:

1. For period-certain annuities, the fixed annuity cash flows aggregated by each insurance company in the pool.
2. For life-contingent annuities, the annuity cash flows of each life in the pool with the associated insurance company (current rating, if any) making the annuity payments; the base mortality table used by the issuer in its analysis; and the mortality ratings and/or life expectancies determined by a medical underwriter for each life in the pool.

C. The Assignment of a Rating

AM Best applies default assumptions (as determined by *Best's Idealized Issuer Default Matrix* which can be found in *Best's Insurance-Linked Securities & Structures Methodology* [BILSM]) and recovery assumptions associated with each insurance company in the transaction. If an insurer is not rated by AM Best but is rated by another nationally recognized statistical rating organization (NRSRO), the rating issued by that NRSRO, if known and available, will be applied to the insurer. An insurer that does not have a rating from any NRSRO and that not become impaired in the past will generally be assigned an Issuer Credit Rating (ICR) of "bb+". An insurer that does not have a rating from any NRSRO and that has become impaired in the past (and recovered from such impairment) or an insurer that does not have

Securitization of Annuities

a rating from any NRSRO and that is under regulatory supervision will be assigned an ICR of “b”. In such cases, an exception may be made subject to analytical judgement when: 1) the company has continued making payments on its contract obligations for the past three years or 2) insurance regulators have expressed confidence that all annuity obligations will be paid in full during the rehabilitation or runoff process.

AM Best also applies the appropriate mortality tables to each life in the transaction (for life-contingent annuities) and in some cases, default correlations. The aggregated cash flows resulting from the simulations are applied to the transaction’s waterfall to determine the default probability of the securities backed by the annuities. The rating of the securities is partially determined by correlating the tabulated default to the grid in *Best’s Idealized Issue Default Matrix* as shown in the BILSM.

Published by A.M. Best Rating Services, Inc.
METHODOLOGY AND CRITERIA

A.M. Best Rating Services, Inc.

Oldwick, NJ

PRESIDENT & CEO Matthew C. Mosher

EXECUTIVE VICE PRESIDENT & COO James Gillard

EXECUTIVE VICE PRESIDENT & CSO Andrea Keenan

SENIOR MANAGING DIRECTORS Edward H. Easop, Stefan W. Holzberger, James F. Sneek

AMERICAS

WORLD HEADQUARTERS

A.M. Best Company, Inc.
A.M. Best Rating Services, Inc.
1 Ambest Road, Oldwick, NJ 08858
Phone: +1 908 439 2200

MEXICO CITY

A.M. Best América Latina, S.A. de C.V.
Av. Paseo de la Reforma 412, Piso 23,
Col. Juárez, Alcaldía Cuauhtémoc, C.P. 06600, México, D.F.
Phone: +52 55 1102 2720

EUROPE, MIDDLE EAST & AFRICA (EMEA)

LONDON

A.M. Best Europe - Information Services Ltd.
A.M. Best Europe - Rating Services Ltd.
12 Arthur Street, 8th Floor, London, UK EC4R 9AB
Phone: +44 20 7626 6264

AMSTERDAM

A.M. Best (EU) Rating Services B.V.
NoMA House, Gustav Mahlerlaan 1212, 1081 LA Amsterdam, Netherlands
Phone: +31 20 308 5420

DUBAI*

A.M. Best Europe - Rating Services Ltd. - DIFC Branch*
Office 102, Tower 2, Currency House, DIFC
P.O. Box 506617, Dubai, UAE
Phone: +971 4375 2780

*Regulated by the DFSA as a Credit Rating Agency

ASIA-PACIFIC

HONG KONG

A.M. Best Asia-Pacific Ltd
Unit 4004 Central Plaza, 18 Harbour Road, Wanchai, Hong Kong
Phone: +852 2827 3400

SINGAPORE

A.M. Best Asia-Pacific (Singapore) Pte. Ltd
6 Battery Road, #39-04, Singapore
Phone: +65 6303 5000

Best's Financial Strength Rating (FSR): an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. An FSR is not assigned to specific insurance policies or contracts.

Best's Issuer Credit Rating (ICR): an independent opinion of an entity's ability to meet its ongoing financial obligations and can be issued on either a long- or short-term basis.

Best's Issue Credit Rating (IR): an independent opinion of credit quality assigned to issues that gauges the ability to meet the terms of the obligation and can be issued on a long- or short-term basis (obligations with original maturities generally less than one year).

Best's National Scale Rating (NSR): a relative measure of creditworthiness in a specific local jurisdiction that is issued on a long-term basis and derived exclusively by mapping the NSR from a corresponding global ICR using a transition chart.

Rating Disclosure: Use and Limitations

A Best's Credit Rating (BCR) is a forward-looking independent and objective opinion regarding an insurer's, issuer's or financial obligation's relative creditworthiness. The opinion represents a comprehensive analysis consisting of a quantitative and qualitative evaluation of balance sheet strength, operating performance, business profile, and enterprise risk management or, where appropriate, the specific nature and details of a security. Because a BCR is a forward-looking opinion as of the date it is released, it cannot be considered as a fact or guarantee of future credit quality and therefore cannot be described as accurate or inaccurate. A BCR is a relative measure of risk that implies credit quality and is assigned using a scale with a defined population of categories and notches. Entities or obligations assigned the same BCR symbol developed using the same scale, should not be viewed as completely identical in terms of credit quality. Alternatively, they are alike in category (or notches within a category), but given there is a prescribed progression of categories (and notches) used in assigning the ratings of a much larger population of entities or obligations, the categories (notches) cannot mirror the precise subtleties of risk that are inherent within similarly rated entities or obligations. While a BCR reflects the opinion of A.M. Best Rating Services, Inc. (AM Best) of relative creditworthiness, it is not an indicator or predictor of defined impairment or default probability with respect to any specific insurer, issuer or financial obligation. A BCR is not investment advice, nor should it be construed as a consulting or advisory service, as such; it is not intended to be utilized as a recommendation to purchase, hold or terminate any insurance policy, contract, security or any other financial obligation, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser. Users of a BCR should not rely on it in making any investment decision; however, if used, the BCR must be considered as only one factor. Users must make their own evaluation of each investment decision. A BCR opinion is provided on an "as is" basis without any expressed or implied warranty. In addition, a BCR may be changed, suspended or withdrawn at any time for any reason at the sole discretion of AM Best.

