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Best's
Methodology and Criteria

Securitization of Annuities

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Securitization of Annuities

Outline

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: 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: where specified payments are made to the annuitant until he or she dies. There are also annuities that combine period-certain and life-contingent features.

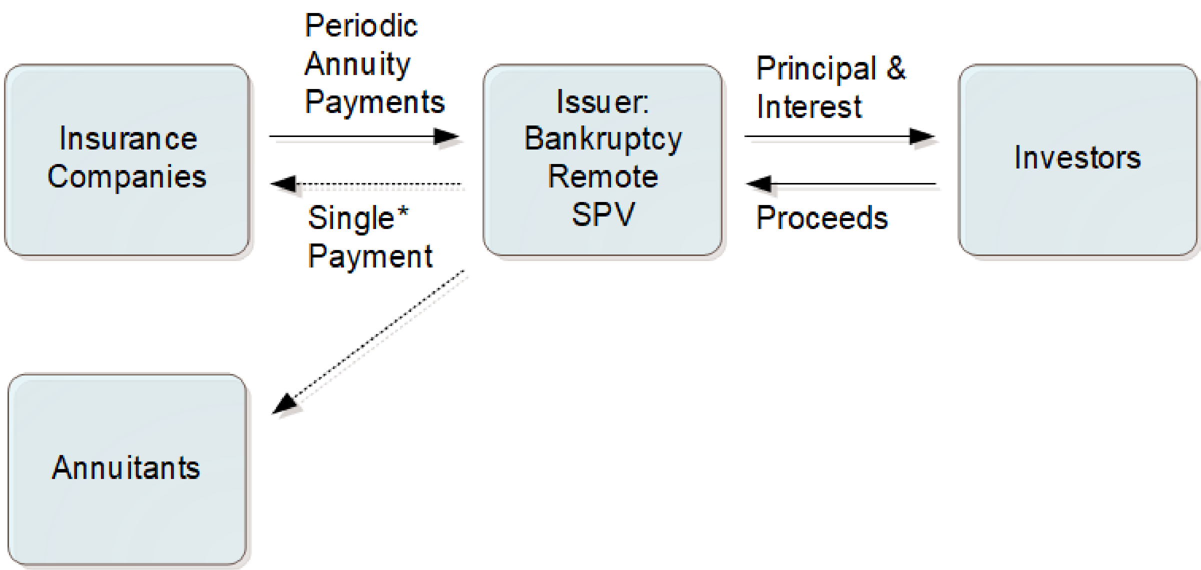
The most important risks associated with annuities (regardless of whether the annuities arise from structured settlement transactions or from annuity/life insurance arbitrage transactions) are credit risk and mortality risk. While transactions can contain a combination of annuities, life settlements 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 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

- 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 and 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 NRSO and that has 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 NRSO and that has become impaired in the past (and recovered from such impairment) or an insurer that does not have 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.

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METHODOLOGY AND CRITERIA

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