

OFFSHORE GROUP OF INSURANCE SUPERVISORS

OGIS

Risk Transfer between Banks & Insurers

**The Issues and Guidance for Supervisors of Licensed
Insurance Special Purpose Vehicles**

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1. Introduction

The convergence of the banking and insurance markets and the transfer of risk between the two has been a subject of conjecture since the early 80s. The fact is that until recently only asset-backed securitisations (ABS) had grown with any rapidity. Liability based securitisations (LBS) have shown only small growth.

ABS deals are those where an asset (often a future income stream such as trade receivables) is transferred to a Special Purpose Vehicle (SPV) which transforms the asset into a securitised instrument (bonds, notes etc) which can then be sold to investors.

LBS deals follow the same rationale, but certain liabilities of an insurer, e.g. the risk of an Earthquake occurring in a specific location is securitised in order to provide the originator with either contingent or pre-financed capital to fund potential losses. This can occur either with or without an actual transfer of the underlying insurance risks. If the insurance risks are actually transferred then the LBS market can be seen as an alternative to the reinsurance or retrocession markets.

Insurers participate in both markets as originators and investors.

This paper seeks to provide guidance for a supervisor of an licensed insurance SPV, the company or cell that facilitates the securitisation by acting as a translator of financial documentation when risk is 'transferred' from the capital markets to the insurance markets or vice versa.

The guidance offered is based on the following assumptions:

- The SPV requires to be licensed as an insurer.
- The SPV is a fully-funded, bankruptcy-remote entity.
- While the entire SPV represents the 'reinsurance' security of the originator, it is capitalised with only a small amount of common equity.
- The common equity is not at risk.
- The SPV is tax neutral.
- Both originator (i.e. the party that wishes to securitise either their asset or liability) and investor (i.e. the party that wishes to purchase the resulting securities) are regulated financial services businesses.

The guidance also focuses more on insurance linked securitisations (ILS), where insurers transfer insurance related risks to the capital markets.

The issues for the SPV supervisor addressed in the following sections.

2. Residual Risks

a. Documentation (legal) risk

Also known as basis risk, the issue at stake here is the matching of the incoming and outgoing documentation to ensure that the SPV is not exposed to any differences in the documents' requirements that may give rise to a liability.

Fig.1

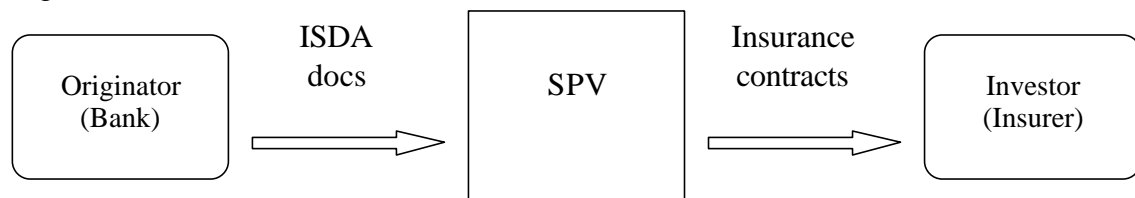


Figure 1 shows a simplified Credit Default Swap (CDS). The Bank wishes to pass the risk of default on a portfolio of debtors to the insurers. However, the bank is not licensed to contract under insurance documentation, and the Insurer is not licensed to contract under ISDA (International Swaps & Derivatives Association) documentation.

The SPV is unencumbered by the regulatory constraints of the bank or insurer and is able to contract using either set of documentation.

The two sets of documentation are very different. ISDA documentation, written specifically for the purpose of contracting swaps & derivatives is water-tight as to the rights and obligations of each party. Insurance contracts, having developed over years as directed by case law, and being subject to the axiom of utmost good faith, are arguably less well defined.

By acting as a translator of the documentation, the SPV stands the risk that the contract authors may not match the rights and obligations in both sets of documentation, thereby leaving the SPV liable to either a window of risk, in the case of mismatched timing or an ongoing liability which it may not realise until it is called upon.

Where possible, a supervisor should ensure that its in house legal department assess both sets of documentation, supported by the opinion of counsel in the originator's jurisdiction. The supervisor should consider a joint declaration of originator / SPV / Investor that there will be no mismatching claims due to faulty wordings.

Where this is not possible, an outsourced opinion from the originator's jurisdiction and a further opinion from counsel in the SPV's jurisdiction as to the efficacy of the contracts may suffice.

Further, a joint declaration on behalf of the originator, SPV & Investor that there are no mismatching claims due to faulty wordings can ensure that the risk is minimised.

b. Credit Risks

While the documentation might be tight, a credit risk will usually reside within the SPV.

As noted in the introduction an SPV is usually 'fully funded', i.e. it is able to meet any potential liabilities through a combination of its own capital resources and rights owed to it by other parties, i.e. reinsurance contracts, Letters of Credit etc.

Where the SPV is reliant on such rights, and unless any contingent funds are ring-fenced, a credit risk will exist with the obligor (i.e. the party from whom the right is due).

This credit risk should be assessed by the supervisor accordingly, and a view as to the reasonableness of the risk in proportion to the overall deal should be taken.

3. Counterparties

The simplest of securitisations will involve at least three counterparties, the originator, the SPV and the investor. Other parties that may be involved include:

Administrator

The administrator acts on behalf of the SPV and facilitates general banking services, record keeping, filings and correspondence with supervisors, and correspondence with investors relating to the securities or the swap.

Indenture Trustee

The trustee performs his obligations on behalf of the SPV, including the payment of principal and interest, the registration of the securities, and the maintenance of the collateral accounts.

Bond Issuer

Provides the prospectus for a bond/securities issue and markets the sale.

Modelling agencies

Independent modelling is a crucial component to providing investors with confidence in the level of risk involved in the investment. Modelling firms provide an analysis of the risk.

Rating agencies

While a number of different rating agencies rate ILSs, a rating from at least one of either Moody's or Standard & Poor's is critical.

Legal counsel

In the typical transaction, the underwriter of the securities and the originator will retain separate legal counsel. The originator's counsel however generally also represents the SPV.

Verification Agent

The agent verifies the trigger and calculates the resulting principal reductions on the securities.

Loss reserve specialist

The specialist performs an independent actuarial analysis whenever an index or an indemnity trigger is part of the transaction. He verifies loss reserves over the term of the securitisation and provides a commutation calculation at the end of the extension period.

With such a plethora of parties involved it becomes extremely difficult to ensure that the transaction will develop along its expected path. The parties may be based in a number of jurisdictions and some may seem remote from the SPV's sphere of operations.

It is essential that the supervisor fully understands the role of each counterparty, and the ramifications should any party fail to perform to expectations.

It is also important that the supervisor ensures that all transactions between these parties are at arms length and on terms that are made available to the market.

Standard due diligence checks should be carried out on all counter parties with these issues always borne in mind.

4. Understanding Cash Flows

Once the contracted rights and obligations have been fully understood, it is essential that the expected and potential cash flows are fully comprehended. The cash will usually come from the investor and make its way to either the SPV or the originator depending on the type of securitisation under consideration. In the fullness of time, subject to either a trigger or maturity of the investment, some of the cash will then make its way back to the investor.

Typically one would expect the involvement of a trust arrangement with a high percentage of contingent funds (those funds required to meet investors expected returns) held in trust by a custodian bank until maturity of the deal.

If this is the case then the jurisdiction of the custodian bank must be taken into account, and the security and availability of the funds must be fully considered.

However, it is not always the case that a trustee/custodian structure will be put in place. Security may be offered by a Letter of Credit or other form of security, in which case the SPV supervisor must apply its usual strictures as to the form and status of that security.

The SPV supervisor must be aware of where the cash is to be held at all times, the security of the cash holding arrangements, who is authorised to move the cash, and what events will trigger a transfer of cash between parties.

Any doubt regarding either the security or the route of the cash flows must be cleared before licensing.

5. Communication with other supervisors

Supervisors in a number of territories have recently drawn attention to the scope for complex reinsurance transactions to cause a misunderstanding of balance sheets to the peril of investors and perhaps also policyholders (e.g. APRA's comments in Australia concerning the failure of HIH).

Issues for supervisors of originators and investors that are regulated insurance entities have recently been outlined in the IAIS Draft Issues Paper on Insurance Securitisation and include:

- How does the supervisor exercise jurisdiction?
- Many securitisations may, individually or when aggregated, affect the financial position of the ceding entity. If the ceding entity is regulated the insurance supervisor should inform the securitisation vehicle's supervisor of the details of the transaction prior to its inception.
- How can separateness between the SPV and the originator best be achieved?
- Who will be permitted to issue or invest in ILS?
- What controls need to be in place to monitor exposure?
- What constraints must be put in place for insurers who invest in ILS?
- What impact does an insurance-linked securitisation have on capital and solvency?
- What financial reporting requirements need to be put in place for originators and investors?
- How should the investment be recorded?
- What impact do tax rules have on ILS?
- What is the impact of supervisory arbitrage?
- Should securitisations from multiple cedants be allowed?
- How should hedge effectiveness be measured, and what financial reporting requirements should be put in place?
- Impact on policyholders.
- Potential change of control issues in e.g. contingent capital transactions.
- Capacity, resources and expertise of the supervisor to evaluate and effectively monitor securitisation transactions.

See the IAIS paper for further discussion on some of these issues.

It is obvious that there are many areas that require consideration at all stages of any securitisation, and the SPV supervisor needs to be aware of the concerns of his fellow supervisors abroad.

For the SPV supervisor it is essential that a full and frank exchange of information with the prudential supervisor of both the originator and, if applicable, the investor is undergone, and that the comfort of those supervisors with the transaction is sought prior to licensing of the SPV.

6. Potential Regulatory Arbitrage

In seeking to understand the commercial rationale for the transaction, the SPV supervisor must always be aware of the potential for regulatory arbitrage as a contributory factor.

Obviously an element of regulatory arbitrage often plays a part in attracting insurance business to offshore jurisdictions. In a complex securitisation it is essential that any such arbitrage is identified, understood, discussed with the home regulator of the party looking to gain from the arbitrage, and deemed to be acceptable to the SPV supervisor.

7. Outsourcing of Supervisory Support Services

There are a number of functions that are required to support the supervisory assessment of a securitisation deal that the supervisory body may not be able to perform in-house. Some of these might be:

Legal assessment of contract documentation
Assessment of financial standing of counterparties
Assessment of the rating agencies' rating of the SPV

It is reasonable for the SPV supervisor to rely on the opinions of non-supervisory experts in these cases. However, a minimum of two opinions should be sought on each issue.

8. Ongoing Supervision

Once the SPV has been licensed and the deal has been done, the SPV should be monitored in the usual manner subject to the procedures of the supervising jurisdiction.

It is important however, to keep the channel of communication between the SPV supervisor and home supervisor of originator and, if applicable, the investor open. It will often be those home supervisors who have the opportunity to spot any deviation from the proposed transaction at the earliest instance. These supervisors should be aware of any aggregations where there are several similar transactions possibly involving more than one SPV in different jurisdictions.

It is recommended that communication to check these supervisors' comfort should be made on an annual basis as a minimum.