Insurance Linked Securities Webinar

Presented by Hogan Lovells, with participation from HM Treasury and HM Revenue & Customs

April 26, 2016
Insurance Linked Securities

General Introduction

• Securities whose return is affected by an insured loss event and sold to capital markets investors.
• Provide an alternative to traditional reinsurance by offering the debt capital markets as an alternative risk transfer solution.
• Catastrophe bonds or “cat bonds”
  – Launched in the 1990s to provide insurance companies an alternative to what was deemed steeply priced reinsurance
  – Designed to provide sponsoring companies with an alternative or compliment to traditional reinsurance cover for financial losses caused by large natural catastrophes
  – Cat bonds cover natural perils such as earthquakes, windstorms and hurricanes and have covered occurrences in many different jurisdictions
• Sidecars
  – Covers a specified book of insurance/reinsurance business where investors take on the risks and benefits of that business
Insurance Linked Securities

General Introduction

- Life Insurance Securitization
  - Covers such areas as mortality and longevity risks
- Distribution
  - Not publicly offered
  - Typically distributed by initial purchasers on a global basis only to Qualified Institutional Buyers (QIBs)
  - Some transactions are offered to a wider group of investors on a private placement basis; often in a “cat bond lite” transaction, which streamlines the documentation process
- Market Size
  - The market stood between $24 billion to just under $26 billion at the end of 2015, depending on the source used
  - Total issuances for 2015: $6.9 billion (Artemis)
  - First quarter 2016: $2.215 billion, compared to $2.06 billion for first quarter 2015 (Artemis)
Overview of Reinsurance

Insurance Company
a.k.a. “cedent”

Coverage
Premium

Insurance Company
a.k.a. “reinsurer”

Coverage
Premium

Insurance Company
a.k.a. “retrocessionaire”

Coverage
Premium

Policyholder

Coverage
Premium

Policyholder

Coverage
Premium

Policyholder

Coverage
Premium

Insurance Policy

- Reinsurance Agreement
- [Collateral]

- Retrocession Agreement
- [Collateral]
U.S. Structural Overview

**Noteholders** (can be in Series with multiple Classes)

1. Original Principal Amount
2. Interest Payments
3. Return of Original Principal Amount

**SPV Issuer**
Caymans/Bermuda or Ireland with a local Administrator

**Collateral Accounts** (Directed Investments)

1. Original Principal Amount
1. Interest
2. Original Principal Amount

**Sponsor (Insurer/Reinsurer)**

1. Fixed costs of issuer (including closing payment and ongoing deal expenses, payment of Issuer/Service Provider insurance policy in lieu of side letter (if applicable)
2. Premium payment component of the interest payment. Generally made directly to note payment account (may net out earnings on collateral)

**Indenture Trustee**

1. Interest
2. Original Principal Amount

**Collateral Arrangement**

1. Investment Yield
   2. Investment earnings on directed investments (may be MMF yield, IBRD/EBRD returns or floating rate return from collateral contract (e.g. Triparty Repo)

**Interest Payments**
1. "Interest Rate" equals a specified reference rate plus a specified interest spread.

• Note proceeds may be deposited and invested through a NY Regulation 114 Trust Account. There are separate class accounts for each class of notes.
Special purpose vehicle ("SPV") is established (typically in Bermuda, Cayman Islands or Ireland) for the purpose of issuing bonds to investors.

The SPV is formed specifically to serve as the vehicle that provides the reinsurance to the insurer. The SPV accesses the capital markets by issuing bonds for which the payment of principal and interest is tied to the severity of certain catastrophic events (e.g. earthquakes, windstorms, floods or hurricanes).

Sponsor insurance company and SPV enter into a reinsurance agreement and SPV contemporaneously issues bonds to investors in a Rule 144A or Section 4(a)(2) placement.

Proceeds raised from bondholders are placed in a collateral or trust account with an indenture or reinsurance trust trustee pursuant to an indenture or a reinsurance (Regulation 114) trust agreement and the principal is held and invested by the trustee pursuant to instruction hardwired in the agreements.
U.S. Structural Overview (continued)

• If a natural catastrophe strikes of sufficient magnitude -- measured by wind speed, earthquake force or by indemnified losses related to a defined subject business the issuer pays the relevant loss amount to the insurer pursuant to the reinsurance agreement and the related principal amount to be repaid to bondholders will be reduced by an equivalent amount pursuant to the indenture and trust agreement.

• The SPV is used to segregate assets. In addition, in order to get insurance accounting treatment (credit for risk transfer), the sponsoring insurer should not own the SPV.
• The “bankruptcy remoteness” of the SPV makes the separateness of the SPV from the sponsor important from the investor’s perspective as well. This bankruptcy remoteness keeps the assets of the SPV out of the reach of creditors of the sponsor insurer if it were to become insolvent.

• Non-consolidation analysis:
  – Fact intensive
  – Alter-ego doctrine
  – Corporate separateness
  – Reliance by creditors

“Balancing of equities favoring consolidation with equities favoring non-consolidation.”
### ILS – why does it matter to the UK?

#### Graph:
- **USD billions**
- **Categories:** Catastrophe Bonds, Sidecar, ILW, Collateralized re and others

#### Table:

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<th>Reinsurance expertise</th>
<th>Capital markets expertise</th>
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<td>Reinsurance broker / deal arranger</td>
<td>Alternative funds / investment management</td>
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<td>Reinsurance modelling / underwriting</td>
<td>Credit rating agencies</td>
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<td>Legal – risk transfer</td>
<td>Legal – capital markets arrangement</td>
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<td>Industry loss reporting agency / claims reviewer</td>
<td>Collateral management / trustee services</td>
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<td>SPV management</td>
<td>Securities trading (?)</td>
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What does the UK ILS project aim to deliver?

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<th>Effective authorisation / supervision</th>
<th>With PRA and FCA we’re working to introduce:</th>
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<tr>
<td></td>
<td>• Tailored authorisation and supervision consistent with Solvency II requirements</td>
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<td>• Streamlined authorisation – for some deals, this could be a matter of weeks</td>
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<td>• An internationally trusted regime - PRA &amp; FCA approval to become ‘stamp of quality’</td>
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<th>New corporate structure</th>
<th>Multi-deal vehicles need a Protected Cell Company which will:</th>
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<td>• Robustly segregate assets / liabilities of each ILS deal</td>
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<td>• Have clear governance / insolvency arrangements</td>
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<td>• Command the confidence of protection buyers and investors</td>
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<th>Bespoke, competitive tax treatment</th>
<th>Tax should reflect economic reality of ILS deals, which could include:</th>
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<td>• Exempting SPV from corporation tax</td>
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<td>• Shifting the burden of tax to investors</td>
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<td>• Ensuring the taxation of foreign investors is consistent with treaty arrangements</td>
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Protected cell company regime

Getting governance and insolvency arrangements right is crucial
What are the challenges on tax?

Other regimes have become established, attractive ILS centres

• Low tax regimes with minimal / no tax on SPV dominate the market
• Specialist investment funds are crucial to the ILS market, also mostly domiciled in low tax regimes

Issues we will need to consider

• Appropriate and competitive approach
• What does exemption of SPV mean for taxation of ILS investors?
• Particular challenges of foreign investors and ILS funds – withholding tax?
• How do we deal with risk of tax evasion / abuse?
EU insurance regulatory framework

- EU insurance regulatory framework

**LEVEL 1**
- Solvency II Directive
  
**LEVEL 2**
- Solvency II Regulation
  - SPV Implementing Regulation

**LEVEL 3**
- EIOPA Guidelines

**Not directly effective. Each EU member state is required to implement by its own national law.**

**Automatically directly effective as law in every EU member state.**

**Not strictly legally binding, but regulators and insurers are expected to comply.**
Solvency II balance sheet of an insurer
Effect of reinsurance (traditional or through ILS)

- Reduces the risk margin component of technical provisions
- Reduces the loss suffered in theoretical future scenarios
- Reduces the loss suffered in actual scenarios
- Reduces the amount of assets required to be held
- Reduces the Solvency Capital Requirement
- Reduces actual losses or increases profits
- Increases the excess capital of the insurer
Regulatory requirements for authorisation

- Solvency II generally imposes onerous requirements
  - authorisation
  - regulatory capital
  - governance
  - reporting
- But there is an exception for SPVs that provide reinsurance and that meet certain minimum standards
  - fully funded liabilities
  - claims of debt and finance providers limited recourse, and subordinated to claims of insurer
  - shareholders and managers must be "fit and proper"
  - effective system of governance
  - investments follow prudent person principle
- Regulator likely to seek confirmation that all documentation is agreed before giving authorisation
Special provisions for SPVs

- No regulatory capital requirement (other than "fully funded" requirement)
- Simplified governance arrangements
- Annual reporting, on simplified basis, rather than quarterly reporting
- Regulator has 6 months to give authorisation
  - Solvency II does not reduce the time for SPVs, but HM Treasury hopes that, in practice in the UK, the Prudential Regulation Authority (the "PRA") will normally give authorisation in 6 to 8 weeks
Multi-arrangement SPVs

- SPV Implementing Regulation foresees "multi-arrangement SPVs"
  - ‘multi-arrangement special purpose vehicle’ means a special purpose vehicle which assumes risks under more than one separate contractual arrangement from one or more insurance or reinsurance undertakings

- Authorisation requirements assessed taking into account each individual contractual arrangement

- SPV's solvency must not be capable of being adversely affected by the winding-up proceedings of any one of the insurers to which its provides reinsurance under the arrangement

- UK "PCC" proposals would meet these requirements
Interaction with capital markets regulation and practice

Meeting ISPV minimum standards in practice

• "Fully funded" liabilities requirement
  – SPV to have assets that are equal to or greater than the aggregate limit of the SPV’s obligations at any time (including any future fees and expenses)
  – Contractually due future premium or investment income may be considered to satisfy the fully funded criteria for future fees and expenses only, not its obligations to the undertaking (except in limited circumstances)
  – Limited ability to inject new funds into the SPV to ensure it remains fully funded, so a guaranteed level of assets could be maintained through derivative instruments such as a total return swaps, but derivative counterparty exposure to be considered

• Prudent person investment principles will reduce investment risk (asset duration matching, high quality and counterparty diversity), and valuation haircuts likely

• Limited recourse and maintaining solvency
Interaction with capital markets regulation and practice

Restriction to sophisticated investors

• Qualified institutional investors only
  – ILS seen against the main comparable fixed income type benchmarks is a low volatility, low correlated, stable return asset class
  – Yields attractive in current low interest rate environment to pension fund investors amongst others particular and opportunity for diversification within its investment portfolio

• Some investors may have liquidity requirements
  – For example, for occupational pension funds, one of the key statutory requirements under the Investment Regulations is that the assets must consist "predominately" of assets traded on regulated markets, and assets which are not so traded must be kept to a "prudent" level

• Ability to appoint an administrative receiver only if a "capital market arrangement" given proposal is that notes will not be rated, listed or traded
Interaction with capital markets regulation and practice

Multi-arrangement ISPVs

• PCC regime
  – Ring-fencing of assets and liabilities, both pre and post insolvency
  – Costs, expenses and non-contractual liabilities of the "core", pro rata sharing between cells or separately liable?
  – Non-attributable liabilities attributed to the "core"?
  – No ability to wind up the "core" as a separate and independent event
  – Qualifying floating charge

  – Law of the Member State where the main proceedings are opened determines questions arising in the insolvency of the debtor, so question if other EU jurisdictions will recognise PCC ring-fencing
U.S. State-Based System of Insurance Regulation

- **Domiciliary state is an insurer’s principal regulator**
  - An insurer also is regulated by every state in which it does business

- **Comprehensive jurisdiction**
  - Licensure
  - Solvency and risk-based capital (RBC) requirements
  - Statutory accounting
  - Transactions with affiliates
  - Policy rates and forms
  - Market conduct

- **Interstate collaboration and coordination through the National Association of Insurance Commissioners (NAIC)**
  - Accreditation standards for financial regulation
  - Model laws and regulations
NAIC Response to Offshore Securitization

• Model laws
  – Special Purpose Reinsurance Vehicle Model Act (2001)
  – Protected Cell Company Model Act (2002)

• Stated purposes
  – Achieve greater efficiencies in conducting insurance securitizations
  – Diversify and broaden insurers’ access to alternative sources of risk-bearing capital
  – Make insurance securitization generally available on reasonable terms to as many U.S. insurers as possible

• Not widely adopted

• Calls to re-evaluate and update
  – Consider making accreditation standard
Special Purpose Reinsurance Vehicle Model Act

Key Features

- Limited certificate of authority; plan of operation subject to prior approval
- Minimum initial capital requirement of $5,000
- Annual filings: audits of financial statements and statement of operations
- Exempt from state premium taxes and other state taxes incidental to operation of business
- Fully funded and secured with assets held in trust for the benefit of the ceding insurer
- Assets held or invested in:
  - Cash or cash equivalents
  - Securities listed by the NAIC Securities Valuation Office and qualifying as admitted assets under domiciliary state statutory accounting
  - Any other form of security acceptable to the Commissioner
- May not control, be controlled by, or be under common control with ceding insurer party to SPRV contract
- Ceding insurer granted credit for reinsurance
- Permissible triggers:
  - Indemnity
  - Non-indemnity only in accordance with regulations adopted by commissioner
Protected Cell Company Model Act

Key Features

• Plan of operation for each protected cell subject to prior approval
• Assets and liabilities segregated from those of other protected cells and the protected cell company’s general account
• Bankruptcy remote
• Attributed assets must be
  – in cash or readily marketable securities with established market values
  – at least equal to reserves and other liabilities attributed to protected cell
• Permissible triggers:
  – Indemnity
  – Non-indemnity only in accordance with regulations adopted by commissioner
## Common Principles

<table>
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<tr>
<th>HM Treasury Consultation Paper</th>
<th>NAIC SPRV Model</th>
<th>NAIC PCC Model</th>
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<tr>
<td>• Accelerated application review</td>
<td>• Limited certificate of authority</td>
<td>• Segregation of assets and liabilities w/in PCCs</td>
</tr>
<tr>
<td>• ISPV must be fully funded</td>
<td>• SPRV must be fully funded</td>
<td>• Cells not legal persons separate from PCC</td>
</tr>
<tr>
<td>• Investor rights subordinate to obligations to cedant</td>
<td>• Investor rights subordinate to obligations to cedant</td>
<td>• Prior approval of plan of operation or amendments for each cell</td>
</tr>
<tr>
<td>• ISPV arms-length from cedant</td>
<td>• No control or common control as between SPRV and insurer</td>
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