Securitisation of Insurance

Thomas Bicknell
t.bicknell@tamimi.com

November 2013

Local insurers often rely on reinsurance from international entities to shore up their capital requirements. The sourcing of foreign capital is a common theme of emerging insurance markets such as the UAE where local capital is thin on the ground compared to the mature markets of Europe and the United States. In light of increases in capital requirements, international insurers have been turning to capital markets to provide cover for large scale risks that require capital not easily obtained in the traditional insurance market. Insurance-linked securities, such as catastrophe bonds, are proving a popular asset class with investors. Could insurance-linked securities provide an alternative for local insurers to the sourcing of capital from international reinsurers?

Securitisation of insurance – how does it work?

The insurer will incorporate a special purpose vehicle (SPV) with the SPV's shares usually held in a charitable or purpose trust on behalf of the insurer. Depending on the jurisdiction, the SPV can also take the form of a cell of a protected cell company (discussed below). The SPV enters into a contract to either insure or reinsure a particular risk, for example earthquake catastrophe. The SPV then 'transfers' the liability for the risk to the capital markets by way of a bond or note issue.

Owing to the complex nature of the instruments used, offers are generally limited to the 'sophisticated investor' class thus avoiding the need to comply with public issue disclosure requirements. The SPV will then fully collateralise the ceded risk by depositing the proceeds from the issue in a restricted trust or collateral account for the benefit of the insurer. The SPV uses income from the premiums paid under the insurance contract as well as the releases from the collateral trust to meet its payment obligations to noteholders.

If no loss event occurs, note holders receive a return of both principal and interest payments. Where a loss event occurs, the SPV transfers funds to the insurer in accordance with the insurance contract; investors will then suffer either total or partial loss of interest and/or principal. So as to better quantify the loss for investors, insurers are moving to non-indemnity based contracts whereby the loss event is actually the physical event itself, i.e. an earthquake (a 'parametric trigger') as opposed to the loss arising from the event. Insurers are also using weighted industry indexes that model the loss for a particular catastrophe thereby reducing the reliance on costly and time-consuming loss assessment after the event has occurred.

[image src="http://www.tamimi.com/en/media/get/20131121_securitisation-insurance.jpg" class="__image__" imageId="2581″]

Whilst insurance securitisation is often used for the hedging of catastrophic risks, it is also used by life insurers to securitise future cash flows from a block of business thereby obtaining immediate access to the value of their in-force book.

Use of SPVs in the DIFC

Following a round of consultation in mid-2007, the DFSA introduced a framework for insurance securitisation that allowed for the establishment of insurance-specific SPVs (ISPV) as well as the treatment of ISPV-generated capital.

For an insurer to treat the funds of an ISPV as either an asset or as reinsurance, the insurer must first apply for and obtain a waiver from the DFSA. For the application to be successful the ISPV will either need to be authorised to carry on the business of an insurer in the DIFC or, if it is not, it will need to show that it is subject to financial services regulation in a jurisdiction acceptable to the DFSA. As with most jurisdictions that allow ISPVs, the insurance contract must provide for the transfer of risk occurring under the insurance contract. Under DIFC requirements, an ISPV is not able to insure a risk outside of the DIFC; it can only contract to reinsure the risk. In addition, the DFSA must be satisfied of the ‘bankruptcy remoteness’ of the ISPV from the insurer, that is, the degree to which the assets of the ISPV are isolated from the any creditors of the insurer. Bankruptcy remoteness can be achieved through limiting the purpose of the ISPV as well as ensuring the ISPV’s governance decisions around bankruptcy will be made in isolation of the insurer.

The framework exempts ISPVs from certain business and risk requirements that would be overly restrictive and inappropriate in light of the ISPVs singular function as well as its relationship with the ceding insurer. The ISPV is still required to maintain a compliant risk management system of its own.

The arrangement must also serve to ensure that the assets of the ISPVs are at all times equal to or greater than the ISPV’s liabilities. To effect this position, the DFSA requires that the SPV be in actual receipt of the funds from any debt issuance and include in the insurance contract that the SPV’s contractual liability does not exceed its assets at that time. The terms of the notes must provide for the subordination of the holders’ rights to the claim of the ceding insurer under the insurance contract.

Use of a protective cell companies for insurance securitisation

The DIFC provides a comprehensive framework for the establishment and use of protected cell companies (PCC), including as SPVs. PCCs are entities that are able to offer individual cells to third parties that are legally and financially ring-fenced from the PCC itself as well as the PCC’s other cells. Traditionally, PCCs were used by non-insurance companies to allow those companies to put in place their own insurance cover (known as ‘captive insurance’).

Recently, PCCs are increasingly being formed to be used as SPVs for securitisation of insurance products. By using the cell of an existing third party PCC, the regulatory burden is minimised (though the insurer is still required to obtain a waiver from the DFSA) and the insurer can leverage off the expertise of the PCC in respect of management of the ISPV. In addition, an insurer is able to create different categories of notes using different cells known as ‘cellular-asset backed securities’. For example, one class of note may only expose the investor to the risk of losing their coupon with the capital outlay remaining intact, whereas another class may expose both capital and coupon investments.

Just as with standalone SPVs, collateral accounts can be used, the funds from each cell being aggregated and placed into the account for the benefit of the insurer (provided the assets of each cell remain identifiable). The insurer is then able to cede a risk to the PCC equal to the aggregated funds received from all classes of notes issued. Currently, the DIFC limits the use of PCCs for insurance purposes to ‘Contracts of Insurance’ for risks situated in the DIFC. By comparison, other jurisdictions are expanding the notion of insurance to include payment in the event of a loss of money or money’s worth on the happening of an event.

At present, the UAE is yet to see an issue of insurance-linked securities with most listings being confined to the US and European markets. However, with the steady growth of the UAE insurance industry and the ever-increasing need to obtain and manage capital, local insurers may yet seek out this alternative to traditional insurance funding.