Insurance securitisations in Canada: key principles for a Canadian regulatory regime

by Robert McDowell and Koker Christensen, Fasken Martineau DuMoulin LLP

Insurance securitisation provides a way for an insurer or reinsurer to transfer risk to capital markets. This type of transaction typically involves an insurer or reinsurer, commonly referred to as a 'sponsor', entering into a reinsurance or other type of agreement with a special purpose vehicle (SPV), which issues securities to investors to fund its obligations under that agreement.[1]

These transactions raise a number of regulatory issues, some of which are addressed by existing laws and regulation in Canada.[2] However, there is no regulation in Canada specifically addressing insurance securitisations. Presumably the reason for this is that there has not been significant demand for insurance securitisations and other forms of insurance-linked securities (ILS) in Canada. As a result, Canadian law-makers and regulators have not had to respond by developing a regulatory regime for such transactions.

In countries with developed markets for ILS, there tend to be specific regulatory regimes governing these types of transactions. If a Canadian market for insurance securitisations develops, as some expect, a Canadian regulatory regime for insurance securitisations would likely need to be created.

This article provides an overview of the key principles that would likely be included in a Canadian regulatory regime for insurance securitisations (if one were developed).[3] The principles discussed in this article are derived from a review of the regulatory regimes governing insurance securitisation in the US, the European Union (i.e. Solvency II) and the UK, as well as principles articulated by the International Association of Insurance Supervisors (IAIS).

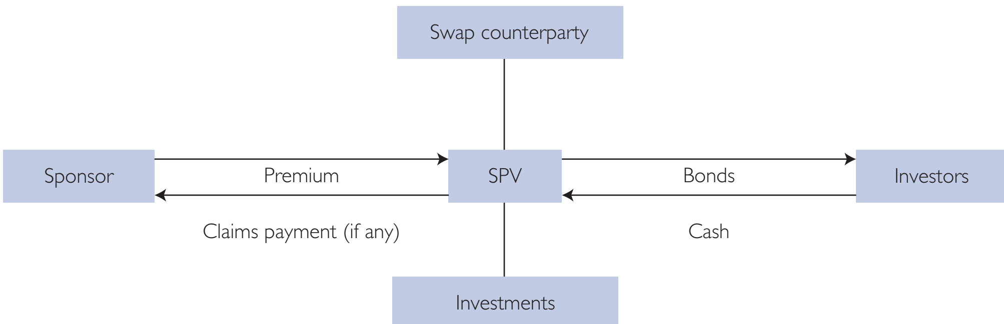
An overview of insurance securitisation

P&C securitisations

P&C insurance securitisations, specifically the issuance of catastrophe or 'cat' bonds, have been the most widespread type of insurance securitisations. A typical cat bond transaction involves a bankruptcy remote SPV (i) entering into a reinsurance contract under which the sponsor is the cedant and (ii) issuing securities to investors. The SPV holds funds equal to its exposure under the reinsurance contract. These funds are invested in high-quality securities and held in a collateral trust. A swap may be entered into with a swap counterparty converting the investment return on the collateral into a rate based on the LIBOR or some other reference rate.

The SPV uses income under the reinsurance contract and releases from the collateral trust to meet its payment obligations under the securities. The terms of the securities will specify a 'triggering event'. If no triggering event occurs, investors receive a return of principal and a stream of coupon payments. If a triggering event occurs, the SPV is required to transfer funds to the sponsor pursuant to the reinsurance contract and investors suffer either partial or total loss of interest and/or principal.

Figure 1: A typical cat bond structure



Source: Fasken Martineau DuMoulin LLP

The foregoing description assumes that the contract between the sponsor and the SPV is a reinsurance contract involving an indemnity trigger. It is also possible to have non-indemnity-based triggers in the contract between the sponsor and the SPV, including the following:

- industry or weighted industry loss index triggers which are based on an industry-wide index of losses determined by third parties such as Property Claims Services (PCS) in the US, PCS-Canada in Canada, and Pan-European Risk Insurance Linked Services (PERILS) in Europe;
- parametric triggers, which are based on the occurrence of a specified physical event;[4] and
- modelled loss triggers, which are based on estimated losses generated by a model.

It is also possible to have a combination of these triggers.

Figure 1 illustrates a simplified version of a typical cat bond structure.

Life securitisations

Most life securitisations have primarily been ways of obtaining financing, not transferring risks. In this respect they differ from P&C securitisations, which have focused on transferring catastrophic risks. However, life securitisations can also be used to transfer risks. For example, there have been securitisations covering pandemic risk (Swiss Re's Vita bonds would be an example), which are comparable to transferring P&C cat risks via cat bonds.

Some of the primary forms of life insurance securitisations are as follows:

- securitisation of future cash flows from a block of business (which involves the sponsor obtaining immediate access to the value of the in-force business);
- reserve funding securitisations (which are undertaken to ease regulatory reserve requirements); and
- life insurance risk transfer securitisations (i.e. transactions that protect insurers and reinsurers against mortality or longevity risk).

Principles to be addressed in a Canadian regime for insurance securitisation

Before proceeding with a discussion of possible key elements of a Canadian regulatory regime for insurance securitisations, it is important to understand the context in which such regulation would apply. Generally, there are two components to the regulation of insurance securitizations:

(i) regulation governing when a sponsor will receive credit for reinsurance; and

(ii) regulation of domestic SPVs.

Regarding the first component, there are existing Canadian requirements regarding when a cedant will receive credit for reinsurance. The key elements of these requirements are as follows:

- In determining whether a ceding (re)insurer is entitled to capital relief, the Office of the Superintendent of Financial Institutions (Canada) (OSFI) will consider whether there has been effective risk transfer.
- The requirements of OSFI Guideline B-3 – 'Sound Reinsurance Practices and Procedures' must be met. Guideline B-3 sets out, among other things, OSFI's expectations regarding reinsurance risk management practices and reinsurance contract terms. Guideline B-3 states that if an insurer fails to meet the principles set out in the Guideline, on a case-by-case basis, OSFI may not grant a capital/asset credit for the reinsurance arrangement, or may, commensurate with the risk, use its discretionary authority under the 'Insurance Companies Act' (Canada), to adjust the insurer's capital/asset requirements or target solvency ratios to compensate for reinsurance that is not, or may not, be wholly effective or reliable.
- In the case of unregistered reinsurance, e.g. with an offshore SPV, credit will only be available if the requirements of OSFI's 'Guidance for Reinsurance Security Agreements' are satisfied, including that assets of the unregistered reinsurer are pledged to the ceding company to secure the payment of the potential liabilities of the reinsurer under one or more reinsurance agreements pursuant to a security agreement, the pledged assets are held in Canada by a collateral agent that is a Canadian financial institution not affiliated with the unregistered reinsurer, and legal opinions are obtained.

The second component, regulation of domestic SPVs, addresses the possible recognition of domestic, or 'onshore', SPVs. Most securitisations have involved foreign, or 'offshore', SPVs. In those cases, the SPV is subject to regulation in the offshore jurisdiction, not the jurisdiction of the sponsor. Some jurisdictions have introduced regimes providing for domestic SPVs. For example, in the US, model legislation has been adopted by the National Association of Insurance Commissioners (NAIC) that provides for the creation of Special Purpose Reinsurance Vehicles (SPRVs). SPRVs are required to obtain limited certificates of authority and are subject only to limited sections of state insurance codes.[5]

One of the questions that must be considered with respect to a Canadian regime for insurance securitisations is whether there should be a regime providing for domestic Canadian SPVs. If Canadian SPVs were recognised as registered reinsurers, the Canadian cedant would receive credit for reinsurance with such a SPV.

Possible key principles for a Canadian ILS regulatory regime

1. SPV must be fully funded

This involves an SPV holding, at all times, assets equal to or in excess of the exposure assumed under the reinsurance or financial contract with the sponsor. The requirement to be fully funded should include anticipated fees and expenses. This requirement means that the aggregate exposure of the SPV must have a clearly defined limit.

2. SPV's assets must be held in trust

The assets that the SPV holds are to be held in trust to ensure that the SPV's obligations *vis-à-vis* the cedant are collateralised.

3. SPV must be bankruptcy remote

An SPV is bankruptcy remote if it is sufficiently isolated from the sponsor such that creditors of the sponsor would not have a claim against the SPV if the sponsor became bankrupt.

4. Non-recourse

Investors should have no recourse to the sponsor for repayment. Investors can only look to the SPV for interest payments or repayment of bond principal at maturity.

5. Investors have a subordinated claim on SPV assets

The claim of investors is to be subordinated to the claim of the sponsor.

6. The SPV shall be subject to prudent person investment principles

The assets held by the SPV shall be invested in accordance with a prudent person standard. For example, according to the 'Advice for Level 2 Implementing Measures on Solvency II: Special Purpose Vehicles' issued by the Committee of European Insurance Occupational Pensions Supervisors (CEIOPS) (which has been replaced by the European Insurance and Occupational Pensions Authority (EIOPA)), the appropriate application of prudent person principles to the investment strategies of SPVs entails the following requirements: assets should reflect the duration of underlying liabilities; assets should be of a high quality and counterparty exposures should be sufficiently diversified; and derivatives should be used only for risk reduction and efficient portfolio management.[6]

7. Effective risk transfer

A major concern of the ceding (re)insurer is whether it will receive credit for the reinsurance provided by the SPV. While approaches to the allowance of credit for reinsurance for the SPV contract vary across regulatory bodies, a common requirement is that there must be an effective, or real, transfer of risk in order for credit to be granted to a ceding (re)insurer.

Under Financial Services Authority (FSA) rules, factors which should be taken into account in assessing whether a transaction effectively transfers risk and the extent of that transfer include:

- whether the economic effect of the transaction is accurately documented;
- whether the extent of the risk transfer is clearly defined and incontrovertible;
- whether the fulfillment of any terms or conditions of the transaction are outside the direct control of the ceding firm; and
- whether the transaction is legally enforceable in all relevant jurisdictions.[7]

A related issue is basis risk, which is the risk that the compensation received by the sponsor in the event that a loss event occurs will not match the sponsor's actual losses. This risk exists where the trigger under the relevant contract is something other than the sponsor's actual loss (i.e. it is not an indemnity trigger).

The degree of basis risk is relevant in considering the question of effective risk transfer and, thus, is relevant to the granting of credit for reinsurance or the equivalent (in the case of a financial contract). The IAIS Release states that "Any basis risk should be considered with reference either to the amount of credit given by the supervisor for the [SPV] arrangement, or in the cedant's risk-based capital requirement, where such mechanisms are used." In general, indemnity-based arrangements are viewed as effectively transferring risk and non-indemnity based arrangements that may result in material basis risk are viewed as needing to be assessed on a case-by-case basis to determine if they involve effective risk transfer.

8. Transparency of arrangements

Regulators must be able to understand the details of the transaction and understand whether the necessary requirements have been met. This requires full transparency of the arrangements between the ceding (re)insurer and the SPV. Transparency should also continue through to the on-going supervisory reporting requirements of ceding (re)insurers and SPVs.

On-going reporting dialogue with supervisory authorities should not be unduly burdensome, however, it should allow the supervisory authorities to monitor the ceding (re)insurer and on-going compliance of the SPV after authorisation. Any material changes to initial information originally supplied for the authorisation of an SPV should be communicated with the supervisory authority for additional approval.[8]

Conclusion

If a market for ILS develops in Canada, potential sponsors will need to know what the regulatory expectations and requirements will be. Regulators, for their part, will need to know what elements need to be in place to ensure that ILS transactions provide appropriate risk transfer and protection for (re)insurers and their policyholders.

We believe that the key principles outlined in this article are the basic elements of a regulatory regime pursuant to which (re)insurers, as well as other risk-taking entities, such as banks that wish to protect their mortgage books and governments that wish to protect their infrastructure, can tap into the ILS market to fund their exposures as a complement to existing approaches to risk, including traditional insurance/reinsurance and self-insurance.

Notes:

1. A version of this article was first published in MSA/Baron Outlook Report Q2-2011.
2. For an overview of insurance-linked securities and how existing Canadian law and regulation applies to them, please see our article 'Insurance-Linked Securities: The State of Canadian Law and Regulation', MBA/Baron Outlook Report, September, 2010. For more recent relevant regulatory developments relating to reinsurance please see Fasken Martineau's Bulletins 'OSFI's New Draft Reinsurance Guideline' dated October 8, 2010 and 'OSFI Finalises Reinsurance Guidance' dated March 1, 2011.
3. This article is focused on insurance regulation, not other legal issues. Accordingly, this article does not address tax or other issues relating to insurance securitisations.
4. Pure parametric triggers are based on the occurrence of a specified physical event (e.g. the location and magnitude of an earthquake). Parametric index triggers are more refined types of parametric triggers that use a greater number of locations and apply different weights to each location to reflect a sponsor's exposure to events in a given area.
5. The NAIC has also adopted model legislation relating to protected cell companies. A protected cell is a specific pool of assets and liabilities of a special purpose company segregated and insulated by statute from other assets and liabilities held by the special purpose company.

[6] See s. 3.3.3.

[7] See s. 1.1.19E of the FSA's Prudential Sourcebook for Insurers, INSPRU 1: Capital resources requirements and technical provisions for insurance business.

[8] For example, under s. 4 of the NAIC Model Act, any material change of the SPRV's plan of operation requires prior approval of the commissioner. Similarly, the FSA reserves the right to request confirmation that there has been no material change to the information originally supplied for authorisation prior to granting a waiver allowing capital relief.

Authors:
Robert McDowell, Partner
Tel: +1 (416) 865 4408
Email: rmcdowell@fasken.com

Koker Christensen, Partner
Tel: +1 (416) 868 3495
Email: kchristensen@fasken.com

Fasken Martineau DuMoulin LLP
333 Bay Street, Suite 2400 Bay Adelaide Centre
Box 20 Toronto, Ontario M5H 2T6. Canada
Web: www.fasken.com