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Insurance-linked securities: The new UK regime

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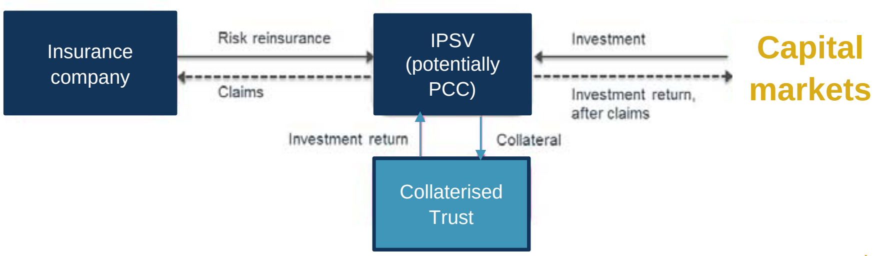
What is an Insurance Linked Security?

An **alternative risk transfer** ("ART") instrument

Purpose is for investors to be able to take on risks in a way that does not require them to be a regulated insurance / reinsurance company



The role of the ISPV is to transform insurance risk to the capital market instruments (e.g. debt or equity)

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What are the benefits?

For the issuer

- ✓ Ability to access capital markets directly
- ✓ Alternative source of risk mitigation to reinsurance
- ✓ Low / no exposure to counterparty default risk
- ✓ Potential to lock in multi-year protection
- ✓ Flexible potential for capital optimisation
- × Most – investors have a short/ medium-term investment horizon (3-5 years)
- × Cost and extent of placements dependent on capital market demand and liquidity
- × Depending on design of triggers, may be residual basis risk

For the investor

- ✓ Attractive returns, particularly in low-interest rate Environment
- ✓ Uncorrelated to economic cycle (depending on specific risk transferred)
- ✓ Defined maximum loss
- ✓ Generous tax exemptions
- ✓ Diversification of investment portfolio
- ✓ Historically lower volatility than high-yielding corporates
- × Lack of liquidity – may be difficult to exit
- × Relatively complex and unfamiliar risks, so need to be relatively sophisticated and prepared to invest in understanding the underlying risk

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Authorisation and Supervision – Regulated Activity

- Section 13A, FSMA Regulated Activities Order

  "It is a specified kind of activity for a transformer vehicle to assume a risk from an undertaking where:

  - the undertaking assumes a risk under a contract of insurance (the "underlying risk"); and
  - the assumption of risk by the transformer vehicle has the legal or economic effect of transferring some or all of the underlying risk to the transformer vehicle."
- New regulated activity (outside of effecting and carrying out insurance) of "insurance risk transformation"
- PRA approval subject to Article 318, SII Regulation

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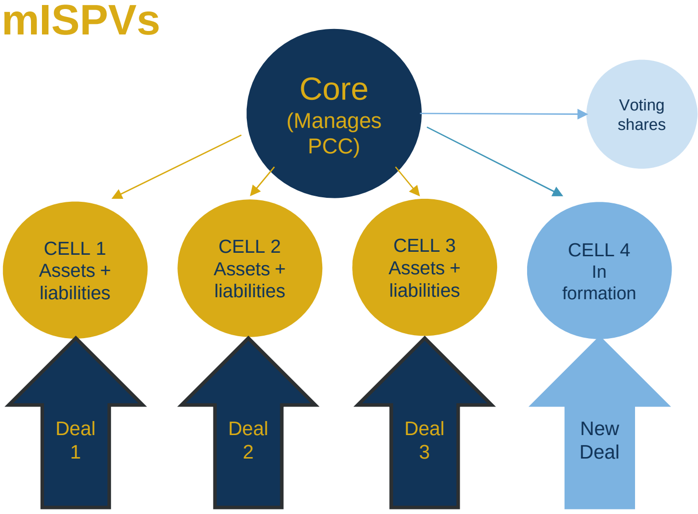
mISPVs



- Separate cell for each risk transfer contract
- Segregated pool of assets and liabilities (record-keeping)
- Each cell is insolvency-remote from each other cell
- Investors in cells confined to non-voting securities

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“Effective” Risk Transfer

- Article 210 SII Regulation
  - the transfer is effective in all circumstances
  - the extent of risk transfer is clearly defined and incontrovertible
- Risk transfer to be “legally effective and enforceable in all relevant jurisdictions” (Article 209, SII Regulation)
  - answer is “based on” whether the risk transfer “is subject to any condition which could undermine the effective transfer of risk, the fulfilment of which is outside the direct control of [the cedant]” (Article 210, SII Regulation)
  - Query circumstances where ISPV can have termination right for EU cedant change of control, loss of authorisation etc.
- Co-operation between cedant and ISPV supervisor before/after ISPV is authorised (Articles 8 and 9, ISPV Implementing Regulation)

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Fully Funded requirement

- Articles 319 and 326, SII Regulation “The contractual arrangements … shall ensure that the special purpose vehicle is at all times fully funded in accordance with Article 326”
- Key requirements:
  - assets must be valued in accordance with IFRS or UK GAAP
  - ISPV must at all time (1) have assets which equal or exceed the aggregate maximum risk exposure and (2) be able to pay amounts as they fall due
  - proceeds of debt issuance must be fully paid-in
  - cannot use contingent assets

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Public Offers

- ISPVs can only make offers of investments to “qualified investors”
- Obligation to “take such steps as are reasonable” to stop non-qualified investors subsequently being offered to
- How to control disposals by original investors?

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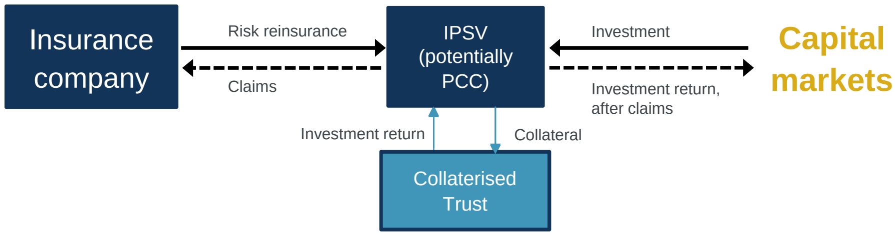
Potential structures – Insurer reducing Solvency II capital requirements



Why?

- Rebalance risks retained
- Where reinsurance cannot be obtained or is too expensive
- Well-trodden precedents
- Risks more predictable and less severe than GI catastrophe

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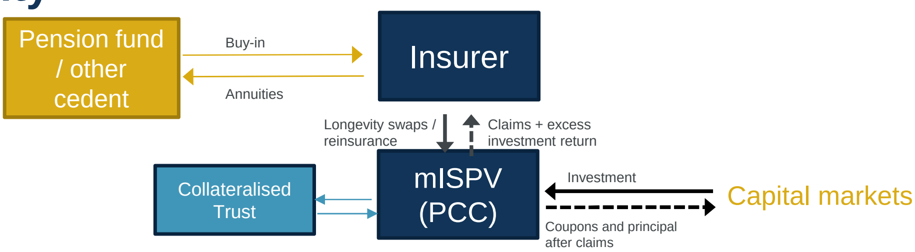
Potential structures – Insurer wishing to expand capacity



Why?

- Price, availability and structure of traditional longevity reinsurance
- UK transactions regulated by UK regulators?
- Capital market appetite
- Cost effective, once initial company structure is in place

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