MATHESON
ORMSBY
PRENTICE
Dublin
London
Palo Alto

THE FUTURE OF IRISH ALTERNATIVE RISK TRANSFER (APRIL 2003)

INTRODUCTION

Ireland's favourable tax regime has promoted the development of an ART industry in Dublin, with internationally known players - General & Cologne Re, Hannover Re, IRECO, to name a few. A major aspect of Irish ART business is finite reinsurance, which for tax reasons is particularly suited to Ireland. Irish reinsurance operations have also become involved in innovative financing arrangements. Hannover Re has undertaken a series of financing transactions (L1, L2, L3 and L4) by which its policy acquisition costs for life reinsurance business have been financed by the capital markets. Finally, in the late 1990s, Ireland emerged as a location for securitisation special purpose vehicles (SPVs), and insurance-linked transactions, including the NPI, Atlas I and II and Mediterranean Re deals, were structured through Ireland. This article will consider the deal structures involved in these three types of ART activity, and will identify some of the legal and regulatory issues arising, before attempting to assess some of the future challenges facing the Irish ART industry.

DEAL STRUCTURES

Insurance linked securities

The most common example of an insurance linked security remains the catastrophe bond. An Irish example was the Atlas II issue on behalf of SCOR in late 2001. Atlas II offered $150m of floating rate notes in two tranches, $50m of Class A notes and $100m of Class B notes. SCOR had underwritten reinsurance in respect of North European windstorm events and Japanese and Californian earthquake risk and sought to cede this risk to the capital markets. The securitisation was structured as follows:-

(i). Atlas II raised $150m by the issue of notes, which was deposited in a collateral account and invested in safe securities.

(ii). Atlas II issued a retrocession contract to SCOR by which it agreed to indemnify SCOR for up to $150m of loss sustained in respect of North European windstorms or Japanese or Californian earthquakes.

(iii). Premium payments under the retrocession contract would be used by Atlas II to service interest payments on the notes.

(iv). If losses arose, depending on their severity, noteholder might lose either their entitlement to interest or their entire principal. The different degree of risk was reflected in the differential interest rates on the two tranches.

Issues raised by the structure included the choice of the "trigger" for payment under the retrocession treaty and the notes. The originator of an issue seeks matched coverage, whereas the noteholders seek to ensure that the originator does not cede risks which it knows to be poor (adverse selection) and does not alter its behaviour so as to increase the risk once the coverage is in place (moral hazard). The choice therefore is between using actual loss to the originator on the one hand, or some industry index

or other fact external to the originator on the other hand as the trigger for payment under the notes. With an external trigger bondholders have certainty as to whether a loss has occurred or not, and do not have to wait for inwards losses to develop. It will also largely remove the potential for adverse selection, since payment to the originator depends on an event which is likely to result in loss to the industry as a whole.

Issues to date have been based on complex actuarial modelling of the likelihood of losses arising, and these models need to be reviewed by the rating agencies and accepted by investors. The cost of preparing and explaining these models drives up the cost of catastrophe bond issues.

Finite(or financial) reinsurance

Finite reinsurance is a method of spreading of individual risks over time, whereas traditional commercial insurance is based on the law of large numbers. Examples of finite reinsurance contracts include:-

loss portfolio transfers: the reinsured transfers outstanding claims reserves to the reinsurer, who agrees to indemnify the reinsured in full. The time value of the reserves transferred will be explicitly taken into account when calculating the reinsurance premium. The contract transfers the timing risk of unexpectedly rapid claims settlement to the reinsurer.

retrospective excess of loss covers: the reinsured pays the reinsurer a premium to indemnify the reinsured for losses that exceed the reinsured's existing reserves. The reinsured retains his reserves and continues to invest them himself. The reinsurer assumes the risk that claims settlements will exceed the reinsured's reserves plus investment income earned.

spread loss treaties: the reinsured pays premiums to the reinsurer which are transferred to an experience account. Premiums paid to the experience account are credited with interest, while claims payments made by the reinsurer are debited to the experience account. If the balance on the experience account is negative the reinsured must repay that balance before the policy period expires. The effect of the treaty is to "smooth" losses over accounting periods.

Structured finance transactions/bank reinsurance financings

The purpose of these can vary, but in the case of the Hannover Re transactions mentioned above, these were designed to transfer the acquisition cost, or new business strain, of finite life reinsurance transactions to the capital markets. Hannover's arrangements with its cedants, as is common, required payment to cedants of significant reinsurance advances which would be recouped by Hannover out of premiums paid by the cedants over the lifetime of the contract. Hannover wished to secure financing for part of these advances from the capital markets. Thus, Hannover entered into finite reinsurance transactions with a SPV which matched its obligations to its cedants, with the SPV's obligations under those transactions in turn being financed by a limited recourse loan provided by a bank or syndicate of banks.

LEGAL AND REGULATORY ISSUES ARISING

Regulatory status of the Special Purpose Vehicle ("SPV")

An Irish SPV which underwrites a reinsurance or retrocession contract must comply with the Insurance Act 2000. This provides that a company registered in or operating in Ireland cannot carry on reinsurance business unless it has given the DETE at least 30 days advance notice. In practice a minimum period of 6-8 weeks should be allowed. A reinsurance company must have minimum paid up share capital of €635,000. Over and above this, its capitalisation is for discussion with the DETE, but the amount of capital required is a highly material factor when deciding the location of a SPV and is vital to address at the outset of any structuring.

Noteholders conducting insurance/reinsurance business

In some US jurisdictions, investors in insurance-linked notes may be regarded as "conducting insurance business" by purchasing the notes. In the Georgetown Re securitisation structured by St Paul Re in 1996, confirmation was obtained from several US state insurance regulators that the purchase of such notes by investors in those states did not infringe their insurance laws. The point has never arisen before an Irish or English court, but it seems highly unlikely that Irish or English law would regard an investor as conducting insurance business simply by purchasing an insurance linked bond.

Prospectus requirements

An Irish company that makes an offer of bonds to the public may need to prepare a prospectus in accordance with the Companies Act 1963 or the EU Prospectus Directive and file this with the Companies Registration Office. Exemptions are available which should benefit most insurance-linked note issues, but this must be examined on a case-by-case basis for each proposed issue.

Tax issues

In Ireland, income of a SPV will be taxable and to minimise tax leakage, tax deductions are required for sums paid out. Tax deductions are available for trading companies, but SPVs do not typically trade. Legislative intervention was therefore necessary to permit a SPV to be treated as a trading company for tax deduction purposes, and section 110 of the Taxes Consolidation Act 1997 was introduced to deal with this issue. The section was recently amended by the Finance Act 2003 to expand the relief given. The amended section 110 permit a SPV to be entitled to tax deductions as if it were a normal trading company where it acquires a financial asset, holds or manages a financial asset or enters into an arrangement which would itself be a financial asset. "Financial asset" is also widely defined under the Irish legislation, and the effect of the recent amendment will further facilitate all forms of securitisation activity in Ireland.

Originators also need to consider the impact of Irish withholding tax on payments of interest to noteholders. Exemptions from withholding tax are available where investors are resident either in the EU or in a state with which Ireland has a double taxation treaty, or where the notes are listed on a recognised stock exchange and are in bearer form.

Finite reinsurance contracts

In December 2002, the UK FSA issued a policy statement (Policy Statement 144) requiring life assurers to show the effect of financial reinsurance and contingent loans on the firm's solvency position in their regulatory returns, and requiring the firm's appointed actuary to disclose their effects on his annual valuation. Linked with the work currently being undertaken by the International Accounting Standards Board, it appears that greater disclosure is now expected of the effects of finite reinsurance transactions on insurers' accounts, and this may have an impact on the demand for finite reinsurance provided by Irish firms.

DEVELOPMENT, CHALLENGES AND OPPORTUNITIES

Reinsurance regulation at EU level

*A*n EU directive on reinsurance regulation seems likely to be adopted by 2004 and this directive may adopt a modified form of the current EU insurance directives methods of prudential supervision. A reinsurance directive would have a major impact on the use of Irish SPV reinsurers, as it would probably increase their capitalisation requirements, require them to maintain technical reserves against any contracts underwritten and require them to demonstrate a solvency margin on some basis set by the directive.

Fair value accounting

The International Accounting Standards Board has been examining the introduction of an international standard for insurance company accounts, which would eliminate many of the hidden reserves currently contained in insurance company accounting. As the primary motivation of many financial reinsurance transactions is to permit insurers to convert accounting "assets" of this nature into working capital, the eventual implementation of fair value accounting standards would have a major impact on this market.

The future of Irish ART is therefore in the balance, and will be determined primarily by international, rather than domestic developments. What is certain is that the innovation exhibited to date will stand the players in this market in good stead to develop their business going forward.

787531.1

© MOP April 2003

The information in this document is provided subject to the Legal Terms and Liability Disclaimer contained on the MOP Website. The Material is not intended to provide, and does not constitute, legal or any other advice on any particular matter, and is provided for general information purposes only.

.

For further information in relation to this article, please contact: Liam Flynn
T: 00353 1 619 9000 E: Liam.Flynn@mop.ie