CONSULTATION PAPER

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Proposed Regulatory Framework for Insurance Securitisation

Monetary Authority of Singapore

PREFACE

1 Insurance securitisation is an alternative risk management tool to reinsurance. Through securitisation, insurers can transfer insurance risk directly to the capital market. Recognising the merits of such risk mitigation techniques, especially for managing risks arising from pandemics and natural catastrophes, and the potential demand for insurance linked securities (ILS) in Asia, MAS is developing a regulatory framework for insurance securitisation.

2 This paper sets out the proposed regulatory framework governing Special Purpose Reinsurance Vehicles ("SPRVs") set up in Singapore to issue reinsurance contracts and ILS, the proposed regulatory treatment of reinsurance ceded by registered insurers to SPRVs, and registered insurers' investment in ILS.

3 MAS invites interested parties to submit their comments on the recommendations set out in this consultation paper. Submissions in electronic form are strongly preferred and should be sent via e-mail to the following address: ils_ins07@mas.gov.sg. Written comments should be submitted to:

Insurance Supervision Department
Monetary Authority of Singapore
10 Shenton Way
MAS Building
Singapore 079117
Fax: (65) 6229 9694

All comments should be submitted to MAS by 12 July 2007.

4 Please note that all submissions received may be made public unless confidentiality is specifically requested for the whole or part of the submission.

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1 BACKGROUND

1.1 INTRODUCTION

1.1.1 Insurance securitisation refers to the transfer of insurance risk from the insurance market to the capital market. It is commonly done via a special purpose vehicle established solely for securitising the insurance risk, typically called Special Purpose Reinsurance Vehicles ("SPRVs"). A SPRV issues bonds through the capital market and then invests the bond proceeds together with the reinsurance premiums paid by the ceding firm (which may also be the sponsor) in a portfolio of highly rated securities. The contingent obligations of the SPRV under the reinsurance contract are also typically fully funded and secured with assets held in trust.

1.1.2 In the event that there is no claim, investors will receive the return of their principal plus the income and gains generated from the investment portfolio and the reinsurance premiums less the operating expenses of the SPRV. However, if a claim is made under the reinsurance contract, the principal and income of the bonds may be at risk of default.

1.1.3 MAS recognises the merits of such risk mitigation techniques, especially for managing risks arising from pandemics and natural catastrophes. These insurance-linked securities (ILS) also contribute to a more diverse and vibrant capital market. While there are few insurance securitisation deals sponsored by Asian insurers to-date, there is potential for growth when Asian insurers explore alternative means of efficient management of risk and capital.

1.1.4 In view of the prudential and developmental benefits of insurance securitisation, MAS is developing the regulatory framework governing SPRVs set up in Singapore to issue reinsurance contracts and ILS as well as the proposed regulatory treatment of reinsurance ceded by registered insurers to SPRVs and registered insurers' investment in ILS.

2 PROPOSED REGULATORY FRAMEWORK FOR SPRVs

2.1 IMPLEMENTATION APPROACH

2.1.1 MAS proposes to register SPRVs incorporated in Singapore to issue reinsurance contracts and ILS as “reinsurers” under Section 8 of the Insurance Act. Although SPRVs are carrying on reinsurance business, they pose less regulatory risk compared to other type of registered reinsurers given the limited scope of their operations and the bankruptcy remote structure that will be required of SPRVs. Therefore, MAS proposes to subject SPRVs to customised regulatory requirements that are proportionate to the risks posed by these vehicles, by way of new legislation.

2.2 CUSTOMISED REGULATORY REQUIREMENTS

<u>Structure and Mode of Operations</u>

2.2.1 The SPRV shall be structured and managed as a bankruptcy remote entity. To be viewed as such, the SPRV must:

a) be fully funded i.e. the value of its assets must be sufficient to fund its liabilities under the reinsurance contract and its operating expenses. Given that this would be the primary requirement to justify a light regulatory regime for SPRVs, an actuarial certification in respect of the adequacy of the funds raised and its expected income to meet all its liabilities will be required, as a pre-registration requirement;

b) not be part of any corporate group and no third party shall have recourse to the SPRV’s assets held in trust, other than the cedant in respect of the SPRV’s obligations under the reinsurance contract. A written legal opinion with respect to compliance to this condition will be required prior to registration;

c) not engage in any activity other than fulfilling its obligations under the reinsurance contract and the issuance of securities or any other instruments to fund its exposure under the reinsurance contract and operating cost; and

d) ensure that any claims for monies from the SPRV by investors of the ILS and any other parties shall be subordinated to the reinsurance obligations of the vehicle.

Capital and Solvency Margin

2.2.2 Observance of the conditions stated in paragraph 2.2.1 would greatly minimise the chances of a SPRV not being able to meet its reinsurance obligations in full. Hence, there is strong justification to subject the SPRV to the lightest capital and solvency requirements amongst all types of registered insurers:

a) minimum paid-up ordinary share capital of S$20,000;

b) fund solvency requirement, for an insurance fund established and maintained by the SPRV under the Insurance Act, of assets not being less than the liabilities of the fund; and

c) capital adequacy requirement of positive shareholder’s equity and surplus.

Other Key Exemptions

2.2.3 A SPRV will be exempted from the following requirements, which are applicable to registered reinsurers:

a) statutory deposits (Section 14 of Insurance Act);

b) annual actuarial investigations of its insurance liabilities (Section 37 of Insurance Act); and

c) submission of quarterly returns.

A SPRV will only need to submit selected annual unaudited and audited returns.

Annual Licence Fee

2.2.4 MAS will place the onus on the registered insurer which has ceded risks to the SPRV to reflect in its regulatory returns, the impact of the SPRV’s financial condition on the registered insurer’s fund solvency and capital adequacy positions. This would allow a light supervisory approach for SPRVs and as such, we propose to impose an annual licence fee of $5,000 for a SPRV.

2.3 INTERIM ARRANGEMENT

2.3.1 Pending the completion of the consultation process as well as the drafting and implementation of the proposed new legislation governing SPRVs, parties which are interested in setting up SPRVs in Singapore can approach MAS directly to work out suitable arrangements that could be customised according to the type of risks that will be assumed by the SPRV.

3 REGULATORY CREDIT FOR REINSURANCE CEDED TO SPRVs

3.1 CASE BY CASE APPROVAL

3.1.1 Although market players are hoping to develop ILS into a standard product, to-date each deal has been different and usually involve fairly complex structures and terms. As such, MAS will require a registered insurer which intends to cede its insurance risks to a SPRV (whether set up in Singapore or otherwise) and with the intention of obtaining regulatory credit for the reinsurance ceded to the SPRV, to seek prior approval on the amount of regulatory credit applicable. MAS will be amending paragraph 10 of the First Schedule of the Insurance (Valuation and Capital) Regulations 2004 in respect of reinsurance adjustment to reflect this requirement.

3.2 ASSESSMENT CRITERIA

3.2.1 Before a registered insurer can claim regulatory credit for the reinsurance ceded to the SPRV, the transaction must first satisfy the guidelines on substantial risk transfer in MAS Notices 208 and 316, which pertain to general and life financial reinsurance respectively. Should the transaction fail to meet the condition, the contract shall be classified as a financial instrument, for example as a loan or a deposit, and would not enjoy regulatory credit since there is no significant transfer of insurance risk.

3.2.2 Once it has been established that there is significant risk transfer, the onus is on the registered insurer to satisfy MAS that there will be little or no basis risk i.e. any mismatch between the amount of loss under the registered insurer's underlying portfolio ceded to the SPRV and the actual amount recoverable from the SPRV during loss events will be negligible. MAS will expect the registered insurer to develop robust models to analyse this risk, and be able to estimate the capital necessary for the basis risk being retained on its balance sheet.

3.2.3 In the event that a registered insurer invests in an ILS issued by a SPRV for which the insurer is also the cedant, MAS will require the regulatory credit taken by the registered insurer to be reduced, on a dollar for dollar basis, by the amount of finance provided by the registered insurer to the SPRV.

4 TREATMENT OF ILS INVESTMENT

4.1 Registered insurers may also participate in insurance securitisation as investors of ILS. Such investment will attract the same investment and asset concentration risk charges as non insurance-linked securities under the Insurance (Valuation & Capital) Regulations 2004.

4.2 There could conceivably be some correlation in the performance of the ILS held as an investment and an insurer's own underwriting portfolio. Hence, MAS proposes that registered insurers that invest in ILS be required to disclose in the insurance returns, their aggregate quantum of exposure to ILS and provide pertinent information for the ILS investments that may be correlated with their own underwriting portfolios. An insurer with significant investments in ILS that appear to be correlated with its underwriting portfolios may be requested to provide details on how it monitors and manages concentration risk arising from the ILS investment and its underwriting portfolio.

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