

RESPONSE TO FEEDBACK RECEIVED - CONSULTATION PAPER ON THE PROPOSED REGULATORY FRAMEWORK FOR INSURANCE SECURITISATION

1 INTRODUCTION

1.1 On 13 June 2007, MAS issued a consultation paper (“the CP”) inviting comments on the proposed regulatory framework governing Special Purpose Reinsurance Vehicles (“SPRVs”) set up in Singapore to enter into reinsurance contracts and issue insurance linked securities (“ILS”), the proposed regulatory treatment of reinsurance ceded by registered insurers to SPRVs, and registered insurers’ investment in ILS.

1.2 The consultation period closed on 12 July 2007. MAS would like to thank all respondents for their contributions. The list of respondents is in Appendix A.

1.3 We have considered the comments received and will take the relevant feedback into account when drafting the regulatory requirements. Comments that are of wider interest, together with MAS’ responses, are set out below.

2 GENERAL COMMENTS ON THE SCOPE OF THE FRAMEWORK

2.1 Uneven Playing Field

2.1.1 One respondent commented that given the current perceived oversupply of competitive traditional reinsurance in the Asian market, SPRVs will not be necessary in the foreseeable future and is concerned that the “light” supervisory approach for such vehicles will create an uneven playing field.

MAS' Response

2.1.2 Whilst MAS can provide a regulatory framework for insurance securitisation, ultimately there must be commercial demand before such alternative risk transfer transactions will occur in Singapore. The regulatory framework is proportionate to the risks posed by SPRVs, because unlike traditional reinsurers, SPRVs must obtain funds upfront to cover all potential insurance obligations and are only permitted to carry out limited activities as approved by the Authority.

2.2 Types of Insurance Securitisations Permitted

2.2.1 The CP mentioned the use of insurance securitisation as a risk mitigation technique, especially for managing risks arising from pandemics and natural catastrophes. As such, a few respondents were of the impression that the CP is oriented towards Property & Casualty insurance securitisation and sought clarification whether the framework applies to life insurance securitisations and synthetic risk transfer instruments such as credit risk derivatives.

MAS' Response

2.2.2 We would like to clarify that the proposed framework is intended to cover all types of securitisation involving transfer of insurance risks for both life and general insurance business. For life insurance, this refers to one or more of the following types of risks: mortality, morbidity, investment, persistency and expenses, as set out in MAS Notice 316. Therefore, life insurance securitisations such as extreme mortality and embedded value transactions would fall within the scope of the permitted activities of an SPRV. In this aspect, we do not preclude prescribing more details in future for life insurance securitisation if necessary. We would like to clarify that the proposed framework is not intended to cover non-insurance financial products like credit risk derivatives, and an issuer of these products need not be registered as an insurer with MAS.

2.3 Market Access

2.3.1 A respondent sought clarification whether only insurers can use SPRVs, and whether non-insurance corporations can use such structures to purchase insurance as well.

2.3.2 Another respondent queried whether MAS would permit, or treat any differently, business ceded from an insurer registered outside Singapore to a Singapore-based SPRV for securitisation.

MAS' Response

2.3.3 From various publicly available reports, we note that to date, the bulk of global insurance securitisation transactions involve insurance companies transferring insurance risks to the capital markets. Correspondingly, this framework is tailored for SPRVs reinsuring risks from insurance companies. A corporation that wants to set up an Insurance Special Purpose Vehicle ("ISPV") to purchase insurance, and the ISPV itself, will be subject to the appropriate regulatory requirements.

2.3.4 A Singapore-based SPRV will be allowed to accept risks from an insurer registered outside Singapore and there will be no difference in the regulatory treatment of the SPRV.

2.4 Detailed Rules

2.4.1 Some respondents suggested a range of detailed rules governing the operations of SPRVs, including the specific activities and type of investments permitted of such vehicles. Others highlighted additional scenarios which may warrant consideration such as the regulatory capital treatment when the equity tranche is absorbed by the originating insurance company, or when there is retention of risk at different credit rating levels (across the different tranches).

MAS' Response

2.4.2 The rules governing the operations of an SPRV, including the exemptions from applicable legislation, structure, permitted activities, capital and solvency requirements and specific returns to be submitted, will be set out in the Insurance (SPRV) Regulations. The valuable feedback given from the respondents will be taken into consideration when finalising the regulations. However, we do not intend to prescribe details such as the type of investments an SPRV could undertake as such decisions are best left to the parties putting together the deal and the prospective investors, who should be institutional or sophisticated investors with the capacity to assess the merits and risks of such investments.

2.4.3 Also, certifications to confirm that the SPRV is fully-funded and that the ownership structure of the SPRV is bankruptcy remote are considered pre-registration requirements. These will be set out in the application form that will be made available on the MAS website in due course.

3 STRUCTURE AND MODE OF OPERATIONS OF SPRV

3.1 Bankruptcy Remote/ Non-Recourse

3.1.1 It was mentioned in the CP that an SPRV must be structured and managed as a bankruptcy remote entity, and that it cannot be part of any corporate group. A respondent commented that it was unclear what “not being part of any corporate group” means. Another respondent suggested that the SPRV should be a bankruptcy remote vehicle separate from the cedant/sponsor, whereby any notes issued by the SPRV are to be on a non-recourse basis. In other words, the payments due pursuant to the terms of the notes are the obligations of the SPRV only, such that in the event of a default, the note holders will not have recourse to the assets of the cedant/sponsor.

3.1.2 One respondent opined that in order for SPRVs to achieve sufficient “bankruptcy remoteness” from the originators, the framework should address

areas like restrictions on the activities of the entity, limitations on its debt issuance, prohibition of reorganisations, mergers and changes in ownership, independence from the originator, appropriately structured security charges over the SPRVs' assets and tax treatment.

MAS' Response

3.1.3 The intent for an SPRV not to be part of any corporate group is to ensure that the SPRV does not have any related corporation, including any accompanying creditors, which could have recourse to the assets of the SPRV. This forms part of the overarching requirement for the SPRV to be bankruptcy remote. MAS would take note of the suggestions from the respondents when drafting the Insurance (SPRV) Regulations.

3.2 Multiple Cedants and Contracts

3.2.1 A respondent proposed allowing SPRVs to deal with multiple cedants and to issue multiple reinsurance contracts, as some multi-tranche transactions use multiple contracts. Furthermore, as with traditional reinsurance, the reinsured might consist of multiple entities.

3.2.2 A respondent suggested that in situations where an SPRV introduces a multi-issuer programme to issue a segregated series of securities, each backed by a segregated pool of assets, proper guidelines should be in place to ensure that the segregation vehicle is bankruptcy remote for each series of securities. This means that if one series of securities defaults, the issuer's creditors (including the relevant series security holders) cannot render the issuer insolvent or accelerate its obligations. Such a structure will enable different pools of exposures to be created for different investor appetites. In addition, instruments with different credit ratings may be issued to reflect the underlying risk of the portfolio being securitised.

MAS' Response

3.2.3 The proposed framework will not preclude an SPRV from issuing multiple reinsurance contracts to a single cedant or to multiple cedants,

provided that at all times, the SPRV is fully-funded up to the aggregate limit of the reinsurance contract(s), if any. However, it should be noted that currently there is no legislation that provides the necessary legal segregation between the assets and liabilities attributable to different cedants of reinsurance risks to the SPRV.

3.3 Permitted Activities of a SPRV

3.3.1 In the CP, it was proposed that an SPRV should not engage in any activity other than fulfilling its obligations under the reinsurance contract and issuing securities, or any other instruments, to fund its exposure under the reinsurance contract and the operating costs. A respondent commented that this strict “single purpose” intent is overly restrictive and would not allow for the SPRV to enter into derivative contracts (in particular, asset total return swaps) or service contracts.

3.3.2 Another respondent suggested that it may be better to restrict the activities of the SPRV by excluding “non-related activities”, and that it may be helpful to specifically expand the scope of permissible activities to include day-to-day management and operation of the SPRV.

MAS' Response

3.3.3 We note the potential practical difficulties and unintended consequences that might arise from the restrictions posed by the strict definition. We will make adequate provisions in the Insurance (SPRV) Regulations to allow the SPRV to undertake activities that are necessary for it to fulfil the purposes that it is registered for under the Insurance Act.

3.4 Fully-funded – Actuarial Valuation

3.4.1 It is stated in the CP that an SPRV must be fully-funded, and that an actuarial certification in respect of the adequacy of funds raised from investors (including the expected income arising from investing these funds) to meet all liabilities will be required. A respondent informed that being fully-

funded is a concept that works on a current or inception basis, but it does not accommodate the funding of future liabilities if such liabilities are growing. Most ILS issued in the US will have the ability to issue more debt in order to continually fund any future reserve strain.

3.4.2 A respondent also pointed out that in the ILS transactions that have been undertaken so far, actuarial firms certify that the assumptions used to develop the cash flows are valid and reasonable, but do not provide certification on the adequacy of the funds or the expected income needed to satisfy the liabilities.

3.4.3 There was also a suggestion to replace the actuarial certification requirement with the submission of an operating budget and certification from the sponsor of the SPRV together with such other supporting evidence as reasonably required by the regulator. The respondent was also of the view that actuaries have no particular expertise in evaluating the adequacy of operating expenses, and that operating expenses will not be fixed in any case. The respondent suggested that the SPRV should only be fully-funded up to the stated limit for an excess of loss transaction, and that for contracts like proportional reinsurance treaties, a requirement to be fully-funded is not practical. The respondent was of the view that being fully-funded should not include coverage for operating expenses if there is only a remote risk that funds are insufficient to cover operating expenses and this risk has been adequately disclosed to the ceding companies.

MAS' Response

3.4.4 MAS notes the respondents' comments and would continue the dialogue with market players to determine what would be considered as sufficient assurance that an SPRV has met the requirement to be fully-funded. MAS is prepared to consider alternative supporting evidence that can demonstrate that an SPRV has met the requirement to be fully-funded, for example if the SPRV only enters into reinsurance contracts with clear aggregate limits of exposure and/or liabilities.

3.5 Subordination

3.5.1 It was proposed in the CP that any claim for monies from the SPRV by investors of the ILS and any other parties should be subordinated to the reinsurance obligations. A respondent commented that the requirement to put the reinsured in first position in the waterfall in all respects would not work in regards of asset-total return swaps, multi-tranche setups, and proportional arrangements.

3.5.2 Another respondent felt that the requirement is acceptable in principle, but the term "any other parties" is too broad. For example, the expenses for operating the SPRV should not be subordinated to the reinsurance obligations.

3.5.3 It was further suggested that to further protect the solvency of SPRVs, MAS may consider imposing restrictions on the use of capital funds exclusively for the repayment of reinsurance obligations and capital repayments only. Clearly distinguishing assets and liabilities for their primary purpose would assist SPRVs in meeting the obligations that they had been set up for, and would mitigate the need for subordination of other claims.

MAS' Response

3.5.4 MAS notes the comments and would qualify the requirement appropriately in the Insurance (SPRV) Regulations to permit other payments such as those for operating expenses to be made before paying out the claims arising from the reinsurance obligations. However, MAS does not intend to prescribe rules on the usage of capital funds. Instead, we would expect the stakeholders of the SPRV to impose the appropriate governance and controls to ensure that the capital funds are used appropriately.

3.6 Capital & Solvency Requirements

3.6.1 A respondent commented that the regulatory requirements should take into account both the difference between (a) the accounting impact, and

(b) the actual assets available to support liabilities of the SPRV. For example, an SPRV can experience an accounting loss associated with an increase in reserves or an accounting write-down, but neither may have a real economic impact on the SPRV. The respondent informed that there have been cases of SPRVs having negative shareholder's equity from an accounting perspective, but still being fully-funded to meet any current or future liability.

3.6.2 Clarification was also sought in respect of the issuance of variable interest and principal-at-risk securities, specifically whether such issuances will conflict with the technical solvency requirement.

MAS' Response

3.6.3 MAS will require the assets of an SPRV to be at least equal to its liabilities. If an SPRV's liabilities are greater than its assets, the SPRV will have to demonstrate that it continues to be able to meet its liabilities in full. The valuation basis for assets and liabilities will be in accordance with the Insurance (Valuation and Capital) Regulations 2004.

3.6.4 The issuance of variable interest and principal-at-risk securities will not conflict with the regulatory solvency margin requirement.

3.7 Investments held by an SPRV

3.7.1 Whilst one respondent commented that there was no need to specify limitations on the types of investments that a SPRV may hold, another respondent felt that some consideration should be given to provide for criteria or guidelines regarding the types of investments that a SPRV can hold, for example, the SPRV should be allowed to invest only in highly rated liquid assets. Investment in illiquid or speculative assets may pose problems in terms of liquidation and trading, and may increase the severity of loss to ILS holders.

3.7.2 There was also feedback that securities with tenors longer than the maturity of the eligible investments may introduce market risk to the

repayment of principal to ILS holders upon the sale of the collateral. Hence, there should be appropriate asset-liability management to address investment risks, like interest rate risk and currency exchange risk.

MAS' Response

3.7.3 MAS agrees that the SPRV should invest the funds prudently, and would give due consideration to the investment strategy of the SPRV at the application stage, as part of the assessment of the overall risk management systems and controls that the SPRV would put in place. However, as mentioned in paragraph 2.4.2, it would be more appropriate for the SPRV and other key stakeholders, such as the cedant and the investors, to determine how the funds should be invested and in what manner should various inherent risks be managed.

3.8 Accounting Treatment and Performance Measurement

3.8.1 One respondent suggested that guidelines should be in place to address the nature and process of monitoring the performance of the ILS. This could involve recommending a standard report to be furnished by the servicer on a periodic basis, containing information sufficient for rating agencies to assess the performance of the insurance portfolio. It may also include regular evaluation of servicers and validation of their procedures and accounting methodology.

3.8.2 Another respondent felt that in the pricing process, understanding the implications of the deal price is important. The lack of expertise by participants would be detrimental to the long term development of the market.

3.8.3 One of the respondents commented that interest payments should be calculated in accordance with the Singapore accounting standards and that it is important that the calculation of interest payments can be reproducible by an independent party. External parties, using the same information, should be able to verify that the calculation of interest is accurate. Similarly, there should be certain guidelines to ensure proper standards are in

place with servicers when evaluating a claim. Claims may also have to be validated by a third-party to ensure independence from the originator/servicer.

3.8.4 Another respondent commented that the results of the underlying portfolio covered by the reinsurance contract may take longer than 3-5 years to manifest and questioned the point at which these accounts will be closed off. He suggested that clear regulations on the accounting treatment may be required for open liabilities as this may result in unresolved accounts due to contingent events normally associated with insurance liabilities. Duration and the cost of insurance may be impacted by these factors.

MAS' Response

3.8.5 Unless otherwise provided by insurance legislation, all registered insurers, including SPRVs, are required to present their financial statements in accordance with the Singapore Financial Reporting Standards and be subject to annual statutory financial audits by external auditors. However, we feel that it is more appropriate for stakeholders like the cedant, rating agencies and investors to work out the requisite disclosure and controls to be put in place when structuring and rating an insurance securitisation transaction.

3.8.6 In addition, as part of our on-going supervision, a ceding insurer which is registered in Singapore will be required to assess the adequacy of the claim liabilities reserved by the SPRV it originates, in order to claim regulatory credit for the risk transferred to the SPRV.

3.9 Taxation of SPRVs

3.9.1 A respondent noted that the taxation of SPRVs is an important issue where clarity is required.

MAS' Response

3.9.2 The existing tax concession scheme for asset securitisation will be extended to include insurance securitisation. This will create an efficient tax

environment for the structuring of insurance securitisation vehicles and its capital market issuances out of Singapore.

4 REGULATORY CREDIT FOR REINSURANCE CEDED TO SPRVs

4.1 Reinsurance Transactions Failing Risk Transfer Test

4.1.1 Section 3 of the CP sets out MAS' intended approach and assessment criteria in respect of regulatory credit for reinsurance ceded by insurers registered in Singapore to SPRVs. In response, one respondent suggested that a transaction with the legal form of reinsurance, but not meeting standard insurance risk transfer tests with similar economics to bank securitisations achieving regulatory relief, should obtain equivalent regulatory relief, even if lower than the full relief available for normal reinsurance transactions.

MAS' Response

4.1.2 As per the current treatment for all reinsurance arrangements, reinsurance ceded to SPRVs that fail the significant risk transfer test will be treated in accordance with MAS Notices 208 and 316. MAS will review whether further guidance is required.

4.2 Level of Basis Risk

4.2.1 In the CP, it was stated that an insurer intending to claim regulatory credit for an ILS transaction will be expected to assess potential basis risk that might arise from the transaction. A respondent commented that the use of negligible basis risk as a standard for being able to claim reinsurance credit will limit insurance securitisations to those that employ indemnity-type default triggers. This would be too restrictive. Another respondent shared a similar view and commented that the basis risk treatment is inconsistent with other jurisdictions. The respondent added that it is not clear why a different standard would apply for reinsurance under an insurance securitisation transaction than for traditional reinsurance that also introduces basis risk.

Generally, in other jurisdictions, double trigger approaches (eg. industry loss warranties) do qualify to be treated as a form of reinsurance.

4.2.2 Another respondent asked whether MAS will be issuing guidance on how it would want an insurer to demonstrate that there is little or no basis risk, and/or the extent to which basis risk will be permitted. The respondent shared that based on past experience, it is extremely difficult to quantify basis risk reliably ex-ante.

MAS' Response

4.2.3 MAS appreciates that it would be difficult to quantify basis risk reliably, but as with other forms of non-traditional reinsurance, the registered insurer that is seeking regulatory credit for the reinsurance contract with the SPRV must demonstrate that there will be significant risk transfer in order to obtain any regulatory relief. We would like to clarify that the granting of regulatory credit will not be limited to only indemnity-type ILS transactions. In addition, even if some basis risk exists, regulatory credit may still be granted but the amount would likely be lower than the amount of credit applicable to an indemnity-type contract. MAS will continue to work closely with market players on this issue.

4.3 Investment in ILS by a Sponsor

4.3.1 The CP proposed that if 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. A respondent suggested that any reduction in regulatory credit should be based on the nature of the risk as well as the nature of the investment instead of reduction on a dollar-for-dollar basis.

MAS' Response

4.3.2 The amount of regulatory credit to be reduced will be evaluated on a case-by-case basis, and the maximum reduction in regulatory credit granted will be the dollar-for-dollar reduction. In determining the appropriate reduction

in regulatory credit given, we will take into consideration the impact that the investment in the ILS issued by the SPRV will have on the registered insurer. Ultimately, there must continue to be a significant risk transfer after taking into consideration the amount of ILS purchased by the cedant.

5 INVESTMENT IN ILS

5.1 Investors of ILS Not Carrying On Insurance Business

5.1.1 Respondents sought clarification on whether investors who purchase ILS will be considered to be carrying on insurance business, as these investors will then have to be registered with MAS accordingly.

MAS' Response

5.1.2 Investors who purchase ILS will not be considered as carrying on insurance business and therefore are not required to be registered as an insurer.

5.2 Accumulation Risk

5.2.1 One respondent commented that by allowing insurers to participate in ILS issued by Singapore SPRVs, it may precipitate the advent of an incestuous market spiral similar to the LMX (London Excess of Loss Market) spiral experienced by the Lloyd's market. It would be normal, for example, to expect that a catastrophic event in Singapore would affect most insurers and consequently an aggregation of losses would occur in both underwriting and investment if insurers participated in catastrophe type ILS.

MAS' Response

5.2.2 While MAS shares the respondent's concern regarding accumulation risk, we would like to highlight that a n SPRV based in Singapore may not necessarily be reinsuring domestic risks. We do not want to prohibit Singapore insurers from investing in ILS issued by a Singapore-based SPRV as such investments, if uncorrelated with their underwriting portfolios, could

provide diversification benefits to these insurers. In the event that a registered insurer's ILS investment has significant correlation with its underwriting portfolio, we will consider the appropriateness and necessity of imposing additional capital requirements on the insurer.

Appendix A

List of Respondents to the Consultation Paper on the Proposed Regulatory Framework for Insurance Securitisation

1. Mr Allwyn Barreto
2. Fitch Ratings
3. Navigation Advisors, New York
4. Scottish Re Group Ltd
5. Standard & Poor's
6. Swiss Re
7. XL Re