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U.S. Alternative Risk Management Products: A Reinsurance Perspective*

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1. Introduction

Unprecedented losses associated with U.S. natural disasters in the early 1990s caused the insurance and reinsurance industries to reassess the financing and underwriting of natural hazard risk. This reassessment led to an increased demand for catastrophe reinsurance and capacity in the marketplace rebounded. Most insurers realigned their risk exposure and reevaluated their reinsurance programs, while some insurers, particularly those who believed the price of catastrophe reinsurance was equivalent to or higher than their potential cost of capital, looked for alternatives to traditional reinsurance.

Since 1994, reinsurers, investment bankers and financial market traders have moved to develop additional contingent capital, reinsurance and derivative risk management products. Additionally, they have sought to increase market capacity through newly capitalized companies. Depending on a particular buyer's needs, these new risk management products will provide an alternative to or will supplement traditional reinsurance.

The success of these alternative risk management products depends, in large part, upon the way they are viewed by insurance regulators, the credit risk associated with them, the structure in which they will be utilized and the accounting treatment they will be afforded.

During the 1990s, U.S. insurance regulators have been struggling with these issues in an attempt to find the proper balance between maximizing market capacity while ensuring that proper solvency standards are maintained. This struggle continues to play itself out in the forum of the National Association of Insurance Commissioners (NAIC) where a group of insurance regulators (Insurance Securitization Working Group) has been working on a variety of alternative risk issues, including: a protected cell approach to securitizations, the creation of on-shore special purpose vehicles and reinsurance-like accounting for derivative products. Consistent with NAIC practice, a group of technical advisors has been assembled to work on the development of draft legislation, accounting guidance and other regulatory papers for consideration by the Working Group. This technical group (Advisory Committee) includes among its members, lawyers, investment bankers, accounting firms, insurers, reinsurers and other consultants.

The focus of this article includes a brief overview of the various types of alternative risk management products and structures being considered by the NAIC, the accounting issues associated with those products and mechanisms and the perspective of at least some reinsurers in terms of how these issues affect and relate to the continuing role of traditional reinsurance.

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* A continuation of this article will be published in the October issue of *The Geneva Papers*.

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2. Derivatives treatment, exchange and over the counter products

The NAIC is once again reviewing the accounting treatment of derivatives used by insurers as investments or for the purpose of hedging risks. It first reviewed this issue in June 1993 when the Chicago Board of Trade (CBOT) sought approval from the NAIC for a change in accounting rules that would have allowed insurers underwriting treatment for property catastrophe futures and options. In 1993, after several regulatory groups considered this request, the CBOT saw the writing on the wall and acceded to a "miscellaneous income" treatment for insurers which used the products. The resulting NAIC rule on investment income accounting for these products remains in place today.

Continued interest in managing property catastrophe risk and in securitizations, however, has led a group of advocates to approach the NAIC to seek revised accounting treatment for derivative products. Although the arguments have largely focused on property catastrophe risk, the process has encouraged development of regulations that would be open-ended with regard to the type of risk hedged with derivatives products. At the October 1999 NAIC meeting, it is expected that a substantial amount of time will be devoted to the accounting treatment to be afforded derivative products. The earliest any NAIC revised accounting language could be approved appears to be well into 2000.

Critical issues

Reinsurers and the RAA have argued that the NAIC review should be guided by its practice with respect to reinsurance accounting treatment. The RAA has argued that a lesser standard if adopted for derivative products, inevitably will lead to requests for further weakening of U.S. reinsurance regulation. For reinsurers to be able to compete on a level playing field with derivative product competitors, they will need to play by the same collateral ground rules. The RAA has advocated that for any derivative product to receive reinsurance-like-accounting treatment, the derivative product and its sellers must be either subject to insurance regulation or collateral must be provided to secure the transaction.

The RAA has argued that the cornerstone of U.S. reinsurance regulation is that credit for reinsurance is permitted only if:

(1) the reinsurer is subject to state insurance regulation; or
(2) collateral is posted to secure the transaction.

In essence, the U.S. policy is one of open market access – any non-U.S. reinsurer can participate in the market, but as a surrogate for U.S. regulation, collateral must be provided to secure the transaction. This is essential to strong solvency regulation. Insurance regulatory laws, to which licensed U.S. reinsurers are subject, are designed to ensure the solvency of the ceding insurer and likewise the solvency of the reinsurer. Reinsurers not subject to U.S. regulation may, depending on their country of domicile, be subjected to no regulatory oversight or weaker oversight than U.S. regulators deem to be sufficient.

Therefore for a derivative product to qualify for reinsurance-like accounting treatment, the counter party must be subject to U.S. insurance regulation or collateral must be provided. Counter parties who do not meet these requirements may be subject to no regulatory oversight or oversight that does not meet the high standards established by U.S. regulators to ensure the solvency of ceding insurers. For the most part, this paradigm has been adopted by the NAIC's Insurance Securitization Working Group in its continuing study of the proposed changes in derivative accounting.

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The second major issue which the NAIC must confront is whether derivatives truly hedge underwriting risk. In a 1993 letter to California's top financial regulator, Thomas Thompson, the Senior Economist at the CBOT, accurately framed this issue:

> [I]t became clear that the Working Group was reluctant to embrace full reinsurance-like accounting treatment. At the meeting on 20 September, the Working Group expressed concern about any treatment of insurance futures and futures options which would affect companies' loss ratios because these products are new and have not generated sufficient history to make regulators comfortable with them. Accordingly, the Working Group voted to account for insurance futures and futures options by including income from these transactions at line 12 as miscellaneous income.[1]

Thus, the central concern of regulators in 1993 remains a significant concern today. Others argue, that the historical tests are irrelevant, that the sophistication in catastrophe modeling that has developed in the ensuing six years provides enough relevance in testing the efficacy of the products.

The third critical issue is the scope of the proposed new derivative accounting. Justification for the underwriting accounting treatment has been based on the need to transfer risk with regard to property catastrophes. An argument has been advanced that either there is insufficient reinsurance capacity to manage this risk, or that an alternative to reinsurance may reduce the volatility with regard to current utilization of reinsurance to manage it. Of course today, the catastrophe reinsurance market provides abundant capacity at price levels that continue to decline. Setting aside property catastrophe risk, however, there is no similar argument to be made for management of liability risk. Use of derivative products to manage liability risks creates greater questions for regulators with regard to valuation and measurement of the risk that is transferred. One solution might be to limit the revised accounting treatment to property catastrophe risks, deferring the question of whether such treatment should be afforded for liability risks.

The following subsections address the major components of the NAIC project addressing the treatment of derivatives, exchange and over the counter products.

Triggers, indemnity vs index

The NAIC work, thus far, addresses two types of triggers. An indemnity trigger is one where "relief of the issuer's obligation to repay investors is triggered by its incurring a specified level of losses under its policies of insurance or reinsurance."[2] An indemnity trigger is also defined to include a dual trigger in which both an indemnity trigger and an index trigger must be met.

A "non-indemnity" trigger is defined as one where "relief of the issuer's obligation to repay investors is triggered solely by some event or condition other than the individual insurer incurring a specified level of losses under its insurance or reinsurance contracts."[3] Exchange traded derivatives are expected to be index based.[4]

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[1] The letter was publicized by its submission to the Emerging Accounting Issues Working Group of the NAIC on 24 November, 1993. Letter of Thomas Thompson, Chicago Board of Trade, to Norris Clark, California Insurance Department (23 September, 1993) (on file with the NAIC).

[2] Technical Resource Group Draft Paper on Index Based Insurance Derivatives, NAIC Insurance Securitization Working Group 1 (9 September, 1999) (on file with the NAIC).

[3] *Id.*

[4] *Id.*

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Collateralization

The draft paper prepared for the Insurance Securitization Working Group requires that, in order to receive reinsurance like accounting, collateral must be provided for over the counter traded instruments when the protection is provided by a non-U.S. insurance regulated entity. Collateral must be secured in a trust for the benefit of the transferring insurer and equal to the fair value of the insurance-linked derivative. The collateral must be held in the U.S. in a qualified financial institution, subject to withdrawal solely by and under the exclusive control of the transferring insurer.[5] The standards further described by the Working Group are the same as those which apply to traditional reinsurance pursuant to credit for reinsurance rules.

Thus far, the Advisory Committee has advocated an exception to the collateralization requirements for "exchange traded" derivatives. Advocates of this point of view note that the exchanges are regulated by the Commodities Futures Trading Commission (CFTC) and that the counter parties for exchange traded derivatives are either regulated trading corporations or clearing corporations, the credit risk of which are guaranteed by the member trading firms. They argue that the exchanges would not be willing to subject themselves to segregated accounting for insurance derivatives nor would they be willing to make special allowance for insurance receivers to be able to attach a segregated pool of assets. As a result, advocates of this approach claim that an exemption from collateralization is justified. The RAA continues to argue against this point of view before the Advisory Committee and will continue to do so before the Insurance Securitization Working Group. The RAA's rationale is as follows:

- The paradigm that should be followed is the same one that applies to traditional reinsurance in which there is no exemption from the collateralization requirement unless the assuming entity (reinsurer) is subject to insurance regulation. Neither the exchanges nor the counter parties are subject to such regulation;
- Exchanges carry a credit risk which remains unprotected absent collateralization;
- U.S. receivers have, in the case of reinsurance under like circumstances, a fund to attach for the benefit of an insolvent insurer's creditors. One of the prominent U.S. exchanges requires only partial funding, on a margin account basis, of exchange traded risk. A collateral fund is necessary to achieve this goal for exchange traded derivatives, and that fund, like reinsurance requirements, should be fully funded to the extent that reinsurance-like-accounting is being authorized for these products;
- If U.S. regulators accept CFTC regulation as a surrogate for insurance regulation in this instance, a precedent is set (or a loophole created) that invites banks and securities firms to follow; and
- Creation of this loophole for exchange traded products will give reinsurers a strong basis to pursue weaker regulation in order to more effectively compete in the risk transfer markets.

This argument has been framed for discussion by the Insurance Securitization Working Group.

Basis risk

Index based derivative products will contain basis risk. The Advisory Committee's draft paper suggests that regulators accept several methodologies for which basis risk can be

[5] *Id.* at 3, 4.

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managed by the insurer. It is the consensus of the Advisory Committee, that if the insurer meets these tests, the existence of the basis risk itself is not a reason to deny reinsurance-like-accounting treatment. Among the suggestions for management of basis risk are the following:

- Computer modeling;
- Swapping the basis risk to an authorized reinsurer;
- Adjust the attachment point of the derivative to a point in which the certainty of a loss is substantially increased and the basis risk is minimized.[6]

In a draft American Academy of Actuaries' paper on "basis risk", summarized in the Advisory Committee's paper to the Insurance Securitization Working Group, three key factors are identified to measure the relationship of the derivative to the underlying underwriting risk:

(1) Common causation – a viable economic/financial argument must be made that there is a causal relationship between the risk to be hedged and the index (or indices) underlying the hedging instrument.

(2) Relationships of hedged losses to recoveries – there must be demonstrated, under a range of scenarios, a reasonable relationship between the losses to be hedged (often referred to below as 'hedged losses'), and the potential recoveries from the hedging transaction.

(3) Reduction of risk – it must be shown that one can reasonably expect risk to be reduced by the use of the hedging transaction.

It is necessary that all three of these criteria be fulfilled for a hedging transaction to be considered effective. These criteria are the same regardless of whether or not historical data – or a formal model – exist.[7]

The Academy paper further notes: "The purchase of reinsurance, on the other hand, generally does not expose the ceding company to basis risk. It is unlikely that, even with supportive regulatory treatment, index-based insurance derivatives will gain broad acceptance until companies are confident in their ability to measure and minimize basis risk on a pre-event basis."[8]

At the October 1999 NAIC meeting, the American Academy of Actuaries provided a review of the degree to which such hedge products should be expected to relate with an insurer's actual losses. The regulators have identified this correlation issue as their primary concern with regard to granting underwriting account treatment to derivative products.

While only a draft paper from the Academy is available at the time of this writing, the chief drafter of that paper recently provided some insight into the Academy's working framework. The author noted that the Academy group had determined that any effort to use a probability based measure in the area of 95 per cent was far too restrictive. He noted, after reviewing various derivative products in use, that the 95 per cent probability test (one which had been suggested by some insurance regulators) would likely not be achievable, or if achievable would so substantially increase the price of the derivative product as to render it not feasible. The author noted that the Academy was likely to consider a description of acceptable

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[6] Technical Resource Group Draft Paper, *supra* note 3, at 4.

[7] *Id.* at 4, 5, *quoting* Paper on Evaluating the Effectiveness of Index-Based Insurance Derivatives in Hedging Insurance Transactions, American Academy of Actuaries Index Securitization Task Force (7 September 1999).

[8] Paper on Evaluating the Effectiveness of Index-Based Insurance Derivatives in Hedging Insurance Transactions, American Academy of Actuaries Index Securitization Task Force 6 (15 July 1999).

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basis risk as being in the range of 80 per cent to 120 per cent. He noted that basis risk included the possibility that MORE would be recovered and not just LESS and suggested that insurance regulators are primarily interested in the "under recovery" potential. The author described the Academy as considering the appropriate measure of the basis risk to be one that measured the products, on a pre-event basis, at a 75 per cent to 90 per cent probability that the product would provide a recovery of 80 per cent to 120 per cent of expected losses. He also suggested that a sliding scale approach might be taken where the acceptable probability could be lowered to perhaps 75 per cent if the hedging impact of the product on the insurer's surplus was low; and range up to 90 per cent if the hedging impact compared with the insurer's surplus was more material.[9]

Valuation method

According to the paper, derivatives used by insurers in hedging activities must be accounted for in a manner consistent with the item hedged. If the item hedged is accounted for at amortized cost, then the hedging derivative also is accounted for amortized cost. Likewise, if the item being hedged is accounted for at market value, then the derivative is accounted for at market value. The valuation basis for index based insurance linked derivatives should be fair value.

> Fair value [is defined as] . . . the amount at which that asset could be bought or sold in a current transaction between willing parties. Quoted market prices in active markets are the best evidence of fair value and should be used if available. If quoted market prices are not available (as is the case in over the counter instruments); the estimate of fair value shall be based on the best information available, considering values of like instruments and other valuation methods [actual losses, present value of cash flows, historical analysis of index], . . .[10]

This fair value accounting treatment appears to follow the lead being taken with regard to the insurance accounting guidance being developed through the International Insurance Accounting Standards Committee.

Accounting treatment

Amounts paid for an index-based insurance derivative instrument, which has an acceptable basis risk relative to an insurer's underwriting exposure, must be reported as a reduction of written premiums by the ceding company and amortized over the remaining contract period in proportion to the amount of hedging protection provided, or, if applicable, until the counter party's maximum liability under the agreement has been exhausted. Changes in fair value on these instruments must be recognized as a reduction of gross losses and loss expenses incurred in the current period statement of income. Insurance derivative recoverables on paid losses must be reported as an asset, "insurance derivative recoverables on loss and loss adjustment expense payments," in the balance sheet. Insurance derivative recoverables on unpaid case-basis and incurred but not reported losses and loss adjustment

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[9] Note, we report these comments for insight into the Academy's work. They should not be interpreted as reflecting an ultimate Academy work product.

[10] Technical Resource Group Draft Paper, *supra* note 3, at 4.

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expenses are required to be netted against the liability for gross losses and loss adjustment expenses. If the instrument is no longer an effective hedge, then it loses its status as an underwriting account item and reverts to miscellaneous income accounting treatment.[11]

If a derivative instrument produces both indemnification and speculative gain, then the loss based recovery is accounted for on the underwriting side and the speculative gain is recorded in the investment accounts.

3. INEX rule

On 30 November 1998, the Illinois Insurance Department approved a regulation filed by the INEX Insurance Exchange to conduct U.S. based securitization transactions. INEX is the old Illinois Insurance Exchange in a reconstituted form. INEX writes its own rules but is under supervision of the Illinois Insurance Department. In order to approve any INEX based securitization the Insurance department requires that:

- A detailed description of the insurance securitization be submitted to the Director not less than 30 days before the program is implemented;
- Unless disapproved, within the 30 day period, an insurance securitization in accord with INEX rules shall be deemed approved; and
- At least 5 days prior to final asset distribution of any insurance securitization program, written certification must be delivered to the director that all insurance or reinsurance obligations of the program have been satisfied or completed.

The regulation allows insurers to transfer insurance risks to special purpose limited syndicates (syndicates) at the INEX. The syndicates, in turn, issue securities to private investors and place the proceeds in a trust which serves to fully collateralize the underlying insurance risk.

Illinois, which is the home to four of the country's largest insurers, views its role in approving the regulation as assisting its domestic insurers in strengthening their ability to compete in markets by providing new ways of accessing capital. In a 30 November 1998 press release, then Acting Insurance Director Arnold Dutcher stated:

> As the home state of some of the largest property and casualty insurers, Illinois' domestic industry is particularly vulnerable to major catastrophic losses including a significant earthquake exposure along the New Madrid fault. The ability to transfer some of those risks to the capital markets through an onshore mechanism better enables companies to manage their risk exposures.[12]

What is unique about the INEX approach is that it allows on-shore securitizations. Previously, the catastrophe related transactions that have been done since 1994 have been accomplished through the creation of off-shore special purpose vehicles located typically in tax haven jurisdictions. Representatives of INEX believe that a benefit of the regulation is that the issuance and the purchase of securities will be explicitly defined as not being the "business of insurance." This designation assures investors protection from insurance regulators who might otherwise be able to penalize them for engaging in insurance without the requisite licenses and other appropriate structures. Since the transaction occurs with insurance

[11] *Id.* at 9, 10.
[12] Illinois Department of Insurance, Press Release (30 November 1998).

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regulatory supervision and approval, advocates argue that it gives stakeholders an even higher level of security.

In essence, under the INEX rules a Limited Syndicate (LS) can be formed in a manner that exempts it from INEX guaranty fund and deposit regulations. The syndicate can not write business directly but can participate with other syndicates in acting to insure or reinsure risk.[13] A Special Purpose Limited Syndicate (SPLS) can be created to complete one or more securitization transactions.[14] The SPLS must establish a trust in which all assets are held and administered in Illinois and invested in securities meeting liquidity and security requirements established in the business plan. The SPLS basically serves as a reinsurer of the Limited Syndicate with the assets held in trust serving to collateralize the liabilities of the Limited Syndicate. The purchase of securities issued by the SPLS, or any person directly or indirectly controlling or holding a debt or equity interest in a SPLS, does not constitute the transaction of an insurances business. Underwriters or selling agents involved in the securitization similarly are deemed not to be conducting the business of insurance.[15]

On 26 March, INEX completed its first securitization transaction in a program led by Aon Capital Markets for the benefit of Kemper Insurance Companies. Kemper received reinsurance protection for $100 million of Midwest earthquake coverage. The transaction was the first to secure solely central U.S. earthquake exposures and the first securitization transaction to be completed on-shore. As if those "firsts" were not enough, it was also the first such transaction using the new INEX mechanism.[16]

The INEX component of the Kemper/Aon transaction included the use of a SPLS [Domestic Re] which provides retrocessional protection to a syndicate [Kemper Secure] which, in turn, provides reinsurance protection to Kemper. Domestic Re holds the collateral for the multi-year transaction in trust. The source of the capital is Domestic Inc., which is a Delaware-based corporation [Domestic Inc] that issued $80 million in debt and $20 million in equity. This capital provides the assets for Domestic Re.[17]

To date no additional INEX securitizations have been publicly announced. Although the transaction appears complex, its advocates argue that it can be replicated and that it clearly passes muster with regard to the appropriate U.S. tax treatment. Although taxable income still exists on the dividends paid on the securities, the structure operates in such a way as to minimize taxation. Based on conformance with U.S. tax case law, the advocates are confident of the tax treatment and are not expected to seek a private letter ruling from the U.S. Internal Revenue Service.

4. Protected cell legislation

Having had experience with the INEX Rule, the Illinois Department of Insurance has been a regulatory leader in the development of the NAIC Protected Cell Company Model Law.

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[13] INEX Insurance Exchange, Regulation 27 B, Operation of a Limited Syndicate.
[14] INEX Insurance Exchange, Regulation 27 C, Special Purpose Limited Syndicate.
[15] INEX Insurance Exchange, Regulation C 3, Special Purpose Limited Syndicate.
[16] INEX Insurance Exchange, Press Release (26 March 1999).
[17] Anthony A. Rettino, Jr., Address at the RAA Education Conference (25–27 May 1999); (Anthony A. Rettino, Jr. is Managing Director, Aon Capital Markets).

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The concept of the protected cell is to provide a mechanism whereby insurance securitization transactions can be done by an insurer through a separately established account – that is, separate from the assets and liabilities of the insurer's general account.

During the first half of 1999, the Insurance Securitization Working Group and the Advisory Committee worked toward the goal of drafting model legislation that was eventually adopted by the NAIC at the June 1999 NAIC meeting (NAIC Protected Cell Model).

The NAIC Protected Cell Model allows a domestic insurer to establish one or more protected cells with the written approval of the commissioner after reviewing a plan of operation that provides for, among other matters, specific business and investment objectives of the protected cell. In establishing the protected cell, the insurer can transfer assets from the general account to the segregated account. While a protected cell may assume obligations from the insurer's general account, it cannot directly assume obligations from third parties. A protected cell must fully fund the obligations it assumes, whether or not the insurance securitization is indemnity or non-indemnity triggered.[18] Transactions that are not fully funded are prohibited.

The NAIC Protected Cell Model contains various safeguards to ensure that investors are aware of the terms governing the protected cell. For example, an important feature of the model legislation is the "bankruptcy-remoteness" of the protected cell assets. In the event of the insolvency of the protected cell, investors may look only to the assets of the protected cell for the satisfaction of any sums owing to them, not to the general account of the insurer. Likewise, in the event of the insolvency of the insurer, the protected cell assets are not available for payment to the creditors of the insurer that are not otherwise entitled to funds from the protected cell. Additionally, the assets of one protected cell are protected from the claims of creditors of other protected cells established by the same insurer.

Like the transactions conducted pursuant to the INEX Rule,[19] and the Off-Shore Special Purpose Vehicles,[20] the insurance securitization transactions of the protected cell do not constitute the doing of an insurance business.

Rhode Island was the first state to adopt legislation in 1999 based on the NAIC Protected Cell Model,[21] followed closely by Illinois.[22] Vermont also enacted a protected cell statute in 1999, not based on the NAIC Protected Cell Model, which authorizes the creation of protected cells by captives for certain purposes.[23]

5. Proposed on-shore special purpose vehicle

Within the context of continued NAIC exploration, U.S. insurers have created several task forces to attempt to craft NAIC regulations, model legislation and U.S. tax legislation that would allow for the creation, within the U.S., of special purpose vehicles (SPVs) that will, on a tax advantaged basis, be able to handle securitizations of catastrophe risk. At least one insurer is aggressively pursuing this project arguing that the administrative burden of off-shore SPV's

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[18] *See supra* Section II, Triggers, Indemnity vs. Index, of this paper for an explanation of indemnity and non-indemnity triggers.

[19] *See supra* Section III of this paper.

[20] *See supra* Section V of this paper.

[21] R.I. Gen. Laws §§ 27-1.1, 27-12.2-2, 27-14.1-2, 27-14.3-2, 27.14.4-2, 27-16-1.2, 27-34, 27-35-1, 27-43, 27-52-2 (NILS 1999).

[22] 215 ILL. Comp. Stat. 5/107.06a, 5/179A-1 to 5/179A-40 (NILS 1999).

[23] Vt. Stat. Ann. tit. 8 §§ 6001-6002, 6004-6011, 6014, 6018, 60020-6023 (NILS 1999).

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limits their utility and that U.S. tax law uncertainty potentially clouds their continued utility. The goal of the effort is to win either federal tax law change and/or Department of Treasury regulatory changes that would specifically codify the preferred treatment of the SPV's. The work will address both uncertainties with current off-shore SPV's and also attempt to create a regulatory framework that would encourage formation of such entities on-shore. It is possible that only one of these two goals can be realized.

The primary tax and regulatory issues that need to be addressed are whether:

- The issuer [the SPV] of security is an insurance company under state insurance codes;
- The SPV is in the trade or business of writing insurance;
- The securities are debt instruments for federal income tax purposes;[24]
- The ceding insurer can receive reinsurance underwriting account treatment for risks transferred via securitizations;
- Avoidance of "entity level" tax of the special purpose vehicle is possible.

The desired treatment is for the on-shore SPV to not be deemed a "per se" corporation. Such classification would subject the return earned by equity investors to entity level tax. In addition, if the debt instruments issued by the SPV are debt for federal income tax purposes, the SPV would be entitled to a deduction for interest payments. If, however, the debt instruments are considered equity, no such deduction would be allowed.[25]

The SPV working paper, prepared by industry advocates, asserts that Treasury should issue regulations that classify an off-shore entity that enters into a single contract to insure risk as not a "per se" corporation. The paper argues that such an entity is not engaged in "trade or business" and is not an insurance company.

Additionally, the paper asserts that catastrophe bonds should be classified as securities. Advocates claim that this classification helps the U.S. insurer, the SPV and the investors in that it makes it clear that the security issuance does not constitute doing the business of insurance. The final change would clarify that the interest payments on the catastrophe bonds are not excluded from the "portfolio interest exemption from U.S. Federal withholding tax."[26] Finally, the industry paper calls for Treasury to clarify, through regulations, that payments received by entities that enter into a one-time contract to insure a third party against a specified risk are subject to U.S. tax as insurance premiums.

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[24] Ross J. Davidson, Jr., SPV Tax Team Paper 8 (16 July, 1999) (on file with author); (Ross J. Davidson, Jr. is Vice President, Industry Affairs USAA). Note there is a concern that a U.S. Based SPR [Special Purpose Reinsurance] would be taxed. Since the SPR is primarily funded by the proceeds of the bond issue and insurance premiums received on the related reinsurance transaction, any income tax assessed against the SPR would increase the costs of securitizing the risk. SPR generally have minimal capitalization, but have issued large values on bonds. This creates a concern that the IRS will classify the bond instruments as equity, rather than debt. This would result in the periodic payments made by the SPR to the investors being treated as non-deductible dividend payments rather than the deductible interest payment treatment that would result if the bonds were classified as debt. The IRS code mandates that all entities conducting the business of insurance be taxed as a corporation. This eliminates the ability to take advantage of pass through structures in the U.S. such as limited partnerships and limited liability companies, providing another compelling reason to set up a SPV off-shore. Jeffrey Alton and James Morris, CNA, Insurance Securitization, in NAIC conference handout (5 August 1999).

[25] Ross J. Davidson, Jr., Accessing Capital Markets for Funding Catastrophe Exposures 9, Address at NAIC Conference, in NAIC conference handout (5 August 1999).

[26] Davidson, *supra* note 26, at 12.

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There are a series of state regulatory issues that the paper argues should also be addressed. Advocates claim that an NAIC model regulation or law should codify that:

- Securities used for securitizations are not insurance contracts or reinsurance contracts;
- Holders of the securities would not be deemed to be conducting the business of insurance;
- Security holders will not be deemed to be licensed or required to meet other insurance regulatory tests; and
- There are no insurance code limitations that impede the consummation of the securities transactions in accordance with contract terms.[27]

Among the changes being considered by the industry advocates are changes to existing laws such as credit for reinsurance and insurance receivership statutes. In addition, the group is considering creation of a new kind of "trust" statute that would be the basic building block for an SPV-type transaction on-shore. The trust would both sell the securities and hold the proceeds for the benefit of the U.S. insurer. Two options are being explored: one is titled a "contingent capital business trust" and the other an "insurance risk securitization trust." The second would provide that, in addition to regulatory oversight of the transactions between the trust and the insurer, the trust itself would be subject to insurance regulatory oversight.[28] The industry advocates are attempting to model legislation after that enacted for mortgage-backed and other asset-backed securities.

At this point, the obvious question for the reader must be, what would be the substantive difference between the "protected cell approach" and the "on-shore trust approach"? The key distinguishing characteristic appears to be the isolation of the risk from the insurer's balance sheet. In the protected cell approach the cell and its assets and liabilities are still associated with the insurer-called the general account. In the SPV trust approach, there is a separation and isolation of the assets and liabilities into the separate trust. In draft federal legislation prepared by an industry tax group, creation of a "special insurance vehicle investment trust (SIVIT)" was proposed.[29] The drafters of the legislation believe this type of structure will meet the stated tax and regulatory objectives that will facilitate on-shore securitizations of insurance risk. The industry group has stated that the changes to the federal tax law to promote the appropriate tax advantaged treatment will address both protected cells and SPV's. In addition, there will be an attempt to qualify existing SPV's for the tax advantaged treatment. The NAIC Insurance Securitization Task Force discussed preliminary SPV design at the October 1999 NAIC meeting.

6. Conclusion

By year-end 2000, the U.S. picture with regard to the four alternative risk transfer vehicles described in this paper will be further clarified. The development of the "special purpose vehicles" and the derivative accounting regulations will likely take at least another year of regulatory analysis. The on-shore Special Purpose Vehicles project is the most difficult one since it requires legislation to be enacted by the U.S. Congress. On the other hand, both the protected cell approach and the INEX securitization regulations are vehicles

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[27] Davidson, *supra* note 26, at 14.

[28] Letter from Ross Davidson, Special Purpose Vehicle State Regulatory Team Work Sheet 1 (18 August 1998) (on file with author).

[29] SPV Tax Subgroup agenda materials (9 September 1999).

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currently in place which insurers can use today to facilitate on-shore securitizations. While Rhode Island and Illinois are the only two states to have enacted broad protected cell legislation, to date, other states are likely to act in the winter/spring of 2000 when many state legislatures return to regular sessions to consider new laws. U.S. reinsurers will remain active in the legislative and regulatory debate.

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