



FINANCIAL REGULATOR
Rialtóir Airgeadais

Special Purpose Reinsurance Vehicles

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1 Preamble

Any proposal to establish an Irish special purpose reinsurance vehicle (“SPRV”) must be submitted to and discussed with the Irish Financial Services Regulatory Authority (“Financial Regulator”). This paper describes the general process for applying for authorisation as an SPRV, necessary systems and controls and solvency requirements.

In developing this paper, the Financial Regulator has had regard to provisions of S.I. 380, the principles devised by the International Association of Insurance Supervisors (IAIS) [*, and the results of consultation with the statutory consultative panels.*]

1.1 Making submissions

Please submit your comments in hardcopy as well as softcopy. When addressing any issue raised in this paper, please use the corresponding numbers in this paper to identify the section you are referring to. If you are raising an issue that we have not referred to in this paper, please indicate this in your submission.

Submissions should be clearly titled ‘Special Purpose Reinsurance Vehicles’ and submitted to:

Reinsurance Section
Insurance Supervision
Financial Regulator
P.O. Box 9138
College Green
Dublin 2

Email: reinsurance@financialregulator.ie

Tel: 01 410 4044

All submissions should be received on or before the 2nd of March 2007

1.2 Background

Article 46 of the EU Reinsurance Directive ("the Directive") provides that where a Member State decides to allow the establishment within its territory of special purpose vehicles (within the meaning of the Directive), it shall require prior official authorisation thereof and lay down the conditions under which the activities of such a vehicle shall be carried on.

This regime is transposed into Irish law by Statutory Instrument No. 380 of 2006 ("S.I. 380"). Regulation 3(1) of S.I. 380 defines a SPRV as follows:

"...an undertaking (whether incorporated or not) that—

- (a) assumes risks from insurance undertakings or reinsurance undertakings under reinsurance contracts, and
- (b) fully funds its exposures to those risks through the proceeds of a debt issue or some other financing arrangement under which the repayment rights of the providers of the debt or financing arrangement are subordinated to the reinsurance obligations of the undertaking,

but does not include an authorised insurance undertaking or authorised reinsurance undertaking".

1.3 Contract of Indemnification

Where there exists significant basis risk, (the difference between the actual loss to the cedent and the protection afforded by the transaction with the SPRV), the transaction will not be deemed reinsurance and thus the use of an SPRV is not appropriate. For a transaction to be considered reinsurance the payment to the cedent must be dependent upon that party suffering a loss as the result of having to indemnify one or a number of policyholders for actual loss incurred; and obliging the SPRV to indemnify the cedent for the actual loss incurred.

There are a number of mechanisms used by SPRVs as trigger events that would oblige the SPRV to make payment to the ceding (re)insurance undertaking; these currently include:

- Indemnity
- Model Loss
- Parametric

Clearly, the indemnity trigger meets the test, while at the other extreme the parametric trigger in isolation would not. The model loss trigger more closely attempts to match the risk exposures of the ceding entity with the payments made by the SPRV in the incidence of a trigger event and could, depending on the sophistication of the modelling, be argued to meet the indemnification requirement. The Financial Regulator would also be willing to consider other aspects of the coverage provided by the SPRV (such as an "Ultimate Net Loss" clause) which when combined with the model loss and parametrics triggers attempt to mirror indemnification.

1.4 Types of SPRVs

Detailed in Appendix 1 are examples of the types of SPRVs that the Financial Regulator has considered. These are given by way of example and future applications for authorisation need not be limited to these.

1.5 SPRVs other than companies

This paper refers throughout to SPRVs incorporated as companies, as this is the typical structure. For SPRVs other than companies, company-specific terms (such as 'director', 'shareholder' or 'company') refer to the corresponding concept for the nature of person concerned (e.g. the partners of a partnership).

1.6 Legal Basis

Chapter 2 (Authorisation) describes, as to its subject matter, the information and documents to be supplied, and conditions and standards to be satisfied, in order typically to make an application to the Financial Regulator for authorisation as an SPRV in accordance with Regulation 30 of S.I. 380, as well as the general process for such an application.

Chapter 3 (Systems and Controls) states, as to its subject matter, the requirements of which all authorised SPRVs are hereby notified under Regulation 38(1) of S.I. 380.

Chapter 4 (Solvency Requirements) contains rules of the Financial Regulator hereby made under Regulation 39(1) of S.I. 380.

The Financial Regulator expects to publish a separate paper regarding the returns it will typically require from SPRVs.

This paper may be amended or supplemented by the Financial Regulator from time to time and the Financial Regulator may impose or apply different provisions in an individual case. With respect to applications for authorisation, in particular, and without limitation to the foregoing, this paper is issued without prejudice to the power of the Financial Regulator to require additional information and documents pursuant to Regulation 30(3) of S.I. 380.

This paper does not relate to the regulatory position of any person contracting or otherwise doing business with a SPRV. In particular, and without limitation to the foregoing, it does not relate to any regulatory credit that an insurance undertaking or reinsurance undertaking may apply, or request, based on a contract with a SPRV.

Failure by a SPRV to comply with the above provisions of S.I. 380, or rules or other requirements laid down in this paper, may be the subject of an administrative sanction under Part IIIC of the Central Bank Act 1942. Failure to comply with Regulation 38 or 39, above, shall, except where there is a reasonable excuse, constitute an offence, in accordance with S.I. 380.

2 Authorisation

2.1 Application & Assessment

A written application to the Financial Regulator for authorisation of a SPRV should be addressed to the Financial Institutions & Funds Authorisation Department. An application must be made in writing and be in accordance with Regulation 30 of S.I. 380. It must include the items listed in Regulation 30 and, pursuant to Regulation 30(1)(e), plus the following supporting documentation, where applicable:

- i. Actuarial review of underlying business;
- ii. Prospectus/Offering Circular or Private Placement Memorandum;
- iii. Rating agency's pre-sale report on behalf of the SPRV;
- iv. Details relating to the potential use of financial guarantors on any of the tranches of notes to be issued;
- v. Trustee Agreement;
- vi. Overall risk management plan including details as to how the SPRV will be fully funded;
- vii. Financial projections;
- viii. Investment authority and guidelines for assets held in Trust, along with details of any leverage permitted within these guidelines;
- ix. Details of the SPRV's liquidity strategy, including structure of waterfall¹, types of positions, and noteholder withdrawal rules;
- x. Risk implications of the SPRV's investment strategy;
- xi. Details of any intended hedging instruments, such as interest rate swaps or currency contracts;
- xii. Details of Directors/Management fitness and probity;
- xiii. Capital including size, growth, investor concentration, and management share of the capital base; and,
- xiv. Outsourcing and service agreements.

¹ The term "waterfall" in this context, is used to describe the ranking, or priority of payments.

Where it is proposed that the SPRV will take a form other than a company, a copy of the documentation equivalent to the memorandum and articles of association of a company (e.g. a partnership agreement) must be provided, in accordance with Regulation 30(1)(e) of SI 380.

It is understood that due to timing that some of the formal documents listed above will necessarily be in draft form when the application is submitted. However, before the SPRV is authorised, such documents must be in sufficiently final form.

Each application will be assessed by reference to S.I. 380 and this paper. If appropriate, comment may be issued by the Financial Regulator, which should be either included in the next set of drafts or addressed separately in writing. In order to expedite an issue, the Financial Regulator may discuss specific issues with the applicant directly in order to reach an agreement. The time taken to assess an application will typically depend on the nature of the entity, the ease of obtaining the required information and the speed of response of the cession undertaking's regulator.

2.2 Systems and Controls

The Financial Regulator will consider as part of the application process whether the SPRV would be in a position to comply with Chapter 3 of this paper.

2.3 Transparency

Each proposal must be precise regarding potential exposures. Both direct and indirect exposures should be clear from the business proposal at the outset. All material facts and considerations must be fully disclosed in the application.

2.4 Potential Conflict of Interests

The application must adequately disclose any material, or potentially material, conflicts of interest that may arise in respect of the interactions among the various parties to the transactions into which the SPRV will enter (including any such conflict concerning the applicant/cession undertaking).

2.5 Grant or Refusal of an SPRV Application

In order to grant an authorisation, the Financial Regulator must be satisfied that:

- (i) the application complies with Regulation 30 of S.I. 380 (including receiving the information required by this paper);
- (ii) the objects of the SPRV are limited to operating as an SPRV; and
- (iii) none of the grounds in Regulation 31(2) or (3) apply.

Where the Financial Regulator proposes to refuse an application, it will first give the applicant an opportunity to make representations in writing as to why the application should not be refused. If the Financial Regulator then refuses the application, it will give the applicant a written notice of this refusal, including a statement of the reasons for the refusal.

2.6 Conditions of Authorisation

A set of conditions is listed in Appendix 2 that might typically be imposed on a SPRV upon authorisation.

3 Systems and Controls

3.1 Compliance with contractual obligations

Typically, a SPRV is designed such that all permissible functions and activities are contractually defined and limited. Due to these contractual limits, a SPRV's ability to take action in a given situation outside of these contractual confines is generally restricted.

In order to assure the prudential soundness of the SPRV, systems and procedures must be in place to ensure that there is compliance by the SPRV with all its contractual obligations including, but not limited to:

- i. ensuring that any investment restrictions are not breached;
- ii. ensuring that interest payments, dividends, expenses and taxes are properly accounted for;
- iii. providing movement thresholds at which price movements of the trust assets are reviewed;
- iv. ensuring adherence to provisions of waterfall structured payments;
- v. ensuring that assets are legally existent and technically identifiable; and
- vi. ensuring adequate and timely determination of liabilities and satisfaction of obligations.

3.2 Credit Risk

A SPRV must have in place policies and procedures to monitor and report to the Board of Directors counterparty credit risk and to exercise the contractual remedies available to the SPRV as set out in the various agreements. This is to ensure that when triggers are hit and remedial actions are contractually required, these actions are taken.

At a minimum, the credit risk related to unexpected insolvency of any of the following must be monitored and controlled:

- one or more of the investment grade bond insurers;
- swap counterparties;
- hedge providers; and,
- retrocessionaires.

In the context of a SPRV contract that does not specify an aggregate limit, S.I. 380 refers to “projected economic reserve requirements under the contract”. These requirements must be considered net of any effects of risk mitigation instruments entered into by the SPRV. When considering any risk mitigation instruments or other financing mechanism, the assessment must reflect any counterparty credit risk and contractual features that could negatively impact the financial security and solvency of the SPRV.

A SPRV must consider appropriate due diligence exercises and legal advice prior to compiling a report recommending either acceptance or rejection of a counterparty/bond insurer.

3.3 ‘Fully Funded’ for contracts without aggregate limits

In regard to reinsurance contracts without aggregate limits (typically, life contracts) although fully funded per part (b) of the definition of ‘fully funded’ in Regulation 3(1) of S.I. 380, there is potential for the projected economic reserves to exceed the market value of assets held by the SPRV. As such actuarial reviews to determine such reserves should be performed regularly, no less than annually, or at the request of the Financial Regulator, if in its opinion there are developments that could adversely impact the risks covered by the reinsurance contract. The SPRV must, on application for authorisation, demonstrate to the Financial Regulator how it will maintain the fully funded status of the SPRV in the

event of adverse developments, and be in a position to demonstrate this on an ongoing basis. This analysis should include the impact of all ongoing operating expenses.

3.4 Corporate Governance

Primary responsibility for sound administrative and accounting procedures, adequate internal control mechanisms and risk management requirements rests with the Board of Directors of the SPRV.

The Board of Directors of an SPRV must ensure the SPRV operates in accordance with the terms of its authorisation from the Financial Regulator and in accordance with the agreements entered into by the SPRV. The SPRV will be required to demonstrate that it meets adequate corporate governance standards in a manner proportionate to its structure and business.

Each application should, at a minimum, specify the following:

- the number of Directors, which constitute the Board of the SPRV;
- the scope of experience of each of the members of the Board; and
- the number of independent non-executive Directors proposed to sit on the Board of the SPRV.

3.5 Fit and Proper Requirements

Directors and all relevant Managers of a SPRV must be competent to carry out the duties of their posts and should be of good repute. All Directors and relevant Managers of a SPRV must meet the Financial Regulator's standards vis-à-vis fitness and probity (currently set out in the Financial Regulator's document 'Fit and Proper Requirements' of November 2006).

3.6 Structural Features

In the first instance, the special purpose transaction should generally be segregated into a **bankruptcy remote** vehicle separate from the cedent/sponsor. At a minimum, where applicable, this means that the

SPRV must not be related to the cedent, applicant or any other company for the purposes of sections 140 and 141 of the Companies Act 1990. Secondly, the notes derived from the waterfall structuring of the SPRV should be **non-recourse**; in that payments due under the terms of issuance of the notes are the obligation of the SPRV only, and in the event of a default the noteholders will have not recourse to the assets of the applicant/cedent.

Finally, the applicant should be in a position to demonstrate to the Financial Regulator that the cedent, and its Regulators, are aware of the nature of the securitisation transaction and the SPRV. The Financial Regulator should be informed of the relevant regulatory authority(ies) of the ceding undertaking and reserve the right to communicate with them in relation to the special purpose transaction.

The Financial Regulator will require legal confirmation that the core legal documents have effective non-recourse and non-petition clauses.

3.7 Limited Recourse and Non-Petition

The Financial Regulator considers it necessary that the agreements relating to the SPRV contain clauses, in line with acceptable market practice, to the effect that rights to petitions for insolvency of the SPRV are waived. For example, the agreements relating to the SPRV must cater for the interaction between the security trustee, the waterfall and limited liability.

Furthermore, a 'no petition' clause should be included, in the agreements relating to the SPRV, to ensure that no insolvency proceedings are initiated on the SPRV, given that its obligations are discharged.

3.8 Identification of Assets

The Financial Regulator requires that any assets or rights of the SPRV held or controlled by the cedent be separately identified from the non-securitised assets and rights of the cedent.

3.9 SPRV Infrastructural Support

The Financial Regulator places great emphasis on the good repute of the persons involved in the day to day management and operation of the SPRV. These persons should have a demonstrable and relevant track record in the management of insurance and reinsurance risk. The Financial Regulator requires any Promoter of a SPRV to provide (either directly or through a suitably qualified independent third party service provider) a minimum of infrastructural support. This support should cover, as a minimum, the following:

- i) delegated administrative functions of the SPRV;
- ii) tax compliance of the vehicle;
- iii) ensuring that the vehicle operates in compliance with regulatory requirements of the Financial Regulator; and
- iv) an appropriate reporting mechanism to the Board.

The purpose of this requirement is to ensure that the SPRV is operated in an appropriate manner.

4 Systems and Controls

4.1 Minimum Guarantee Requirement

SPRVs are required to hold a minimum guarantee fund of €2.00.

4.2 Full Funding Requirement

In view of the limited nature of an SPRV's business, the level of capital required should at a minimum ensure that the SPRV is 'fully funded', within the meaning of Regulation 3(1) of S.I. 380.

Consultation Closed

Appendix 1 - Types of SPRVs

SPRVs may be categorised as either Asset (Contingent Receipt) SPRVs or Liability (Contingent Pay) SPRVs, [albeit that from a regulatory perspective there is no distinction between the two].

An example of an Asset (Contingent Receipt) SPRV could be a securitisation of future cashflows, typically a **Life** Securitization. For illustrative purposes, the characteristics of an Asset (Contingent Receipt) SPRV generally display the following characteristics:

- SPRV pays a commission to an originator under a reinsurance arrangement in exchange for future cashflows on a defined book of the originator's business;
- The SPRV issues securities, the proceeds of which are used to pay the commission to the originator;
- Ongoing receipts under the reinsurance arrangement generate cashflows which are used to repay securities; and,
- The securities are typically tranching in order of priority for payment of interest and repayment of capital.

An example of a Liability (Contingent Pay) SPRV could be a vehicle used for the purposes of passing catastrophic **non-life** risk from the insurance/reinsurance industry into the capital markets. A Liability (Contingent Pay) SPRV passing catastrophic **non-life** risk would typically display the following characteristics:

- The SPRV issues a (re)insurance contract to a cedant and charges a premium;
- The reinsurance contract would typically, though not necessarily, define the obligations of the SPRV upon the occurrence of a parametric measure defining the characteristics of a particular event, rather than the indemnity amount incurred by the cedant;

- The SPRV issues notes to investors. The payment of the coupon and/or the repayment of the principal are contingent upon the non-occurrence of one or more events. The occurrence of a defined risk event generally triggers a pay out to the cedent at an amount based on the parametric measure;
- The reinsurance premium and invested amounts are invested in investment grade fixed income securities;

An example of a Liability (Contingent Pay) SPRV passing indemnity-based **life** risks would typically display the following characteristics:

- Liabilities are assumed by the SPRV under a reinsurance arrangement;
- The SPRV issues securities, the proceeds of which are used to purchase assets to collateralise the liabilities assumed by the SPRV;
- Ongoing receipts under the reinsurance arrangement together with the return on assets generate cashflows which are used to repay securities; and,
- The securities are typically tranching in order of priority for payment of interest and repayment of capital.

The three bullet points below would be appropriate for describing each of the above securitisations.

- In some instances, the fixed income coupons are swapped into variable rate coupons with the counterparty;
- The investment notes may be rated by an external credit rating agency; and,
- Some of the notes may be “wrapped” by a financial guarantor.

Appendix 2 - Conditions of Authorisation

The conditions listed below are those that might typically be applied to the authorisation of SPRVs:

1. An undertaking that the Memorandum and Articles of Association of the company will not be altered without the prior written consent of the Financial Regulator.
2. An undertaking that any transaction documents listed in 2.1 (of this document) that have not yet been finalised will be submitted to the Financial Regulator when they have been executed. Also, an undertaking that the executed transaction documents will not be subject to material amendments without first notifying and receiving confirmation from the Financial Regulator that it has no objection.
3. An undertaking that the Financial Regulator will be informed, in advance, of any proposed future appointments to the board (including alternate directors) or the significant appointment of outsourced service providers. Such appointments are subject to the Financial Regulator not having an objection to same.
4. An undertaking that the Financial Regulator will be notified as soon as is reasonably practical upon resignation or decision to remove any director or significant outsourced service provider.
5. An undertaking that the SPRV's compliance strategy will make provision for adherence to, in addition to all primary and secondary legislation, all and any guidance issued by the Financial Regulator and its predecessors to date and any future guidance issued by the Financial Regulator.
6. An undertaking that the Financial Regulator will be notified immediately of any plans for significant deviation from any of the original contractual arrangements as set out in the application.
7. An undertaking that the firm will submit on an annual basis, reinsurance returns as prescribed by the Financial Regulator together with audited financial statements.



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