

## SOUTH CAROLINA AND SECURITIZATION

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The South Carolina captive insurance program, administered by the Department of Insurance's Alternative Risk Transfer Section, has taken a giant leap forward as it licensed its 116<sup>th</sup> captive in its fourth year of operation.

South Carolina is one of the fastest growing onshore jurisdictions; however, it is rapidly establishing a reputation as a world leader in utilizing alternative risk transfer platforms as vehicles for sophisticated structured finance transactions. An example of this innovative approach is found in South Carolina's newly enacted "Special Purpose Financial Captive" ("SPFC") statutes.<sup>i</sup> This article will focus on this new legislation.<sup>ii</sup>

South Carolina created the SPFC law, in large part, as a result of increased interest by many insurance companies in securitizations. An insurance securitization is a means of converting insurance risk into securities which are ultimately sold to sophisticated investors. Securitizations allow access to capital through alternative sources, such as global financial markets. Initial securitization inquiries received by the Department were driven by concerns that the National Association of Insurance Commissioners' Triple X Reserve Requirement would require many life insurers to maintain redundant cash reserves, resulting in excessive reserve strain. The SPFC statute, however, envisions many other types of securitizations.

Under the terms of a typical securitization transaction, the SPFC sells surplus notes to an underwriter who converts the notes into money market securities for sale to institutional investors. The securities are similar to bonds and pay interest until a specified maturity date. The parent, or counterparty, cedes certain risks to the SPFC for a specified premium. The premium revenue stream funds the surplus notes and drives the transaction. The proceeds from the sale of securities are held in a specially drafted trust administered by a third party financial institution. The trust funds provide credit for reinsurance and are available to pay the obligations arising under the insurance policies which have been ceded by insurers.

Securitization transactions are important to the insurance industry since they allow the industry to transfer risks by direct access to financial markets and thereby expand and diversify capacity (i.e., they allow insurance companies to access alternative sources of capital). A securitization transaction may be used where coverage in the traditional reinsurance market is either unaffordable or unavailable. Securitizations generally involve two facets. The first element involves creating the securitization vehicle, which is essentially a state regulated function. The second element involves sophisticated financial transactions, administered through an underwriter familiar with the capital markets in which the securities are to be sold. The Special Purpose Financial Captive provisions will significantly reduce the amount of risk involved. Further, and equally as important, the Special Purpose Financial Captives law will significantly, reduce, "friction costs" which involve numerous fees charged by legal counsel, underwriters and financial guarantors.<sup>iii</sup>

In 2003, South Carolina completed its first securitization via a special purpose captive insurance company. South Carolina is the first onshore jurisdiction to receive, approve and finalize an insurance securitization through the captive platform. The securitization involved use of the captive solution for transformation of the risk portfolio into money market securities. These transactions involve substantial monetary amounts, resulting in significant economic advantages to the state, including additional premium taxes and fees.

The new statute addresses many of the issues the Department encountered in the initial transaction. The effect of the SPFC will be to give investors greater certainty and specificity with respect to the transaction, thereby reducing risk and the ultimate cost of the transaction. Among other things, the SPFC legislation establishes minimum capital requirements,<sup>iv</sup> procedures for rehabilitation and liquidation, ensures longevity of orders of the Director and provides strict requirements for the safekeeping of the securitized funds.

There are twenty different definitions contained in new legislation which define, clarify, and delineate various aspects the securitization process. However, the most important aspect of the SPFC law is its purpose:

This article provides for the creation of Special Purpose Financial Captives (SPFCs) exclusively to facilitate the securitization of one or more risks, as a means of accessing alternative sources of capital and achieving the benefits of securitization. SPFCs are created for the limited purpose of entering into a SPFC contract and insurance securitization transactions and into related agreements to facilitate the accomplishment and execution of those transactions. The creation of SPFCs is intended to achieve greater efficiencies in structuring and executing insurance securitizations, to diversify and broaden insurers' access to sources of capital, to facilitate access for many insurers to insurance securitization and capital markets financing technology, and to further the economic development and expand the interest of the State of South Carolina through its captive insurance program.<sup>v</sup>

The SPFC, although regulated and established through a plan of operation, contains general corporate powers under South Carolina law.<sup>vi</sup>

One of the most important provisions of SPFC law relates to the Insurance Director's powers, as reflected in the Director's orders. The SPFC law specifically authorizes the Special Purpose Financial Captive to be regulated in a manner that is tailored to the nature of the securitization. Without the statute there was inherent imprecision of an order in a securitized transaction, due primarily to uncertainty over the permanency and reliability of the Director's orders approving securitization. Uncertainty with respect to the transaction translated into greater risk and higher costs. More specifically, if an order can be rescinded, modified or revoked, as is the normal case, this injects an unusual element of risk in a securitized securitization which often spans over a number of years. The Director, in his or her discretion (usually by an Order), may exempt an SPFC from any provision of the SPFC law which the Director determines inappropriate given the nature of the risks to be insured.<sup>vii</sup> The Special Purpose Financial Captive provision addresses this in a unique way.

An order of the Director cannot be rescinded, modified or revoked unless, and until, a specific and particular finding is made, utilizing an evidentiary standard that is the highest burden of proof in the civil law arena. If a third party, future Director or even the Director who signed the order approving the SPFC attempts to reverse the order, then the challenging party must: "(1) prove the appeal by a clear and convincing evidence standard; (2) demonstrate irreparable harm; (3) not have another adequate remedy at law; and (4) post a bond of sufficient surety to protect the interests of the holders of the SPFC securities and policyholders but in not less than fifteen percent of the total amount of the securitized transaction."<sup>viii</sup> Regardless of the difficulty of proving the first three elements, the security which must be posted to even commence a challenge is likely prohibitive. In sum, once a securitization is in place, while not impossible to overturn an order of the Director, the probability of doing so is negligible. This gives greater comfort to all involved in the transaction, particularly the insurer of the money market securities which, in turn, results in risk minimization and a commensurate reflection in the amounts charged by the wrapper for insuring the money market securities.

Further, the law defines securitization in a manner that will allow the general practitioner to more fully understand all of the components necessary to perform and complete the securitization transaction. For example, there is a clear definition of a "Surplus Note" which is essentially the financial instrument utilized by the SPFC to facilitate the initial capital flow for the securitization transaction. These Surplus Notes are specifically defined to conform with NAIC requirements and accounting rules.

While the application process for a Special Purpose Financial Captive remains essentially the same as that for a traditional captive, there are several specific and new requirements set forth under this provision. The applicant must submit to an extensive NAIC background check, and the applicant is required to prove that it is in compliance with South Carolina law and is exempt as either an exempt security or exempt transaction for purposes of compliance with South Carolina securities law.<sup>ix</sup>

Further, the application requires a detailed plan of operation which forms the roadmap for the securitization process itself.<sup>x</sup> The provisions of the Special Purpose Financial Captive statute were carefully drafted to ensure that securitized funds would be given credit for reinsurance to the counterparty or reinsured.<sup>xi</sup> Without credit for

reinsurance, the securitization transaction would make no economic sense. To ensure the validity of credit for reinsurance, the SPFC legislation provisions afford the counterparty's domicile regulatory authority a review of the proposed securitization to ensure that it will allow the counterparty credit for reinsurance.

The SPFC statute does contain several organizational requirements to ensure financially sound new captives in South Carolina. These requirements include: <sup>xii</sup>

- A SPFC may only insure or reinsure counterparty<sup>xiii</sup> risks, and may only purchase reinsurance as approved by the Director.
- A SPFC is required to obtain a license from the Director, hold one management meeting each year in South Carolina, maintain its principal place of business in South Carolina, and appoint a registered-resident-agent for service of process.
- A SPFC is required to file with the Director a certified copy of its organizational documents and the president's and secretary's sworn statement showing the SPFC's financial condition. In addition, it must present evidence showing the amount and liquidity of its assets relative to the risks assumed, the adequacy of management's expertise, experience and character, the overall soundness of its plan of operation, and any other factors the Director considers relevant.

The SPFC statute allows for the creation of protected cells; however, additional disclosure requirements are placed on these sophisticated business structures. When a protected cell is utilized, a SPFC must also file: <sup>xiv</sup>

- A business plan accounting for the loss and expense experience of each protected cell, and how it reports that experience to the Director
- An acknowledgement that all financial records must be made available for examination by the Director,
- All protected cell contracts and sample contracts,
- Evidence showing an equitable division of expenses between its protected cells.

The SPFC statute also provides that information submitted in compliance with the filing requirements is confidential and subject to strict compliance with disclosure provisions. <sup>xv</sup> The statute also sets forth required examinations, investigations, and ongoing review processes conducted by the Department. <sup>xvi</sup>

Since 2000 the General Assembly has passed several pieces of legislation to facilitate insurance securitization transactions in South Carolina. In 2000, the protected cell legislation was enacted; the Special Purpose Reinsurance Vehicle Model Act in 2001; the Special Purpose Captive Insurance Company in 2002.

The South Carolina captive program has been known for an innovative, flexible, responsive approach to the formation and development of alternative risk transfer mechanisms. The Special Purpose Financial Captive law continues that tradition. Because the transactions may span a period of thirty years it is expected that the present value of the premium taxes to be paid will be significant and important to the state's economy. For example, the present value of expected premium tax payments for the securitization transactions could exceed \$1M for each transaction, from inception to closure. Through enactment of this legislation, South Carolina is branding the jurisdiction as a worldwide leader in the use of captives for structured finance transactions. South Carolina now has the most efficient statutory framework in place for the ever-growing securitization market and will be recognized as a global leader in that arena.

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- <sup>i</sup> 2004 S.C. Acts 269, executed by Governor Mark Sanford on July 29, 2004.
- <sup>ii</sup> S.C. Code Ann. § 38-90-410 et seq. The SPFC law has been designed to facilitate insurance securitizations which previously were accomplished by forming a special purpose captive insurance company. S.C. Code Ann. § 38-90-10(25).
- <sup>iii</sup> Financial guarantors are also known as “wrappers”. These entities are generally involved in securitization transactions to ensure that the securitized paper that is ultimately issued to investors is AAA rated.
- <sup>iv</sup> S.C. Code Ann. § 38-90-460.
- <sup>v</sup> S.C. Code Ann. § 38-90-410.
- <sup>vi</sup> See S.C. Code Ann. § 33-1-10, et seq.
- <sup>vii</sup> S.C. Code Ann. § 38-90-430(C).
- <sup>viii</sup> S.C. Code Ann. § 38-90-620. Of course a SPFC license may be suspended or revoked for insolvency, use of methods which render the SPFC unsound, and failure to maintain minimum capitalization and failure to pay taxes. S.C. Code Ann. § 38-90-570.
- <sup>ix</sup> S.C. Code Ann. § 38-90-440(E)(5). This provision was evidently added due to a concern that there be no “dual regulation” between offices of the Securities Commissioner and the Insurance Director. Several provisions preserve this objective.
- <sup>x</sup> Id.
- <sup>xi</sup> S.C. Code Ann. § 38-90-590.
- <sup>xii</sup> These provisions are found in S.C. Code Ann. § 38-90-440.
- <sup>xiii</sup> A “counterparty” is defined as the “SPFC’s parent or affiliated company, as ceding insurer to the SPFC contract, or subject to the prior approval of the director, a nonaffiliated company.” S.C. Code Ann. § 38-90-420(3).
- <sup>xiv</sup> These requirements are found in S.C. Code Ann. § 38-90-480.
- <sup>xv</sup> S.C. Code Ann. § 38-90-610.
- <sup>xvi</sup> S.C. Code Ann. § 38-90-560.