

## **INSURANCE SECURITIZATION THROUGH SPECIAL PURPOSE FINANCIAL CAPTIVES**

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South Carolina continues to be one of the fastest-growing onshore captive insurance jurisdictions with 29 newly licensed captives in 2006. There are currently 165 licensed captives operating in the state of South Carolina, all of which have been licensed in the last six years. While, historically, our state has been ranked in the top three leading domiciles in the world in overall captive growth, South Carolina has undoubtedly taken the lead in the area of the Special Purpose Financial Captive (“SPFC”) with a total of 21 SPFC’s currently licensed. The precipitating factor behind what can fairly be described as phenomenal SPFC growth is the high level of interest demonstrated by the capital markets in intersecting with the capital needs of the insurance industry. Attracting capital market participation is an innovative and efficient use of the SPFC. This trend, coupled with the State of South Carolina’s progressive, experienced and stable statutory structure, all combine to ensure continued growth. This article supplements and updates one published previously on insurance securitizations in South Carolina and SPFC legislation.

### **Background**

The creation of the South Carolina SPFC statute was a response to the convergence of the insurance industry’s desire to access alternative sources of capital in order to address reserve requirements. These needs, coupled with the readiness of the capital markets to provide access to these markets through a securitization, were a recipe for success. An insurance securitization is a means of transferring insurance risk to the capital markets. Securitization transactions are becoming increasingly important to the insurance industry. They allow insurers to transfer risk by accessing global financial markets and thereby expand and diversify capacity. A securitization transaction may also be appropriate where coverage in the traditional reinsurance market is either unaffordable or unavailable.

Securitizations are comprised of two facets. The first involves creating the SPFC, essentially a state-regulated function. The second is the financial transaction, usually administered through an underwriter familiar with the capital markets. In a typical capital markets 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 highly rated debt instruments and pay interest on specified dates. The parent, or counterparty, cedes certain risks to the SPFC for a specified premium. The premium revenue stream, investment income and other revenue sources fund the surplus notes. 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 pay the ceded obligations.

### **The Beginning**

Since 2000, the South Carolina General Assembly has passed several pieces of legislation to “pave the way” for insurance securitization transactions, including protected cell statutes in 2000, and the Special Purpose Reinsurance Vehicle Model Act in 2001. The Special Purpose Captive (“SPC”) insurance company structure, created in 2002, gave the South Carolina Director of Insurance (the “Director”) great flexibility in licensing a captive that would not otherwise fit into a more traditional captive structure.

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South Carolina enacted the foregoing legislation, in part, due to increased interest by many insurance companies in securitization as a means of accessing alternative sources of capital to address reserve requirements imposed by the Valuation of Life Insurance Policies Model Regulation adopted by the National Association of Insurance Commissioners (the “NAIC”) effective January 1, 2000 (“Regulation XXX” or “Triple-X”). Triple-X requires term life insurance policies with guaranteed premiums to be supported by reserves that are substantially in excess of “economic reserves.” Traditionally, economic reserves are calculated to fund expected mortality risks on a given block of term life policies and essentially equal the premiums for the policies. Regulation XXX requires additional reserves which are often equal to two or more times the economic reserves. Insurers were concerned that once individual states adopted their versions of Triple-X, they would be required to maintain redundant cash reserves, resulting in excessive reserve strain.

### **Initial Legislation**

In 2003, South Carolina became the first onshore jurisdiction to finalize an insurance securitization through a captive platform. This transaction, however, revealed many complicated issues regarding the securitization that would be obviated best by enactment of specific legislation. For example, the flexibility of the SPC structure which allowed the transaction to occur was, ironically, counter to the needs of ratings agencies, financial guarantors,<sup>1</sup> and investors who sought certainty and specificity. These risks translated into greater risk and higher transaction costs. Without a governing statute, there was inherent imprecision in an insurance securitization due to uncertainty over the permanency and reliability of the Director’s orders approving the transaction. South Carolina responded to these concerns in 2004 by enacting its SPFC law<sup>2</sup> to provide a very stable statutory structure underpinning for each transaction.

For some time, South Carolina was the only jurisdiction in the world with legislation specifically addressing insurance securitization through a captive platform.<sup>3</sup> The SPFC law authorizes regulation of SPFCs in a manner tailored to the needs and requirements of each individual insurance securitization transaction.<sup>4</sup> The SPFC law contains several requirements to ensure the SPFC is financially sound and competently operated, including:

- minimum capital and surplus requirements;<sup>5</sup>
- restrictions on risks to be insured/reinsured;<sup>6</sup>
- restrictions on reinsurance that can be purchased;<sup>7</sup>
- strict requirements for trust accounts;<sup>8</sup>
- allowable investments for the safekeeping of the securitized funds;<sup>9</sup>
- officer certifications regarding the SPFC’s financial condition;<sup>10</sup> and
- procedures for rehabilitation and liquidation.<sup>11</sup>

Further, the law defines an insurance securitization in a manner which allows the general practitioner to fully understand the components necessary to complete the securitization transaction and conform the SPFC to NAIC requirements. The provisions of the SPFC law were drafted to ensure that securitized funds would be given credit for reinsurance to the counterparty or reinsured.<sup>12</sup> To ensure the validity of credit for reinsurance, the SPFC legislation affords the counterparty’s domicile regulatory authority a review of the proposed securitization to ensure that they will allow the counterparty credit for reinsurance.<sup>13</sup>

There are several requirements set forth in the SPFC statute. The SPFC’s directors and officers must submit to an extensive NAIC background check.<sup>14</sup> The SPFC is required to prove that the securities to be issued in the transaction are compliant with South Carolina securities law.<sup>15</sup> Further, the application requires a detailed plan of operation which forms the roadmap for the insurance securitization itself.<sup>16</sup> In addition, the SPFC 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.<sup>17</sup>

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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>18</sup> The statute also sets forth required examinations, investigations, and ongoing review processes to be conducted by the South Carolina Department of Insurance (the “SCDOI”).<sup>19</sup> The Director, in their discretion (usually by an order), may exempt an SPFC from any provision of the SPFC law which they deem inappropriate given the nature of the risks to be insured.<sup>20</sup>

The SPFC, although regulated and established through the insurance laws, contains general corporate powers under South Carolina law.<sup>21</sup> An SPFC is required to file with the Director a certified copy of its organizational documents, hold at least one management meeting each year in South Carolina, maintain its principal place of business in South Carolina and appoint a registered agent for service of process.

### **Regulatory Risk Minimization**

One of the most important provisions of the SPFC law relates to the three levels of regulatory authority through which regulatory risks associated with insurance securitization transactions are addressed.

First, the State of South Carolina has a special Administrative Law Court (“ALC”) designed to analyze and resolve disputes which may arise with an administrative agency like the SCDOI.<sup>22</sup> Should there ever be any dispute between the SCDOI and any party regarding an SPFC, it will be resolved by the ALC. The ALC is an established part of the state judicial system and has a long track record of efficiently and definitively addressing administrative actions such as those inherent in an insurance securitization.

Secondly, pursuant to the state’s Administrative Procedures Act,<sup>23</sup> each insurance securitization is accompanied by a detailed order issued by the Director. Each order is specially tailored to address the particular nature and requirements of the specific insurance securitization and the authorized underlying transactions. The order also directly addresses issues which may materialize in the future, such as restructuring of the SPFC or additional capital and surplus requirements resulting from variances in actual performance as compared to expected performance.

Third, and most significantly, the ALC process and the Director’s order are effectively locked-in by the SPFC law,<sup>24</sup> ensuring a comprehensive degree of protection for the benefit of all parties to the insurance securitization. The statute maintains the SCDOI’s authority to protect the integrity of the Director’s order and effectively prohibits the Director or any third party from amending or changing an existing order, except for specifically delineated regulatory purposes.

In sum, once a securitization is in place, while it is not impossible to amend or revise an order of the Director by a third party, the probability of doing so is remote. This gives greater comfort to the parties involved in the transaction. This is particularly true for the financial guarantor, since the permanency of the order results in risk minimization which, in turn, commensurately lowers the amounts charged for the credit wrap insuring the money market securities.

### **Protected Cell SPFCs**

Another example of South Carolina’s innovative approach to insurance securitization is the newly-enacted revisions to the SPFC law regarding the use of protected cells.<sup>25</sup> This addition came in response to several insurance companies expressing a desire to securitize more than one block of business within the same SPFC. The initial SPFC law allowed an SPFC to create and use protected cells; however, an important issue with respect to protected cells is whether or not assets and liabilities of each protected cell are truly segregated. Because the segregation of protected cells has never been judicially tested, there is an inherent risk in the insurance securitization.

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The new statute clarifies that there is a segregation of assets and liabilities and declares that, although a protected cell is not a separate legal entity, it can be sued and liquidated separately from the SPFC.<sup>26</sup> The revisions also provide for separate reporting and capitalization of each protected cell. It also imposes additional disclosure requirements on these structures.

Several changes were made to reflect suggestions of the ALC to clearly define terms, standards, and criteria applicable in a contested case brought by a third party before the ALC. The new SPFC law provisions significantly reduce the amount of risk involved in protected cells. Equally important, the use of protected cells should significantly reduce “friction costs” caused by duplication of effort of legal counsel, underwriters, and financial guarantors. 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 continues to be recognized as a global leader in that arena.

### **Benefit to the State**

Insurance securitization transactions involve substantial monetary amounts resulting in significant economic advantages to the state, including premium taxes, fees and collateral revenues generated by the SPFC’s ongoing operations. 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 values of expected tax payments for most securitization transactions are in excess of \$1 million for each transaction, from inception to closure.

### **Growth and Future Prospects**

The SPFC program has been a great success. In three years, South Carolina has licensed 21 SPFC’s, 12% of the total number of captives authorized to date by the SCDOI.<sup>27</sup> The 8 SPFCs newly-licensed in 2006 comprise 28% of the captives licensed that year. To address the rapid growth, the Director of Insurance for South Carolina has recently implemented an outsourcing program for application review and examinations. Additional resources have been provided to the program to facilitate more efficient and timely operations.

The most significant SPFC event in 2006 was the successful completion of an AXXX transaction. AXXX refers to the NAIC’s Actuarial Guideline 38 (AG38), which is a natural evolution of the Triple-X requirement that addresses reserve requirements for universal life policies. These are very different from term policies in that universal life policies often include no lapse guarantees and are especially interest sensitive. The unique nature of universal life policy benefits makes AG38 securitization transactions much more complex.

South Carolina’s SPFC statute envisions many other complex types of insurance securitizations. The numbers reflect how South Carolina has established a reputation as a world leader in utilizing alternative risk transfer platforms as vehicles for sophisticated structured finance transactions. The state is beginning to see different types of securitizations. For example, a discrete block of disability business has been securitized, wholly unrelated to Triple-X. South Carolina is currently evaluating an embedded-value securitization. This type of securitization will enable insurance companies with profitable blocks of business to increase capital efficiency by avoiding the need to wait for years to utilize the profits on these policies.

As more transactions are completed, South Carolina is gaining a better track record and more credibility, not only with ratings agencies and financial guarantors, but also with other regulators. Most of the counterparty states South Carolina has dealt with to date — Connecticut, Illinois, Maine, Minnesota, Michigan, Missouri, Tennessee, New York, Nebraska, Virginia, Washington — are now familiar with South Carolina’s insurance securitization program. With the SPFC law, and the seasoned SCDOI regulatory team, other domiciles know they are dealing with a competent jurisdiction that will not approve a transaction without ensuring all parties

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and the ultimate policy holders are protected.

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### Endnotes

1. 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.
2. 2004 S.C. Acts 269, executed by Governor Mark Sanford on July 29, 2004.
3. S.C. Code Ann. §§ 38-90-410, et seq.
4. The SPFC law has been designed to facilitate insurance securitizations which previously were accomplished by forming a SPC.
5. S.C. Code Ann. § 38-90-460.
6. A SPFC may insure or reinsure only counterparty risks. S.C. Code Ann. § 38-90-440 (A). 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 (5).
7. S.C. Code Ann. § 38-90-440 (A).
8. S.C. Code Ann. § 38-90-530.
9. S.C. Code Ann. § 38-90-520.
10. S.C. Code Ann. § 38-90-440 (C)(5).
11. S.C. Code Ann. § 38-90-600.
12. S.C. Code Ann. § 38-90-590.
13. S.C. Code Ann. § 38-90-440 (H)(4).
14. S.C. Code Ann. § 38-90-440 (C)(4).
15. S.C. Code Ann. § 38-90-440 (C)(5)(d). This provision was evidently added due to a concern that there be no “dual regulation” between the offices of the Securities Commissioner and the Insurance Director. Several provisions preserve this objective.
16. S.C. Code Ann. § 38-90-440 (E).
17. S.C. Code Ann. § 38-90-440 (C)(2).
18. S.C. Code Ann. § 38-90-610.
19. S.C. Code Ann. § 38-90-610.
20. S.C. Code Ann. § 38-90-430 (C).

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21. S.C. Code Ann. §§ 38-90-410. See also the South Carolina Business Corporations Act of 1988, S.C. Code Ann. §§ 33-1-10, et seq.
22. S.C. Code Ann. § 1-23-350.
23. S.C. Code Ann. §§ 1-23-310, et seq.
24. S.C. Code Ann. § 38-90-620.
25. 2005 S.C. Acts 363, executed by Governor Mark Sanford on July 1, 2005.
26. S.C. Code Ann. § 38-90-485.
27. Because two “Special Purpose Captives” as defined by S.C. Code Ann. § 38-90-10 (26) currently operate as SPFCs, they are included in these totals.