

Protected Cell Model Act and its Implications for RBC

Background: The NAIC has recently promulgated a Protected Cell Model Act. The main purpose of the act is to allow an insurance company to attract funds from capital markets to pay for catastrophe (or other property and casualty or life insurance) losses. The insurance company will pay a premium to have access to this capital and to provide adequate return to the investor. Note that NAIC accounting has only been promulgated for property and casualty exposures, and that index-based contracts are currently excluded from protected cells.

The model law allows an investor to get involved in an insurance type transaction without forming an insurance company. The investors deposit the funds with the insurance company. These deposits, together with investment income and the premium paid by the insurance company, are held in a pool called protected cell. These funds are used to pay the insured losses if any covered event(s) occurs during the specified period. Remaining funds in the protected cell after meeting the obligation between the protected cell and the general account are returned to the investor, per the agreement. The model law protects these funds from all other liabilities of the insurance company. The objective of the model law is to encourage the use of onshore facilities for such purposes.

The AAA Committee on P&C RBC has been asked to provide its input to NAIC on the modification, if any, in the determination of RBC for insurance companies that might use protected cell facilities. In particular, we are responding to the questions and answers in attachment 1 of the June 7, 1999 letter of Mr. Mike Moriarty of the New York Insurance Department. We agree with Mr. Moriarty on many issues except for the last few. However, we may have a slightly different basis for arriving at the same conclusions. Below, the issues raised and Mr. Moriarty's responses are followed by our comments, which are in italics to avoid confusion.

Risk Based Capital Considerations for Insurers with Protected Cells

Questions Posed to the RBC Task Force by the Insurance Securitization Working Group (NAIC)

- Should the general account take a benefit for the underwriting premium transferred to the protected cell for Risk Based Capital purposes?

Yes. To the extent that the insurance securitization transaction is indemnity based and thus provides "reimbursement" for losses incurred by the insurer, any premium paid by the insurer to the protected cell should be recognized in establishing risk-based capital. A securitization transaction is the economic equivalent of a reinsurance transaction. If there is a trigger event, the investor

may lose part or all of the interest/principal associated with the bond. That interest/principal would instead be used by the insurer to offset losses it incurs as a result of the trigger event. The premium transferred to the protected cell is combined with the proceeds of the debt offering and is used to enhance the yield to the capital market investors purchasing the bonds. The enhancement to the yield represents the compensation to the investor for the risk that a trigger event may occur. The premium is equivalent to the reinsurance premium paid to a conventional reinsurer.

***We agree.** The insurance company creating a protected cell is making an insurance arrangement with the investor. If the qualified event occurs, the protected cell funds in the amount of the coverage provided will be transferred to the general account of the company. The insurance company pays premium to the protected cell to be paid to the investors if no such event occurs. The premium paid by the insurance company is to compensate the investors for the risk they take under the transaction. This is analogous to a fully collateralized reinsurance transaction. The insurance company's risk has decreased and should be reflected in the RBC formula.*

- Should the general account recognize the reduction in net reserves as a result of the transfer to the protected cell for Risk Based Capital purposes?

Yes. Essentially for the same reason as the above. To the extent that the insurance securitization is indemnity based and thus provides “reimbursement” for losses incurred by the insurer, loss reserves should be netted to recognize the economic effect of the transaction.

We agree.

- Does a credit risk exist between the general account and the protected cell? If so, how will this credit risk be assessed for Risk Based Capital purposes?

No. Under a fully-funded indemnity based insurance securitization, which is currently the only type of securitization permitted under the proposed Model Act, there does not appear to be a credit risk, as the assets of the protected cells are owned by the insurance company. These assets are separately identified and can contractually be used only to pay back the investors *unless* there is a trigger event. If there is a trigger event, the insurer keeps the assets, which are used to offset losses incurred. The full amount of the coverage provided is funded up front through the proceeds of the debt offering. There is a “market” or “investment” risk that is attendant to the investments made by the protected cell with the proceeds from the securitization. However, that is different than a credit risk between the general account and the protected cell. (See next bullet.)

We agree. As the full amount of the possible recoveries has already been collected and is residing in the protected cell, there is no credit risk to consider.

- Should the assets of the protected cell be assessed a risk factor?

Yes. There is an asset risk attendant to the investments made by the protected cell with the proceeds from the securitization. Should the value of the investments go below the amount of coverage provided **and** a trigger event to the full amount of the cover occurs, the general account would not realize the entire recoverable under the securitization. Conceptually, the risk factor should not be as high as the factors assigned to assets in the insurer's general account since, absent a trigger event, the investment risk remains with the investors in the securitization (i.e., should the investments attributable to the protected cell decline due to default or decline in market value, the investors will not be repaid their entire principal/interest). The asset risk only shifts to the insurer's general account upon an event, which triggers a recoverable under the transaction.

We do not agree. Assets of the protected cell should not be assessed a risk factor. The investors are taking the risk of change in values of the protected cell assets due to market changes. In this situation the insurance company faces the asset risk only if the event has occurred, i.e., the risk that the market value of the protected cell assets at the time the insured event occurs is lower than the book value of protected cell assets. In that case the accounting rule will require that the recovery amount be adjusted to the available funds in the cell. There is no reason to incorporate asset risk, which is borne by the investors.

- Should the securitization recoverable from the protected cell be assessed a risk charge?

No. This risk is the same as the "credit" risk that is the basis of one of the foregoing questions. (Does a credit risk exist between the general account and the protected cell?) Upon the happening of a trigger event, the liability of the protected cell to the security holders is converted to a liability of the protected cell to the General Account. That liability, whether to the securityholders or to the General Account, is fully funded. While there could be a dispute over the coverage provided under the terms of the debt instrument (as there could be under a conventional reinsurance agreement) such a risk is not easily quantifiable for RBC purposes.

We do not agree. The securitization recoverable should be assessed a 10% risk charge analogous to that assessed on reinsurance recoverables. There is currently a 10% charge on amounts recoverable from reinsurers even when collateral exists. There were several reasons to include this charge in the initial RBC formula. One reason was to maintain RBC charge parity between recoverables from U.S. domestic authorized reinsurers and recoverables from

alien reinsurers required to post collateral. The potential that disputes with reinsurers could affect the full recoverability of the ceded balance is another reason. Similar arguments applied to securitization transactions will demand that a risk charge of 10% be applied to the amounts recoverable from protected cells.

- Should the protected cell be required to compute its own Risk Based Capital computation?

Yes (which charge would be added to the RBC of the insurer forming the protected cell). As indicated above, the assets held in the protected cell may merit an investment risk charge. If the Task Force deems that such a charge is necessary, that charge would be added to the RBC computed for the general account (i.e. the insurance company).

We do not agree. The protected cell should not be required to compute its own separate RBC requirement. The cell is not a separate entity or an insurance company, so it does not have its own capital to compare any RBC calculation to. Secondly its obligations are fully funded and there is no need to compute RBC for the cell.