

2010 OUTLOOK: ILS MARKETS IN BERMUDA & CAYMAN

Michael Frith & Kevin Butler – February 2010

The Insurance-linked securities market continues to play an important role in the insurance and financial services industries in both Bermuda and the Cayman Islands. In the past year, there has been a renewed interest in ILS structures such as cat bonds, driven in part by the need to diversify investments and risk transfer strategies, but also helped by recent regulatory developments designed to facilitate such structures.

As jurisdictions, both Bermuda and the Cayman Islands maintain the advantages of tax neutrality, independent location for international investors, light yet effective regulation, accessible and pragmatic regulators and sophisticated service providers that are responsive, timely and thorough. Both jurisdictions are very well-established and respected international financial centres, and both continue to demonstrate their skill at financial innovation. In the sophisticated ILS sphere, these are vital qualities, and when combined with the regulatory enhancements described below, they provide an ideal environment for the continued development of the ILS market.

Bermuda

In Bermuda, the Bermuda Monetary Authority (“BMA”) introduced amendments to the Insurance Act in late 2008 that introduced the concept of Special Purpose Insurers (“SPIs”). These new SPIs provide an efficient and cost-effective vehicle for sophisticated insurance “sidecar” and ILS transactions that would otherwise be established within a traditional insurance company structure under the Bermuda insurance regulatory framework. The amendments creating this new class of insurance vehicles are part of the BMA’s ongoing efforts to enhance and develop the regulation of insurers and ensure that Bermuda retains its reputation as an innovative and responsive jurisdiction. The detailed guidance provided by the BMA to industry on the application of the new class of business was developed in close consultation with leading industry participants, and aims to reflect the needs of those industry participants while maintaining an appropriate level of regulatory oversight.

It is anticipated that SPIs will be an attractive vehicle for use in sophisticated cat bond and life securitisation transactions, among others, noting that, unlike traditional insurers, the nature of the underlying risk is irrelevant when determining whether the business is “special purpose business” (as described below). Accordingly, insurance-linked transactions having either long term (life) or general business underlying risks may be carried out through SPIs.

SPIs will be licensed to write an entirely new category of insurance business referred to as “special purpose business”. In essence, in order to be deemed to be writing “special purpose business” and to be licensed as an SPI (thus enjoying the benefits of an expedited application process, overall lighter regulation and nominal capital requirements, relative to traditional insurers), the applicant will be required to evidence that the business it intends to write will be “fully-funded” and that the parties to the proposed transaction are sufficiently “sophisticated”. The question of what is meant by “fully-funded” and “sufficiently sophisticated” has been intentionally left to the discretion of the BMA, in order to allow maximum structural flexibility. However, certain key criteria have been outlined in the guidance provided by the BMA.

Fully-funded - When considering whether a particular transaction can be deemed “fully-funded”, the use of cash, time deposits and subordinated debt are specifically identified in the legislation as being appropriate for this purpose. However, the BMA will also consider other financing mechanisms, and when determining whether or not a particular class of assets is suitable for these purposes, will have regard to factors such as: (i) the extent to which full disclosure has been made of the fact that cedants’ claims will necessarily be limited to assets held by the SPI; and (ii) that full disclosure has been made to the parties (initially and on an ongoing basis) as to the investment guidelines being utilised and the asset quality from time to time. There is otherwise no specific restriction on the types of assets that may be held.

Sophisticated participants - The approach to regulation of collateral described above is coupled with the other essential element of the SPI; that they are open to use by “sophisticated participants” only. The transactions contemplated by this new structure are necessarily very sophisticated and technically advanced, and as such, the BMA will have regard to the sophistication and business acumen of the parties involved before approving a particular structure as an SPI.

Benefits - Where an applicant satisfies the above criteria, and is licensed as an SPI, it will be subject to an expedited application process as well as a lighter regulatory regime than that of traditional insurers. The most notable regulatory differences, particularly in the transaction cost-conscious ILS context, are:

- (i) minimum capital requirement of \$1;
- (ii) the margin of solvency (i.e. the amount by which assets must exceed its liabilities) is also \$1;
- (iii) returns of capital are not subject to the restrictions applicable to traditional insurers;
- (iv) in appropriate circumstances un-audited management accounts (e.g. prepared in accordance with GAAP, IFRS etc.) may be accepted by the BMA in lieu of audited or statutory accounts.
- (v) there is no requirement for a loss reserve specialist.

These legislative changes, and the BMA’s policy in respect of the application of the changes, will serve to facilitate the continued development of sophisticated insurance transactions in Bermuda. Cat bonds, insurance sidecars, life securitisations and transformer vehicles are just some of the possible users of the SPI concept, with the built-in flexibility of the legislation and the continued accessibility of the BMA allowing the industry to develop new concepts and uses as needs warrant. When coupled with Bermuda’s sophisticated and firmly established insurance and reinsurance industry and well-developed professional support infrastructure, the innovation facilitated by these legislative changes will allow the ILS market to continue to flourish.

Cayman Islands

While the legislative changes described above have helped to make Bermuda a more attractive jurisdiction for cat bonds and other ILS structures, the Cayman Islands’ cat bond track record and resulting well-developed professional and service infrastructure continue to make it a leading jurisdiction in this specialised industry as well. The Cayman Islands is still seeing healthy growth in insurance linked securities and this is largely due to its established involvement with the capital markets over the years, along with its flexible regulatory framework.

The Cayman Islands has been incorporating and licensing insurance companies used to issue cat bonds for years. A company wishing to implement such a structure applies for a “Class B” insurance licence, which has no set capital requirements, allowing the Cayman Islands Monetary Authority (“CIMA”) the flexibility to issue the licence with only nominal capital in place. The flexibility of the regulatory regime in the Cayman Islands, together with the established infrastructure and reasonable costs, have been instrumental in building the Cayman Islands’ track record and will most likely be instrumental in continuing to see ILS structures (and cat bonds in particular) established in the jurisdiction. In addition, CIMA remains a very responsive regulator,

and since CIMA has seen so many vehicles used for cat bonds, the application and licensing process is well developed and very straightforward.

It is also important to note that investors, rating agencies and other professionals involved in a cat bond transaction have become very comfortable with the Cayman Islands and as such, rarely have concerns about the structure or legal consequences of using the Cayman Islands as a jurisdiction.

In short, the advantages of both Bermuda and the Cayman Islands as innovative and sophisticated international financial centres provide a fertile ground for ILS structures to develop, and as the need for diversification becomes ever more apparent in the financial sector, their popularity can only increase.

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