

Risk transformation: Structure and regulation of Jersey SPV issuing catastrophe bonds

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Background to catastrophe bonds

Bonds may be issued by a company ("SPV") to investors with the purpose of raising capital for the specific purpose of hedging the SPV exposure to a risk of a third party which has been assumed by the SPV.

Historically, bonds which were issued by an SPV to hedge against exposure to the risk of a third party in relation to a natural disaster, became known as catastrophe bonds. This term now refers to a bond issued to hedge against almost any risk assumed in relation to a third party, including credit default risk.

The assumption of risk by the SPV to the third party may be in the form of an insurance, reinsurance or other contract entered into with the third party. The SPV usually pays a high rate of return to catastrophe bondholders, mainly funded by the premium received on the contract with the third party. However, in the event of the catastrophe occurring, the bondholders typically lose their money and the capital of the bonds is used to pay the third party.

Given its ability to establish a bridge between the capital markets and insurance / reinsurance markets, an SPV is also sometimes referred to as a transformer.

Legal Structure

A Jersey SPV which will issue catastrophe bonds is usually established as a limited company pursuant to the Companies (Jersey) Law 1991 ("Companies Law"), and requires consent pursuant to the Control of Borrowing (Jersey) Order 1958 ("COBO").

The Companies Law permits both protected cell companies and incorporated cell companies. Further, Jersey has a wide range of legal structures which may be used as an SPV, including partnerships with and without legal personality, should structuring needs of an SPV require this.

Regulation

A Jersey SPV will require a permit pursuant to the Insurance Business (Jersey) Law 1996 ("Law") if it carries on insurance business in or from within Jersey. The Law is supplemented by various Orders, as well as Codes of Practice for Insurance Business ("Codes") issued by the Jersey Financial Services Commission ("JFSC").

Article 5(2) of the Law provides that "subject to the provisions of this Law, no person shall carry on in or from within Jersey insurance business to which this Article applies unless that person is authorized by a permit granted under Article 7 (to be known as a "Category A permit" in the case of a permit holder which is granted a permit by virtue of its authorization by or under the law of a jurisdiction outside Jersey and a "Category B permit" in the case of any other permit holder) to carry on business of the description in question."

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The consequences of regulation under the Law has a substantial impact on the manner in which the SPV operates, in particular given that a permit-holder will be subject to the Law and Codes. Further, the insurance contracts which it issues will be subject to the principles of insurance, including the requirement of utmost good faith.

The Guidance Note for Applications Under the Insurance Business (Jersey) Law 1996 ("Guide"), states that "Category A permits will be granted to persons that are already authorised to carry on insurance business by a jurisdiction outside of Jersey; (and) all other persons intending to carry on insurance business will be granted a Category B permit".

The Guide states in paragraph 1.2 that: "In addition to the incorporation of traditional forms of insurance company, the Category B permit facility also allows for the formation of captives, and caters for the establishment of Special Purpose Vehicles such as transformer vehicles and companies for the securitisation of insurance risk. A captive insurance company incorporated under the Companies (Jersey) Law 1991, needs to hold a Category B permit even if it does not undertake its insurance business in or from within the Island."

The Law does not define "insurance" and instead only states in Article 1 that "insurance includes reinsurance". Article 5(1) of the Law further provides that Article 5 applies to long-term business and general business. The writing of insurance contracts against risks related to credit, suretyship and miscellaneous financial loss are included in Classes 14 to 16 of the list of "general business" in the First Schedule to the Law. Notably, these are the sort of risks typically associated an SPV.

The absence of a definition of insurance in the Law and Orders, and further absence of any policy guidance from the JFSC, means that the concept of "insurance" remains a matter of common law in Jersey. In this regard, the Royal Court of Jersey apply a mix of the principles of Jersey (in particular in determining the underlying requirements of a contract) and English common law (in particular in relation to insurance as a specific contract) in determining this issue.

The requirements of an insurance contract are detailed, however, one of the most important principles of insurance which is of relevance in the context of an SPV is the concept of an "insurable interest". An "insurable interest" refers to the requirement for an assured to have a pecuniary interest in the subject matter of the insurance arising from a relationship with it recognised in law.

In the case of an SPV which does not issue a contract to a person with an insurable interest in relation to the risk being insured, it will not be carrying on insurance business. There may be other factors which are relevant too, for instance the nature of the return which the contract provides, indemnification for actual loss as opposed to a fixed or formulaic return usually encountered in the case of non- insurance contracts.

Licensing Requirements for Category B

All Category B applications, which would ordinarily be made by an SPV carrying on insurance business, must be made using the required Application Form, and supported by (1) a five year business plan; (2) projected solvency calculations; (3) details of any reinsurance arrangements; (4) completed personal questionnaire or additional appointments form for all directors, shareholders and key persons. An annual fee is also payable to the JFSC on application as further detailed below.

Government and Licensing Fees

Apart from standard Registry fees payable by an SPV (£200 for a limited company or cell of a cell company), licensing fees will be payable if the SPV requires a permit under the Law. In the case of a Category B permit, where the permit holder will carry on general business and is not a cell company or a cell, the annual fee will be £4,725; and in the case of a category B permit where the

applicant is a cell company, the annual fee will be £4,725, or £1,350 if the permit applied for or to be renewed is to be granted to a cell of a cell company.

Requirements under the Codes

The Codes issued by the JFSC are arranged under seven fundamental principles. Among other things, these require an insurer to (1) conduct its business with integrity; (2) have due regard for the interests of its policyholders; (3) organise and control its affairs effectively for the proper performance of its business and be able to demonstrate the existence of adequate risk management systems; (4) be transparent in its business arrangements; (5) maintain and be able to demonstrate the existence of adequate capital resources; (6) deal with the JFSC in an open and co-operative manner; and (7) not make statements which are misleading, false or deceptive.

Among other things, key structural requirements of an insurer are that it must be under the control of at least three appropriately qualified and experienced people, have at least two Jersey directors, have a Compliance Officer, Money Laundering Officer and Money Laundering Compliance Officer, provide an annual declaration by the Directors to the JFSC, provide CPD of not less than 35 hours per annum to all employees engaged in insurance-related activity, maintain its records in Jersey for at least ten years, maintain capital (minimum £100k) sufficient to meet its insurance liabilities and further meet solvency requirements prescribed by the Law and Orders, appoint and maintain auditors and prepare annual audited accounts.

An SPV may enter into a contract for the services of a management company pursuant to an outsourcing contract. Although the SPV would remain ultimately responsible under the Law, Orders and Codes for its obligations, an existing licensed insurer in Jersey may be used to assist in meeting certain of its obligations on a day to day basis, including the appointment of relevant personnel and officers. This is expressly recognised by the JFSC, and would usually be the case with an SPV which does not have substance in Jersey.

Catastrophe Bonds as Insurance Business

A catastrophe bond would not be regarded as insurance as it is not issued to person in respect of an insurable interest in a risk, but instead in respect of a capital investment which provides a return to investors irrespective of whether or not they have an insurable interest in the subject matter of the risk to which the bond relates. Further, a catastrophe bond does not pay out to the bondholder, but instead hedges the SPV for its exposure to a third party, in the event that the risk to which the bond relates matures. In other words, the catastrophe bond is intended to raise finance to cover a risk that the SPV has covered for a third party.

Other Contracts and Instruments as Insurance Business

An SPV issues catastrophe bonds to hedge its risk to a third party, which may be assumed by way of an insurance contract, reinsurance contract or other form of contract or instrument. Although in the case of entering into an insurance contract or reinsurance contract, a Jersey SPV would be carrying on insurance business under the Law, any other contract (for instance a credit default swap) entered into by the SPV would need to be evaluated to assess whether it constituted insurance business under the Law. The concept of an insurable interest would be key in determining this issue. Notably, an SPV which wishes to enter into reinsurance contracts as an insured party will need to hold a permit under the Law.

In Summary

A Jersey SPV is usually established as a limited liability company pursuant to the Companies Law, and requires consent pursuant to COBO.

A Jersey SPV which does not carry on insurance business will not require a permit under the Law. Further, the contracts such an SPV issues will not be subject to the principles of insurance. For instance, the requirement of utmost good faith will not necessarily apply as it would in the case of an insurance contract.

In the event that a Jersey SPV is carrying on insurance business under the Law, it will require a permit under the Law and also need to comply with the Codes of Practice for Insurance Business. Further, the principles of insurance will apply to any insurance or reinsurance contract entered into by it.

A key determinant in establishing whether a Jersey SPV is carrying on insurance business is the concept of an insurable interest in the risk being insured.

Catastrophe bonds issued by a Jersey SPV do not require an insurable interest on the part of the bondholder and would not constitute the carrying on of insurance business in Jersey.