Client briefing

Insurance Transformers and Other Structured Insurance Products in Jersey

Introduction

Over the last decade there has been a noted convergence of the capital markets and the insurance/reinsurance markets and the evolution of a variety of structured insurance products.

One type of such insurance products are commonly referred to as ‘insurance transformers’ or ‘transformers’. An insurance transformer is an entity (usually an Special Purpose Vehicle (“SPV”)) which ‘transforms’ one type of financial risk into another. Typically this will be risk under an insurance or reinsurance contract transformed into risk under a credit derivative agreement, or vice versa.

In practice, the use of transformer SPVs may involve a range of different scenarios, which include:

1. the transformer SPV selling credit protection under a credit derivative contract and purchasing an insurance policy from an insurer (the economic terms of the contract matching that of the policy);

2. the transformer SPV selling credit protection under a credit derivative contract and purchasing a reinsurance policy from a reinsurer (the economic terms of the contract matching that of the policy);

3. the transformer SPV writing insurance or reinsurance policies (i.e. being treated as an insurer or reinsurer in its own right such that the SPV is able to write insurance and obtain reinsurance protection) and being sufficiently capitalised by equity or debt (or a combination of the two) in order to meet its obligations under the insurance or reinsurance policies; or

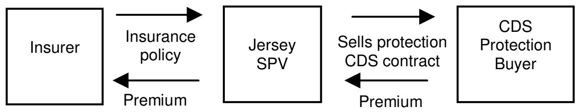
4. as in 3 above, the transformer SPV writing insurance or reinsurance policies but, instead of relying on capitalisation to meet its obligations under such policies, protecting itself by entering into a credit derivative contract (mirroring the economic terms of the policies).

Other variations of the above are possible and specific advice should be obtained on a case by case basis.

This briefing highlights Jersey as a suitable jurisdiction for transformer SPVs and other structured insurance product SPVs.

Insurance Transformers

The following diagram illustrates the basic insurance transformer described in scenario one above.

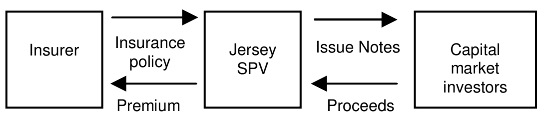


A transformer SPV is set up to sell credit default protection to a third party by entering into a credit derivative contract with it. In turn the transformer SPV hedges itself by purchasing an insurance policy from an insurer. The economic terms of the two contracts will need to be as closely matched as possible, whilst the premiums received by the transformer SPV will need to be sufficient to pay the premium under the insurance policy and meet the transformer SPV’s other costs.

The Jersey SPV is likely to be set up as a bankruptcy remote vehicle and the terms of the credit derivative contract would, therefore, provide limited recourse language, such that the CDS Protection Buyer’s ability to recovery is limited to the assets of the transformer SPV (i.e. the payment received by the transformer SPV under the insurance policy). In this way the CDS Protection Buyer is ultimately taking credit risk on the insurer but doing so by means of a derivative rather than a direct insurance policy.

Insurance securitisation by way of insurance bonds

A transformer SPV may also be used for writing insurance or reinsurance policies (i.e. being treated as an insurer or reinsurer in its own right such that the SPV is able to write insurance and obtain re-insurance protection) and being capitalised by way of debt (i.e. typically by issuing notes to be sold to capital market investors) and/or equity in order to meet its obligations under the insurance or reinsurance policies. The basic cash flows are, therefore, similar to the basic insurance transformer described in scenario one above and, therefore, similar considerations as outlined in section 2 above would apply in respect such Jersey SPV.



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Advantages of Jersey as a jurisdiction generally

Jersey has proven to be popular as a jurisdiction for the incorporation of SPVs for many structured product transactions, including structured insurance products. It is in the same time zone as London and there are close links between the major financial centres of Europe and Jersey. Such features and those set out below, in particular Jersey's tax neutral environment, enable Jersey SPVs to be structured to meet a wide variety of business purposes including the various insurance transformers scenarios referenced above. Advantages of Jersey include the following:

- **Tax neutrality.** An SPV will be established as a 0% rated company for income tax purposes and, it will, therefore, not be liable to pay any Jersey income tax, and any notes and/or any equity issued by it will not be subject to withholding tax.

- **No stamp duty on transaction documents or notes.** Unlike a number of other jurisdictions, Jersey has no stamp duty except in respect of Jersey real property. This removes a complication that can otherwise impact on the closing of a transaction and the execution of relevant documents.

- **Established commercial legal framework**, based in the main, upon established English law principles. The Companies (Jersey) Law 1991 (the "**Companies Law**") has been updated in recent years and draws on many of the provisions of the equivalent UK and other common law jurisdiction's statutes. As a consequence, the principles that apply in Jersey will be familiar to many practitioners and arrangers. The Companies Law does not contain provisions relating to thin capitalisation or moratorium on insolvency.

- **Corporate advantages**. The benefits of using a Jersey company in terms of company law provisions are extremely wide, and generally include separate legal identity, limited liability for shareholders and ease of transfer of ownership. The Companies Law enables capital to be denominated in any currency and share capital of either par value or no par value shares to be issued in various classes, including redeemable shares. It also allows for the incorporation of guarantee companies, unlimited companies and cell companies (the latter providing particular flexibility). A Jersey company is permitted to make a distribution from any source, other than the capital redemption reserve or the nominal capital account, not merely from distributable profits. Distributions may, for example, be made from capital (other than nominal share capital) without a need to obtain court approval for a reduction of capital. Monies payable on the redemption of redeemable shares or on the buy back of shares by a Jersey company may also be funded from any source, including capital.

- **Speed of the regulatory authorities** in issuing the relevant consents to securities issuing vehicles. The Jersey Financial Services Commission (the "**JFSC**") published response time in dealing with applications for consents under the Control of Borrowing (Jersey) Order 1958 and the Companies (General Provisions) (Jersey) Order 2002 is five business days. The approach taken is that of a "gatekeeper", where the entry requirements are checked carefully but there is no annual review process; the JFSC will be concerned to ensure that complex debt instruments are not being offered to ineligible investors that the promoters are organizations which are recognised in the marketplace and that the proposed activities of the SPV are not likely to detract from Jersey's reputation.

- It is a **member of the OECD**. Some investors will be subject to investment restrictions requiring that the SPV is located in an OECD member country.

- Well established as being **acceptable to the rating agencies**.

- **Political stability**.

- **Speed of incorporation**. A Jersey SPV can usually be established within 24 hours.

- **Quality of financial services providers**. Jersey has had a thriving financial services sector for over thirty years, and there is a strong body of law firms, administrative services providers and accountants on the Island.

- **Competitive costs** of legal, accounting and administrative services.

Suitability of Jersey for derivative transactions

Jersey is a 'netting friendly' jurisdiction. Since the adoption by the States of Jersey of the Bankruptcy (Netting, Contractual Subordination and Non-Petition Provisions) (Jersey) Law 2005 (the "Netting Law") the enforceability of contractual netting and set-off arrangements is enshrined as part of Jersey's statutory laws.

The Netting Law provides that, despite any enactment or rule of law to the contrary, a close-out netting or a set-off provision (both such terms being defined broadly) contained in an agreement is enforceable in accordance with its terms. This is the case despite the bankruptcy of a party to the agreement or of any other person, or the lack of any mutuality of obligation between a party to the agreement and any other person.

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Jersey's insurance regulatory regime

In certain of the scenarios set out in the Introduction to this briefing, the transformer SPV may require regulation as an insurer or reinsurer. This will clearly not be the case in the case of the first scenario. However, the SPVs in the other three scenarios may require regulation under the Insurance Law. This is so in respect of the transformer SPV in the second scenario, despite it not carrying out insurance business itself, as the transformer SPV will typically need to be an insurer itself in order to access the reinsurance market.

The regulatory regime in Jersey relating to the carrying on of insurance business in Jersey (and the carrying on of insurance business outside Jersey by Jersey incorporated companies) is covered by the Insurance Business (Jersey) Law 1996 (the "**Insurance Law**"). A summary of Jersey's regulatory regime for insurers is set out in the Schedule to this briefing. The regulatory regime applying to Jersey transformer SPVs is less onerous in comparison with other jurisdictions.

SCHEDULE

Summary of Jersey's regulatory regime for insurers

The Insurance Law provides that a person may only carry on long term or general insurance business in or from within Jersey with a permit (which will be Category A if the applicant is authorised in another jurisdiction and Category B otherwise) granted by the JFSC (Article 5(2)). In addition, a Jersey incorporated company carrying on insurance business outside Jersey must hold a Category B permit (Article 5(6)). A Jersey incorporated SPV will therefore require a Category B permit.

General and long-term business are terms defined in the First Schedule to the Insurance Law. Classes 14, 15 and 16 of the list of General Business in the First Schedule are particularly relevant:

"14. Credit
Effecting and/or carrying out contracts of insurance against risks of loss to the persons insured arising from the insolvency of debtors of theirs or from the failure (otherwise than through insolvency) of debtors of theirs to pay their debts when due.

15. Suretyship
Effecting and/or carrying out –

(a) contracts of insurance against risks of loss to the persons insured arising from their having to perform contracts of guarantee entered into by them;

(b) contracts for fidelity bonds, performance bonds, administration bonds, bail bonds or custom bonds or similar contracts of guarantee,

if, in the case of contracts referred to in head (b) above, such contracts are effected and carried out by a person not carrying on a banking business, and such contracts are effected by way of business (and not merely incidentally to some other business carried out by the person effecting them) in return for the payment of one or more premiums.

16. Miscellaneous financial loss
Effecting and/or carrying out contracts of insurance against any of the following risks, namely –

(a) risks of loss to the persons insured attributable to interruptions of the carrying on of business carried on by them or to reduction of the scope of business so carried on;

(b) risks of loss to the persons insured attributable to their incurring unforeseen expense (other than such loss as is covered by contracts falling within class 18);

(c) risks neither falling within head (a) or (b) above nor being of a kind such that the carrying on of the business of effecting and carrying out contracts of insurance against them constitutes the carrying on of insurance business of some other class."

To carry on insurance business without a permit is an offence the penalty for which would be imprisonment for a maximum of five years and/or a fine (Article 5(4)).

Application for a permit under the Insurance Law

The Commission has indicated that in general the following items are relevant to Category B applications:

1. The standing, reputation and nature of business of the owners of the applicant and their combined level of free capital and reserves.
2. The nature and expertise and insurance matters available to the applicant.
3. The paid-up share capital of the applicant and the level of free capital and reserves compared to premium income.
4. The applicant's reinsurance arrangements (if any).
5. Whether fit and proper persons are employed by or associated with the applicant in the management, control and audit of its operations.
6. The nature of risks to be insured.

The JFSC is generally flexible in considering applications by an SPV applying for a Category B permit.

All Category B permits carry conditions. They can be summarised as follows:

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1. No change in ownership without the JFSC's consent.
2. No change of directors without the JFSC's consent.
3. No change of auditors without the JFSC's consent.
4. The permit holder shall not write risks or introduce new products without the JFSC's consent.
5. The permit holder shall furnish to the JFSC at six monthly intervals such information relating to its business as to the JFSC may determine.
6. The permit holder shall furnish to the JFSC at six monthly intervals financial statements including a balance sheet and profit and loss account.
7. The permit holder shall provide audited accounts to the JFSC within three months of the end of the financial period.
8. The permit holder shall (unless otherwise agreed in writing by the JFSC) restrict the investment of its liquid assets to bank deposits, government securities, certificates of deposit and approved Eurobonds.
9. The auditors confirm (every six months) that items 4 and 8 above have been complied with.

The JFSC may impose additional conditions to those listed above (Article 7(5)).

The JFSC will wish to be satisfied that the permit holder has sufficient funding to finance the first three years of its business and will normally require an initial capitalisation of £100,000.00. However in the case of an SPV where the investors in (or creditors of) the SPV will bear all the risk it will allow significantly lower capitalisation (e.g. £100).

The application process referred to above is two stage in nature. Initially the permit holder's advisers will approach the JFSC to obtain "in principle consent" before a formal application is made on the permit holder's behalf.

The following is the list of information required at the formal application stage (in addition to the information listed above):

1. Latest audited accounts, if any.
2. Details of directors, controllers or managers of the business in the Island.
3. Names and address of external auditors.
4. Class of insurance business which the company wishes to include in the permit.
5. Three year business plan.
6. Draft re-insurance treaty (if applicable).

Again, in the case of an SPV not all of the above requirements will be applicable.

The following application/renewal fees are payable in the case of a Category B permit:

(i) £6,000 if the permit applied for/to be renewed includes long-term insurance business;

(ii) £3,000 in any other case.

If it is accepted by the JFSC that the obligations of the SPV under the credit insurance contract fall within the heads of General Business as described above, the relevant application/renewal fee will be £3,000.

Ongoing Obligations for permit holders generally

The Insurance Law imposes ongoing obligations on permit holders which may be summarised as follows:

Display of permit

The JFSC may give notice of the manner in which the permit holder must display the permit to members of the public, including any amendments to the permit. The penalty for breaching this requirement is a fine (Article 7A).

Annual renewal of permits

Permits must be renewed on 1 October of every year (Article 6(2)). It is an offence to carry out insurance business without a permit. Renewal fees are currently the same as those payable on application for the permit. The penalty is imprisonment for a term not exceeding five years and/or a fine (Article 5(4)).

Disclosure of information

Permit holders must disclose information to the JFSC which is relevant to the JFSC performing its functions under the Insurance Law or the withholding of the information would result in the JFSC being misled on any matter.

Non disclosure is an offence. The penalty is imprisonment for a term not exceeding two years and/or a fine (Article 15(3)).

Accounting records

(i) Permit holders must keep accounting records which are sufficient to show and explain transactions and disclose at any time with reasonable accuracy the permit holder's financial position (Article 16(1)).

(ii) Permit holders must prepare financial statements for each financial period consisting of a balance sheet and a profit and loss account (Article 16(2)).

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(iii) The balance sheet and profit and loss accounts must give a true and fair view of the state of affairs of the permit holder. (Article 16(3)).

The requirements listed at (i), (ii) and (iii) above may be waived by the JFSC.

Appoint an auditor

Permit holders must appoint and retain a qualified auditor throughout the period in which it holds a permit under the Insurance Law (Article 17).

Auditors Report

The permit holder must submit its financial statements to the auditor to enable him to prepare an auditor's report on the activities of the permit holder. The Insurance Law gives auditors the following powers to enable them to form an opinion on the matters dealt with in the report:

(i) access to accounting and other documents relating to the permit holder's business; and

(ii) the right to require such information and explanations from the permit holder as are necessary to enable it to perform its duties as auditor.

Any director, chief executive or shareholder controller who knowingly or recklessly makes a false or misleading statement to the auditors is liable to imprisonment for a term not exceeding two years and/or a fine (Article 20(4)).

The auditor's report must:

(i) be addressed to the JFSC;

(ii) comply with requirements of Article 18(2) - (5) of the Insurance Law inclusive;

(iii) be submitted (together with the financial statements) to the JFSC within three months after the end of the financial year for a Category B permit holder.

Failure to submit the above documents within the prescribed period is an offence subject to a fine.

Ongoing obligations for Category B permit holders

Notification of change in management

Category B permit holders must notify the JFSC of a change of director, chief executive, key person or shareholder controller within fourteen days of becoming aware of the change (Article 23(1)). Failure to do so is an offence.

Category B permit holders undertaking long-term business

(i) If intending to carry out long-term business the permit holder must appoint a qualified actuary (Article 25(1)) and notify the JFSC of any subsequent appointments/terminations.

(ii) The permit holder must keep separate accounts in respect of its long-term business (Article 26(1)).

(iii) Receipts from long-term business must be (with certain limited exceptions) kept separate from other assets, lodged in long-term business funds and only applied for long-term business.

It is an offence to fail to comply with the relevant provisions of Articles 25 and 26 of the Insurance Law.

Solvency Margins

Category B permit holders must maintain certain margins of solvency pursuant to Article 24 of the Insurance Law and the Insurance Business (Solvency Margin) (Jersey) Order 1996. However, the JFSC may by notice in writing waive this requirement. The JFSC has indicated that in SPV transactions where the transaction is limited recourse and investors take all the risk they will consider waiving (and have waived in the past) the solvency margins.

Codes of Practice

The JFSC may issue Codes of Practice to permit holders. No relevant codes have been issued to date.

Functions of the JFSC

Control and supervision of insurance companies carrying out long-term and general business in Jersey is carried out by the JFSC. The JFSC has a number of powers available to enable it to perform its supervisory function (which includes investigatory powers as well as power to assist regulators from other jurisdictions).

About Ogier

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The Group employs over 850 people and provides advice on all aspects of BVI, Cayman, Guernsey and Jersey law and fiduciary services through our international spread of offices that cover all time zones and key financial markets. Our network includes Bahrain, BVI, Cayman, Guernsey, Hong Kong, Ireland, Jersey, London, Shanghai and Tokyo.

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