FOCUS ON INSURANCE COMPANIES

USING TRUSTS AND SECURITISATION WITHIN INSURANCE COMPANY FINANCING

BNY MELLON

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Introducing BNY Mellon's Insurance Industry Roundtable Series

A panel of our insurance industry experts offer their insights on the evolving European insurance industry This newsletter provides an overview of the transcript derived from one in a series of Insurance Industry Roundtable discussions in which our executive team and industry and product experts explore key trends and issues facing our insurance industry clients.

Our Insurance Industry Roundtable series considers the challenges facing Insurers in EMEA and how by accessing BNY Mellon's comprehensive Investment Management and Investment Services solutions we can help them achieve their business objectives. Other topics include:

- Seeking alpha on Insurers' efficient investment frontier
- The hidden value of specialists - Transition & Beta Management for Insurers
- Cash investments in a turbulent world
- Managing your securities financing & derivatives collateral for optimum result
- Using your Global Markets Counterparty to manage risk

EMMA WILKES: How are insurers reacting to the challenging environment of low interest rates, the euro crisis and a wave of new regulation?

CAROLINE CRUICKSHANK: Financial uncertainty in Europe and the changing regulatory environment do create headwinds to business growth; however, they are not barriers. Insurers are conservative long-term investors and keep a close eye on portfolio volatility, protecting their balance sheet as much as possible from impacts like default risk and lower credit yields. Yet there is opportunity - inevitable consolidation in the European market owing to low insurance company valuations and the pressures of conforming to the forthcoming Solvency II regime.

NICOLA DALE: Insurers have come through the financial crisis better than the banking sector.

ROBERT WAGSTAFF: But they've had to deal with the financial impact of a string of catastrophes. We expect insurers to issue an increased amount of debt-like, smaller, more frequent catastrophe bonds through programmes rather than via one-off standalone deals.

EMMA: Given the size and importance of the insurance industry, what impact will Solvency II have on financial markets once insurers react to new rules?

CAROLINE: Until now, only the larger insurers with high credit ratings could bring enough resources to access the capital markets. Under Solvency II, subordinated debt may become a more accessible source of capital, offering more attractive means for issuers to meet EU-mandated solvency capital requirements versus issuing equity.

NICOLA: And for investors, debt is not being issued with long enough tenure. Solvency II is expected to incentivise insurers to match their liabilities with longer term investments which may change their portfolios' asset allocations. This will have an impact on European debt markets. Risk mitigating techniques, such as hedging programs or guaranteed structures, could gain popularity. Solvency II may also impact insurers investing in structured finance assets, potentially hindering the revival of the structured products market. We may see an increase in financial engineering, where Solvency II yielding assets will be developed to enhance return on capital, such as reverse repos and structured notes.

ROBERT: Another impact we see involves clients who finance their assets in bi-lateral trading/lending arrangements using a Collateral Agent. Insurers have increasing demand for an independent third-party to hold less liquid assets such as ABS, CDOs and even Loans, which is a natural fit for our Corporate Trust business. Even if you can't carry out publicly-rated transactions, buyers are willing to participate in a bi-lateral arrangement if a third party like BNY Mellon holds or takes a charge over the collateral.

EMMA: Will we see any uptake in insurance trust and tri-party collateral solutions as a result of Solvency II?

NICOLA: Although letters of credit are still entrenched as a traditional form of collateral, we know that market credit capacity is severely squeezed. Many clients are looking to satisfy reinsurance collateral requirements with alternatives and we are increasingly seeing demand for escrows, tri-party custody, bi-lateral custody, and insurance trust solutions.

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ROBERT: The problem with traditional lending is that much of the European leverage loan market, worth close to $1 trillion globally, is funded by groups of banks lending to corporates due to greater risk weighting or unrated assets. Under Basel III, it will be less attractive for banks to lend to corporates.
One thought is that collateral loan obligations could see a return to a viable funding source in Europe that has been closed since 2008.

EMMA: How significant is the use of special purpose vehicles in the transfer of insurance risks?

CAROLINE: Special Purpose Reinsurance Vehicles, or SPRVs, are used where the underlying risk is transferred through a reinsurance arrangement. The concept of the SPRV is becoming more established in jurisdictions from the Cayman Islands to Singapore, where they are embracing new or improving existing legislation. In Europe, Ireland has been quite innovative with SPRVs, which have seen reinsurance issuers obtaincover against catastrophes like European windstorms, US hurricanes and Japanese earthquakes. Solvency II is set to recognise these types of insurance securitisations, requiring EU member states to allow the establishment of SPRVs in their territories. This is good news because Europe traditionally lagged behind the U.S. CAT bond market to deliver extra catastrophe capacity for reinsurers.

NICOLA: Within the insurance industry, there are also other vehicles that are gaining ground. Captive insurance companies are using protected cell companies and incorporated cell companies to transfer insurance risks. As a form of alternative risk transfer they are gaining momentum; jurisdictions like Guernsey have seen a tremendous growth in captives, PCC and ICC formations.

EMMA: Speaking of risk transfer, are insurance-linked securities likely to play a bigger role?

CAROLINE: Absolutely. The sector is increasingly assessing non-traditional reinsurance products with growing interest in capital markets solutions like ILS, which includes CAT bonds, industry loss warranties and longevity, and embedded-value securitisations. There is also a rise in popularity of sidecars and contingent capital structures, which are seeing a comeback. Although the CAT bond market suffered some set-backs in 2008 and 2009 as a result of the Lehman failure, we anticipate more growth in the ILS market this year.

ROBERT: Many reinsurers have also increased their 2012 budgets for private market reinsurance limits and are looking to incorporate provisions for CAT bond protection for the first time. BNY Mellon has approximately 80% market share of the CAT bond market. We provide comprehensive servicing to CAT bond issuers and their sponsors, acting as a trustee and paying agent on the note issuance, a collateral trustee over the pool of assets in trust, and providing specialized reporting to meet increased transparency requirements.

EMMA: Will captives be impacted by the new capital rules under Solvency II?

CAROLINE: Solvency II was never intended to target captives. But since captives are classified as reinsurers they will be subject to the higher capital requirements. EU captives may have little choice but to strengthen their risk management and governance and, in some cases, may need an injection of additional capital. Instead, we might see a re-domiciliation of captives to jurisdictions that will not have Solvency II equivalency, like Guernsey. When they do, captives will need fronting insurance to write EU-based business. That's when the carrier will request collateral to secure insurance obligations. Captives can opt to post collateral into a Reinsurance Trust.

EMMA: What makes reinsurance trusts appeal?

NICOLA: These arrangements are significantly cheaper than letters of credit. In the U.S., reinsurance trusts have been around for decades and cater to specific collateral regulations, like New York State Regulation 114. However, credit and counterparty risk issues are not just limited to a U.S. context. We cater to collateralising UK and European liabilities through our European Reinsurance Trusts.

CAROLINE: How it works is collateral assets are deposited and pledged to a beneficiary who is entitled to the assets in the event of the captive's default. Assets in trust remain on the captive's balance sheet so they benefit from any income earned. The amount of back office tracking is reduced since trusts don't need to be renewed annually, like letters of credit, and assets can be aggregated into one trust to cover all of the captive's liabilities to the same carrier. Another advantage is that the reinsurance trust provides a framework which meets the requirements for Solvency II, including analytics, reporting and data management.

EMMA: So what can collateral managers do to give insurers counterparty or yield reassurance?

ROBERT: Counterparty risk is a prolific issue. Even if you use multiple triple-A rated counterparties, you shouldn't hold all of your capital with one firm. Insurers could divide their capital among a panel of firms. The spread of counterparties will help insurers minimise risk.

NICOLA: The challenge is how to effectively manage assets that are essentially restricted on the balance sheet as pledged assets. There are solutions that can help collateral managers unlock the value of their portfolios and optimise the potential for income through a wide array of investment options and asset management strategies. For example, insurers may look to alternative assets to increase their yield, such as investing in infrastructure financing for an attractive rate of return.

CAROLINE: Solvency II will have an impact on debt issuance, as the tenor and rating of bonds from corporate issuers will become more significant after the regulation takes hold, and insurers will be pushed toward investment grade debt. Corporates will likely have to adjust their capital structure or offer higher yields in compensation for the capital cost to insurers.

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