SECURITIZING INSURANCE RISKS

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I. INTRODUCTION

Innovations can consist of new lenses for viewing the state of the world. Securitizing risks is such an innovation. The process of securitization has been traditionally used as a method of converting illiquid financial assets into liquid marketable assets. In the process, functions are unbundled, and the risks of investors in these assets can be reduced by diversification and other means.

However, the same process of securitization can be used to transfer risks, whether represented by financial assets or attached to them. By this method risks can be stripped and transferred, creating a derivative security representing the amount and type of risk that investors in the markets are ready to underwrite (for a price).[1] Until recently, risk transfer was

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1 *See* Martha G. Bannerman, *Avoiding and Resolving Reinsurance Coverage Disputes: A Proactive Approach, in* REINSURANCE LAW & PRACTICE: NEW LEGAL AND BUSINESS DEVELOPMENTS IN A CHANGING GLOBAL ENVIRONMENT 1998, at 173, 203–04 (PLI) (noting developments of the insurance-based securities market with 1998 sales of insurance-backed securities likely to surpass 1997 sales of $195 billion; describing recent issues; noting attention securities have received from the investment community); Investors Guar. Fund, Ltd. v. Morgan Stanley & Co., 50 U.S.P.Q.2d (BNA) 1523 (S.D.N.Y. Dec. 23, 1998) (describing the emergence of insurance risk securitization); Lawrence Richter Quinn, *Weather Bonds from Enron, Koch to Debut Today*, INVESTMENT DEALERS DIG., Nov.1, 1999, *available in* LEXIS, News Library, Curnws file (describing the issuance of the first weather

considered the sole domain of institutional intermediaries, especially insurance companies. No longer. This function is becoming a joint domain of institutions and the markets.

The process of insurance securitization follows traditional forms of securitization. It consists of: (1) creating a "special purpose vehicle"(SPV), and making the SPV as bankruptcy proof as possible; (2) causing the SPV to issue bonds to investors; (3) causing the SPV to enter into reinsurance contracts with ceding insurers or other beneficiaries for an annual payment ("premiums") and calculating the appropriate amount of premiums; (4) investing the proceeds from the bond distribution and the premiums; (5) ensuring the safety and soundness of the SPV and its investments; and (6) servicing by reliable collection and distribution of the SPV's net earnings and premiums payments (after paying the claims under the reinsurance contracts, and management and other expenses).[2]

Since banks, insurance companies, and other financial intermediaries hold mostly financial assets, risk securitization enables them to reduce their portfolio risks in full or in part. They can continue to maintain client relationships, hold the benefits from financial assets, and pay investors to absorb the risks. If, for investors, the risks are lower than for the institutions, investors may demand lower payments for underwriting the risks, and the institutions, the investors or the insureds can pocket or share the difference.
Like most innovative ideas, securitization of insurance risks is simple; it reflects insurance principles. After all, insurance consists of pooling risks from a large number of those who are at risk and transferring-distributing these risks among them (mutual insurance), or among a large number of underwriters (insurance company shareholders). Securitization of insurance does the same thing.

The new pooling, distribution, and transfer of risks can take two forms. It can directly provide insurance to policyholders. Or it can constitute an added and magnified layer over the traditional insurance, in which case insurance and/or reinsurance ("insurance") remain intact, and a new system of reinsurance is layered over it. SPV reinsurance contracts may absorb all or specified parts of the ceding company's obligations, or can be limited to an index of aggregate damages from a particular type of disaster.

Although the securitization of insurance risk is similar to the traditional forms, it presents a number of significant innovative differences.

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bonds, and noting that if the bonds are not called investors may make as much as 30% but the risk is high).

2 *See generally* 1 TAMAR FRANKEL, SECURITIZATION § 1 (1991) [hereinafter FRANKEL, SECURITIZATION]. For a general description of the process, *see* Tamar Frankel, Securitization, *in* FINANCIAL PRODUCTS FUNDAMENTALS ch. 4 (1999).

First, if the transfer of the risks is from insurance companies, they remain the secondary risk bearers.[3] Second, the new risk underwriters are investors, and not other insurance companies. Third, the risks are transferred to investors through the securities markets and the use of securitization.[4] Fourth, because payment of claims is conditioned on payment of premiums, investors' credit risks are far lower than their risks from mortgages or other debt. Nonpayment of premiums automatically eliminates insurance obligations. Fifth, because the premiums must cover investors' risks, the calculation of the premiums is of great importance to the safety and soundness of the SPV and investors' revenues. Such a risk, however, exists also in pricing and valuation of loans in traditional securitization. But pricing the bonds involves uncertainty.

The bonds issued by SPVs insurance securitization are unique. Under these bonds payment of principal and/or return to investors depends upon the occurrence (or nonoccurrence) of an event or events, which the SPV covers by direct obligations to insureds or obligations to insurance companies under reinsurance contracts. Thus, if such events occur in a given year, and payments on claims exceed the premiums or the proceeds on the bonds (and returns on investment of these amounts) investors will lose. If, however, under the SPV's obligations, payments due on claims are less than the investments of the premiums and on the proceeds of the bonds, the bonds will earn the difference.[5]

Securitization of insurance is currently used to cover damages from natural catastrophic events, such as earthquakes and floods ("catastrophic events"). The investments involving risk coverage of such events are attractive to investors because the risks do not correlate with business and economic risks. The bonds offer diversification to the investments that most

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3 Insurance companies may not transfer their obligations without the consent of the policyholders, and we assume that such a consent is not forthcoming for practical and other reasons.

4 *See* William D. Torchiana, *Outline of Legal Issues For Insurers and Reinsurers Considering Securitization of Insurance Risk, in* NUTS & BOLTS OF FINANCIAL PRODUCTS 1999: UNDERSTANDING THE EVOLVING WORLD OF CAPITAL MARKET & INVESTMENT MANAGEMENT PRODUCTS 659, 661 (PLI).

5 Presumably, if the bonds are assessable, and payments due to policyholders exceed the assets held by the SPVs, the bondholders will have to make up the difference. Otherwise, bondholders will have a limited liability; that is, they may lose their investments but not their homes.

investors hold. However, this type of insurance is highly risky for insurers.[6] The number of catastrophic events is relatively small, and their frequency is hard to predict, while the damages from these events can be enormous. Residents in parts of the country that do not experience such events are unlikely to seek insurance. Price of insurance after the occurrence of a catastrophic events usually rises and then falls when memory fades, rendering the business of reinsurance volatile. The reinsurance industry does not have sufficient capital to cover such risks. That is one reasons why the U.S. government offers flood insurance in parts of the country.[7] In effect, substantial losses from natural disasters are transferred and distributed among taxpayers.[8]

The novel system of risk transfer addresses these problems by (1) pooling a larger number of catastrophic events risks, and creating a more diversified portfolio of such risks; (2) substituting investors (both individuals and institutions that then distribute the risk to individuals) for insurers (and risk taking taxpayers); (3) utilizing the mechanisms of the securities markets to reach investors; and (4) in general, utilizing securitization techniques to achieve these purposes, including manipulating the aggregate risks (e.g., by institutional risk underwriters such as banks, other reinsurers). Through this technique investors become insurers and reinsurers of catastrophic events. Consequently, as compared to insurance risks covered by the capital of the reinsurance industry, insurance risks through securitization are covered by far larger and more liquid capital markets.[9] However, even though insurance securitization may relieve the insurance industry by providing it with added

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6 Steve Tuckey, *Regulator Sess [sic] Catastrophe Bonds as the Answer*, ASSET SALES REP., Oct. 25, 1999, *available in* LEXIS, News Library, Curnws File (citing Arnold Dutcher, chief deputy director of the Illinois Insurance Department, that based on predictions "had the storm Andrew gone ashore about 40 miles north . . . about 36% of the carriers covering the losses would have been made insolvent . . . leading to an exhaustion of state guaranty funds and up to $54 billion in unpaid claims").

7 *See* National Flood Insurance Act of 1968, 42 U.S.C. § 4001(a) (1994).

8 *See generally* Charles T. Griffith, *The National Flood Insurance Program: Unattained Purposes, Liability in Contract and Takings*, 35 WM. & MARY L. REV. 727 (1994).

9 *See* Eduardo Canabarro et al. Goldman Sachs and Richard R Anderson et al., Risk Management Solutions, *Analyzing Insurance-Linked Securities,* Oct. 1998 , at 1–4 [hereinafter: Goldman Sachs]; Ruth Gastel, *Reinsurance*, III INS. ISSUES UPDATE, Jan. 2000, *available in* LEXIS, News Library, Curnws File (describing insurance risk securitization).

capital, commentators are concerned that insurance risk securitization may also pose a competitive threat to the reinsurance industry.[10]

Each of the steps in the securitization process raises legal issues. Many of these issues are being resolved by the markets or by new laws. Insurance securitization poses added unique issues at most stages of the securitization process. Underlying these issues is the difficulty of classifying insurance risk securitization as insurance or securities or futures contracts. The questions apply both to the SPVs and the bonds they issue. Since the legal system addresses insurance, securities, and futures contracts separately, whenever the assets represent combined features, similar problems arise.[11] The classification of insurance risk securitization determines the regulation of their operations, taxation, sales, and creditors' rights in the event of bankruptcy.

Legal problems, and especially the applicability of insurance regulation, have triggered the escape of insurance securitization offshore, where institutions such as banks, that are not regulated by insurance laws, are developing a thriving business. That concerned the insurance industry and its regulators. Competitors to the reinsurance companies are relieved from regulation and expanding a lucrative business. Regulators of other institutions are gaining at the expense of insurance regulators. The insurance industry and its regulators have taken steps to resolve the legal issues and invite insurance securitization back on shore. The National Association of Insurance Commissioners ("NAIC") has adopted a Model Law and is currently considering another.[12] A number of states have passed laws

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10 *See* Steve Tuckey, *Outlook Negative for Reinsurance Market*, INS. ACCT., Sept. 13, 1999, at 1, *available in* LEXIS, News Library, Curnws File; *Standard & Poor's Outlook Negative for Global Reinsurance Industry,* PR NEWSWIRE, Sept. 7, 1999, *available in* LEXIS, News Library, Curnws File (noting that reinsurers are packaging and purchasing insurance-linked bonds); Mark P. Gergen, *Afterword: Apocalypse Not*?, 50 TAX L. REV. 833, 843 (1995) ("[S]ecuritization of reinsurance risks seems inevitable given the current tribulations of the reinsurance market."). A similar concern was posed by the banking industry. However, rather than fight it, the banks joined it. It seems that a similar attitude is adopted by the insurance industry.

11 *See, e.g.*, Tamar Frankel, *Variable Annuities, Variable Insurance and Separate Accounts,* 51 B.U. L. REV. 173, 177–219 (1971) (discussing the structure and legal classification of variable annuities and variable life insurance and the status of separate accounts under the securities acts) .

12 *See Protected Cell Company Model Law* (visited Jan. 25, 2000) <http://www.naic.org/1papers/models/1299docs/protected_cell_company_model_law.htm>; *NAIC Adopts Catastrophe Bond Protected-Cell Model,* BESTWIRE, Dec. 7, 1999, *available in* LEXIS, News Library, Curnws File (noting that the Model Law is similar to an Illinois act); *NAIC Addresses Reinsurance*

addressing some of the issues.[13] The legal adjustments required to accommodate insurance securitization are not yet complete.

The method of risk transfer by securitization is especially important for insurers and reinsurers engaged in the business of risk underwriting, and could drastically change insurance concepts and the insurance industry.[14] The method can also have an effect on policyholders and taxpayers. A similar process, however, may be used for securitizing risks of other financial assets, including bank assets, and it seems that experts are at work to design risk transfers in that area as well. Because it is a prototype for future risk securitization, this Article focuses on securitizing insurance risks.

This Article analyzes and evaluates the legal problems that have arisen in connection with this rapidly developing insurance risk securitization. The first part of the Article deals with legal issues concerning the SPVs that undertake insurance and reinsurance contracts with ceding insurers and the other parties to the transaction. The Article addresses the dilemma in choosing the laws applicable to SPVs, the bonds they issue, and the persons and entities that form part of the securitization transaction. These laws involve state insurance laws, bankruptcy and tax laws, the Investment Company Act of 1940 and the Commodity Exchange Act of 1934, the Securities Act of 1933 and the Securities Exchange Act of 1934. All these laws treat insurance and securities differently, and do not comfortably fit both. In addition, the insurance/securities distinction may require a choice between state and federal laws. Further muddying the waters is the McCarran-Ferguson Act, which gives priority in some cases to state insurance laws.

Recent developments in the financial markets have posed similar problems of classification, and attempts have been made to accommodate arrangements that bear the features of more than one "pure" financial asset species. One form of analysis focuses on whether the financial asset resembles one type or another. However, there is no escape from determining what "resemble" means, and that leads to a policy inquiry about the problems which the legislation was designed to reduce or eliminate, and to the policies underlying the chosen solutions. This Article has adopted this approach.

Part II of the Article examines the proposed solutions that the insurance industry and its regulators have offered to the legal problems

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Regulatory Issues at Winter National Meeting, INT'L REINSURANCE DISP. REP., Dec. 27, 1999, at 9, *available in* LEXIS, News Library, Curnws File.

13 *See, e.g.,* sources cited *infra* note 54 (Rhode Island and Illinois laws).

14 *See* Simon Challis, *The Compelling Maths of Insurance Bonds*, EUROWEEK, Sept. 4, 1998 (visited Jan. 22, 2000) <http://www.risconsulting.com/ News/090498 (2).htm>.

involving insurance securitization, and unresolved issues that are still pending. The Article concludes with a proposed guide to addressing the issues.

II. LEGAL ISSUES INVOLVING THE SPVS

A. The Relationship Between State and Federal Laws: The McCarran-Ferguson Act

The relationship between federal and state insurance laws is governed by a special statute that gives precedence to state laws. Under the McCarran-Ferguson Act[15] the "business of insurance" is to be governed by state laws, unless federal laws expressly apply to insurance business.[16] If a state adopts a clear law applicable to insurance securitization, and classifies it as the business of insurance, federal courts might concede jurisdiction,[17] although in some cases they did not (for example, in the case of variable annuities and mergers among insurance companies).[18]

> In Union Labor Life Ins. Co. v. Pireno, the Supreme Court set forth three criteria relevant in determining whether a particular practice is part of the "business of insurance" . . . first, whether the practice has the effect of transferring or spreading a policyholder's risk; second, whether the practice is an integral part of the policy relationship between the

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15 *See* 15 U.S.C. §§ 1011–1015 (1994).

16 For a discussion of what constitutes the "business of insurance" *see*, *e.g.,* Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205 (1979); Union Labor Life Ins. Co. v. Pireno*,* 458 U.S. 119 (1982); Metropolitan Life Ins. Co. v. Massachusetts, 471 U.S. 724 (1985); Pilot Life Ins. Co. v. Dedeaux, 481 U.S. 41 (1987).

17 *See In re* Estate of Medcare HMO*,* 998 F.2d 436, 441 (7th Cir. 1993) (stating that "when Congress has not provided an explicit alternative to state law, we are mindful that the Bankruptcy Code was written in the shadow of state law and conclude that Congress intended state law to fill the interstices"); *see* also Butner v. United States*,* 440 U.S. 48, 54 (1979); *In re Roach,* 824 F.2d 1370, 1373–74 (3d Cir. 1987).

18 *See* SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959) (variable annuities are subject to the Securities Act of 1933); SEC v. National Sec., Inc., 393 U.S. 453 (1969) (mergers among insurance companies may be subject to securities regulation); 1 TAMAR FRANKEL, THE REGULATION OF MONEY MANAGERS § 12, at 44–49 (1978) [hereinafter FRANKEL, MONEY MANAGERS].

> insurer and the insured; and third, whether the practice is limited to entities within the insurance industry.[19]

Although many states use the criteria outlined above in defining the "business of insurance," under the McCarran-Ferguson Act, each state has the authority to define the term differently. In all likelihood, the SPVs will fall within states' statutory definition of the "business of insurance," thus subjecting SPVs to the particular state's insurance regulations.[20] Consequently, state insurance laws will have priority over general federal laws that do not specifically target insurance companies.

B. Bankruptcy Issues: Special Purpose Vehicles (SPVs)

One of the main concerns of investors in traditional securitized assets is that the assets they bought indirectly, and held by the SPV, will be vulnerable to the claims of the transferors' creditors. The claims can be based on the ground that the transfer was faulty[21] or that the SPV is not separate from the bankrupt transferor and should be consolidated with the transferor. Thereafter, its assets would be distributed among the transferor's creditors.

In insurance securitization, however, the assets that investors may lose to the creditors of the ceding insurance company are the premiums due to the SPV under reinsurance contracts. The SPV's other assets derive from the bondholders' payments. In contrast to the traditional process, in insurance securitization the shoe is on the other foot. As to premiums, the SPV is the obligor. If premiums remain unpaid, no claims will be paid either. The policies are canceled before the covered period. Under this scenario investors will not stand in line with other creditors of the ceding company, and they need not perfect a security interest in the assets of the insurance company.[22]

In traditional securitization SPVs are allowed to engage in few activities, usually just holding and servicing the assets. Therefore, the SPVs themselves are unlikely to become bankrupt. In contrast, insurance securitization involves more management and business decisions. For example, the risk involved in calculating the premiums, though it may be

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19 *Union Labor Life Ins. Co.,* 458 U.S. at 129.

20 To avoid such regulation, SPVs were established and operated offshore in Bermuda and the Cayman Islands. *See* Alex Maurice, *NAIC Poised to Adopt Securitization Models*, NAT'L UNDERWRITER, PROP. & CASUALTY/RISK & BENEFITS MGMT., EDITION, July 12, 1999, at S28, *available in* LEXIS, News Library, Curws File; Jeany Haggerty, *U.S. Regulators to Bust Open Insurer Securitization*, DERIVATIVES WK., Aug. 16, 1999, *available in* 1999 WL 11307225.

21 *See* 1 FRANKEL, SECURITIZATION, *supra* note 2, § 10.10.

22 *See id*. § 10.8.

complex, is low if made by experts of a regulated financial institution, such as a bank. Risk may, however, rise if the SPV is not managed by a reliable institution. Further, the pricing of the bonds is difficult. In such a case sponsors of securitization must make every effort to render the SPV "bankruptcy remote" or even "bankruptcy proof." They should ensure the SPV's independence.

Under bankruptcy laws, the status of insurance risk securitization is complex. It seems, however, that the SPVs are subject to insurance laws rather than to the Federal Bankruptcy Code. One reason is the McCarran-Ferguson Act, described above. Since SPVs carry insurance obligations federal courts might view them as insurance companies, subject to the regulation of insurance state laws.

In addition, federal courts may determine SPVs' status as insurance companies under the federal bankruptcy code. Section 109(b)(2) of the Bankruptcy Code provides that a "domestic insurance company" is not eligible to be a debtor under the Bankruptcy Code.[23] The Code, however, does not define the term "domestic insurance company." Federal courts have interpreted the term "domestic insurance company" under a number of approaches. One approach relies solely on state insurance laws to define the term.[24] Under this approach, an entity could be excluded under the state law if either "state law classifies the entity as . . . specifically excluded . . . under section 109(b)(2)," or if state law did not specifically exclude the entity at issue, then "the question becomes whether the entity is the substantial equivalent of those in the excluded class."[25]

A second approach relies on the courts' independent classification, presumably applying a federal common law analysis.[26] Under this approach, a reviewing court would look only to the language and legislative history of section 109(b)(2) and make a determination using traditional techniques of statutory construction.[27] A third approach examines the policy question

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23 *See* 11 U.S.C. § 109(b)(2) (1994).

24 *See, e.g., In re Cash Currency Exch., Inc.,* 762 F.2d 542, 548–52 (7th Cir.) (holding, under both the state classification test and the independent classification test, that a currency exchange was not an excluded entity under section 109(b)(2)) (applying Illinois law), *cert. denied,* 474 U.S. 904 (1985); *In re Michigan Master Health Plan, Inc.,* 90 B.R. 274 (E.D. Mich. 1985) (relying solely on the opinion of the Michigan Attorney General that an HMO was not an insurance company), *rev'g* 44 B.R. 642 (Bankr., E.D. Mich. 1984) (finding HMO to be insurance company under both the state and independent tests).

25 *In re Cash Currency Exchange, Inc.*, 762 F.2d at 548.

26 *See id.* at 551–52.

27 *See id.*

whether federal bankruptcy relief would be a satisfactory alternative to the state proceedings;[28] and a fourth approach follows the classification under the law of the SPV's state of incorporation, so long as that classification does not frustrate the policies of the Bankruptcy Code.[29]

As it relates to insurance securitization, the key test in all these approaches appears to be whether the state classifies and treats the SPV as an insurance company. Thus, the Seventh Circuit stated: "The essential attribute of an insurance company under Illinois law, and the attribute prompting deference to state regulation, is the assumption [by the company in question] of a third party's risk for a premium."[30] Following the Seventh Circuit's approach, the status as a "domestic insurance company" of an SPV that enters into reinsurance contracts with a currently insolvent primary insurance company is likely to be determined under state law rather than the federal bankruptcy law. Having underwritten the insurance companies' obligations, the SPVs step into the insurance companies' shoes for bankruptcy purposes.[31] In addition, since the insurance companies remain liable under the insurance policies, and perhaps also the reinsurance contract, it is inefficient to manage different debtors of the same debt in different courts under different laws.

There are policy arguments against splitting laws and jurisdiction over bankruptcy issues involving SPVs among the various state laws and courts. Unlike insurance companies that are likely to be anchored in one state, investors in catastrophic events bonds can be located all over the world. For them, uniformity of the law and jurisdiction are very important. The applicability of state laws may reduce the price of these bonds to compensate investors for the legal uncertainty relating to the SPV that issued the bonds. On the other hand, if state law and jurisdiction give bondholders greater protection than federal law, investors might forego the inconvenience of lack of uniformity and prefer state laws. Forum shopping, however, is not desirable. Therefore, whatever the outcome, it seems that the states should strive to provide bankruptcy rules governing SPVs that are uniform and predictable.

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28 *See In re* Republic Trust & Sav. Co., 59 B.R. 606, 614 (Bankr. N.D. Okla.1986).

29 *See In re* Estate of Medicare HMO*,* 998 F.2d 436, 440–42 (7th Cir. 1993) (determining that an HMO was a "domestic insurance company" under the Bankruptcy Code and thus excluded from federal Bankruptcy Code relief) (citing Security Bldg. & Loan v. Spurlock*,* 65 F.2d 768, 771 (9th Cir.), *cert. denied,* 290 U.S. 678 (1933)).

30 *Id.* at 445.

31 *See* S. Rep. No. 95–989, at 31 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5817.

C. The Applicability of State Insurance Laws Regulation to SPVs and Persons Involved

Insurance risk securitization and its SPVs pose regulatory issues. SPVs, in whatever legal form, that issue catastrophic event bonds may fall within the state law definition of an insurance company or a reinsurance company.[32] SPVs fall within the definition if they issue reinsurance obligations. However, if they merely buy insurance or reinsurance policies, they become the insureds rather than the insurers. The bondholders are arguably insurers because their payoffs are tied to the insurance risk, and because they finance the direct insurer. Arguably, the parties that finance insurance risks, and the insurance risk securitization, even in an unconventional way through the capital markets by using securitization techniques, may be subjected to insurance regulation.

This quagmire of analysis can not be clarified by asking whether these activities constitute insurance. These activities have no analog. Rather, the question should be: what are the problems that insurance statutes are designed to solve? Does insurance securitization or any part of the process pose the same problems? A number of structures and scenarios may lead to the answer.

If SPVs underwrite insurance risks by undertaking to pay policyholders upon the occupancy of catastrophic events, then the SPVs seem to pose the same problems as any insurance company does. The SPVs may not have sufficient assets to cover the losses under the policies because they would distribute funds to the holders of the securities that they issue without keeping sufficient funds for reserves, or because they invest the reserves in speculative investments. These were some of the problems that led to the passage of state laws. These were the problems that led to the mutualization of insurance companies, since the managements of the companies at that time were more concerned with the safety and soundness of the companies (and the longevity of the managements' positions) than the controlling shareholders, who desired to spend, or speculate in, the reserves. Thus, SPVs that have undertaken to cover catastrophic events by collecting policyholders' premiums directly or through the ceding company should be subject to the reserve and prudent investment requirements of state insurance laws. If, however, the main insurers remain regulated insurance companies, and if they abide by the laws and transfer to the SPVs only the appropriate amounts of dividends, then perhaps SPVs need not be subject to these laws.

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32 *See* Michael P. Goldman et al., *Legal and Regulatory Issues Affecting Insurance Derivatives and Securitization, in* SWAPS & OTHER DERIVATIVES IN 1999, at 433, 441 (PLI).

Instead, they and their shareholders could be viewed as financiers of insurers, even if they underwrite some of the insurance risks and participate in the insurers' profits.

A similar analysis applies to the other parties to the securitization transaction, including the promoters, purchasers, owners, or writers of insurance securitization products. If they are "conducting an insurance business," they will be subject to insurance regulation, including licensing.[33] If they arrange for financing insurers and nothing else, they should not be subject to insurance regulation. The promoters of insurance securitization may be analogized to the promoters of an insurance company, that is, the SPV. However, if they do not continue to manage the SPV they may also be free of regulation. The salespersons of the bonds are unlikely to be characterized as insurance salespersons if the bonds are not insurance contracts. However, to the extent that the SPVs are deemed to be engaged in the insurance business and state insurance laws expressly apply to them, they will be regulated under these laws.

This conclusion does not end the inquiry, however. The next question is whether the SPVs and the issuance and sale of the bonds are subject to the securities acts.

D. Insurance v. Securities

SPVs and catastrophic event bonds that they issue may be subject to the securities acts. If both the assets that the SPVs hold and the bonds that they issue are securities, they will fall within the definition of an investment company. If the bonds they issue are securities, they will be subject to the Securities Act of 1933 and the Securities Exchange Act of 1934.

1. Are the Bonds Issued by SPVs Insurance Obligations?

Arguably, the bonds are insurance obligations because they cover all or part of the damages caused by catastrophic events, and receive compensation for underwriting such risks. In fact, the bondholders indirectly pay the policyholders all or part of the proceeds under their policies if such events occur. However, the bondholders do not underwrite the risks and do not undertake to pay policyholders directly. They do so through the SPV, and most likely through the insurance or reinsurance companies. In that respect the bonds are similar to financiers of the insurer or, better still, its partners. Presumably, investors have no control over the SPVs investment decisions and business practices. Therefore, even though the bonds are linked to underwriting of insurance, their holders are not engaged in the insurance business and are not insurers. The key difference would seem to be control.

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33 *See id.* at 446.

To the extent that the bondholders do not control, they are not insurers. On the insurance side, insurance commissions should issue interpretative statements exempting the parties to insurance securitization transactions from licensing requirements. It is likely that most, but not necessarily all,[34] state insurance commissioners do so[35] and issue such exemptions.[36] The proposed Model Act described below would exclude the bonds from the definition of "insurance contract," and thus would make it clear that federal law applies to the SPV issuers of catastrophic events bonds. This does not mean that insurance companies engaged in insurance risk securitization will not be regulated by the states if they are permitted to engage in that activity which will then be classified as "insurance business."

2. Are the Bonds Issued by the SPVs Securities?

The bonds also may fall within the definition of a "security" in the securities acts,[37] under the rubric of investment contracts. The bonds meet

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34 For example, the New York-based Catastrophe Risk Exchange (CATEX), established in 1996 to promote trading in property and casualty insurance risks, was licensed by the New York Insurance Department as a reinsurance intermediary. *See* Susanne Sclafane, *Insurers Can Soon Swap CAT Exposure*, NAT'L UNDERWRITER, PROP. & CASUALTY/RISK & BENEFITS MGMT. EDITION, July 31, 1995, at 1, *available* in LEXIS, News Library, Curnws File (noting that department licensed CATEX as "neutral" reinsurance intermediary, with "no contractual affiliation to negotiate for either side of a risk-swapping transaction").

35 *See* Torchiana, *supra* note 4, at 671 (noting that "all but a limited number of state insurance authorities have issued written interpretations or other indications" exempting the parties).

36 Of course, even if such exemptions are granted by state insurance commissioners, these determinations will not be binding on a reviewing court.

37 Section 2(a)(1) of the Securities Act of 1933 defines a "security" as any

> note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(a)(1) (Supp. III 1997).

most of the elements of the *SEC v. W. J. Howey Co.*[38] test, since the investors part with their money that is invested in a common enterprise (the SPV) with the expectation of receiving profits from the efforts of others. This last factor may be debatable. That is because the efforts of others have occurred before the bonds were distributed to the public.

Although they may have insurance features, catastrophic event bonds are distinguished from "pure" insurance contracts. In fact, these bonds are akin to variable insurance contracts (variable annuities and variable life insurance).[39] They are securities with insurance features, subject to the securities acts and to some insurance regulation as well.

In that respect the bonds are similar to participations in "viatical settlements," which the Circuit Court of the District of Columbia held to be neither insurance not securities. The court held that securitized life insurance policies are not securities because the promoters performed their efforts before the sale of participations in the policies.[40] The Securities and Exchange Commission, however, is of the opinion that these participations are securities. The jury is still out on the issue. If the catastrophic events bonds are securities, they are subject to the Securities Act of 1933. The SPV and any sales and secondary trading in the bonds will be regulated by the Securities Exchange Act of 1934, ensuring investors of information and regulated secondary markets in the bonds.

3. Investment Companies v. Insurance Companies

The Securities and Exchange Commission viewed traditional SPVs that hold illiquid financial assets (e.g., mortgage loans) as holders of securities and issuers of securities. These elements subjected SPVs to the Investment Company Act of 1940 (the 1940 Act). The 1940 Act has three separate definitions of an investment company, two of which are important. One defines an investment company as an issuer (of securities) that holds itself out or proposes to be primarily engaged in investing and trading in securities. The second definition is an issuer (of securities) of more than 40% of the net value of its assets is invested or held in "investment securities." Investment securities are all securities except government securities and securities of majority-held subsidiaries.

Assuming that SPVs' bonds are securities, SPVs will not be categorized as investment companies unless they also invest or trade or hold

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38 328 U.S. 293 (1946).

39 *See* Frankel, *supra* note 11, at 173.

40 *See* SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir.), *reh'g denied,* 102 F.3d 587 (D.C. Cir. 1996).

securities.[41] If the SPVs do not hold policies but only invest the proceeds of the bonds they issued and the premiums they collect in securities, then their portfolios consist of securities. If the SPVs hold insurance obligations of others, those might not be securities. The Securities Act of 1933 exempts insurance policies from registration, rather than from the definition of the Act.[42] The 1940 Act regulates "face-amount certificate companies" that issue annuities, which would have been included in the definition of insurance products.43 Nonetheless, it was long believed that policies are not securities, and that the exemption from registration was simply an over-precautionary measure by Congress.

SPVs are likely to fall within the definition of investment companies if more than 40% of their assets (reserves) consist of investment securities. If the bonds they issue are deemed securities, then these SPVs will fall within the definition of an investment company.

For traditional securitization this issue is resolved. At the outset, it was obvious that no securitization can take place if SPVs must conform with the Act. Hence, the Commission exempted SPVs from the definition of an investment company, and as a result from the provisions of the 1940 Act, subject to a number of important conditions, listed in Rule 3a–7 under the Act.[44]

For SPVs of risk securitization there is another avenue of escaping the 1940 Act. If SPVs are deemed insurance companies subject to regulation under state laws, then they are excepted from the definition of an investment company under section 3(c)(1) of the 1940 Act. Although the proposed Model Act would exclude the bonds issued by the SPVs from the definition of an investment contract, if the Model Act regulates the SPV in other ways, the SPV may be excluded from the definition of an investment company as an insurance company. Barring such state regulation, however, the better argument seems to be that SPVs are investment companies, unless an exemption or rule 3a–7 applies to them.

The rule requires SPVs to hold static portfolios and does not permit trading in the portfolios. SPVs issuing catastrophic events bonds are in a somewhat different position. If they engage in active trading in their

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41 *See* 15 U.S.C. § 80a–3(a) (1) (A), (C) (Supp. III 1997).

42 *See* 15 U.S.C. § 77c(a)(8) (1994). Even as "supererogation" as Professor Louis Loss suggested. *See* 2 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 1072–74 (3d ed. 1999); Tcherepnin v. Knight*,* 389 U.S. 332, 342 n.30 (1967) (citing an earlier edition of the treatise).

43 *See* 15 U.S.C. § 80a–3(a) (1) (B) (Supp. III 1997).

44 *See* 17 C.F.R. § 270.3a–7 (1999).

investment, and if their portfolio does not conform to the conditions of the rule,[45] they may have to seek a special exemption from the SEC.

E. Tax Issues: Pass-Through Treatment and Deductibility of Payments

Securitization, like other institutional intermediation, involves a number of similar tax issues, regardless of the financial assets that are being securitized. The first issue relates to pass-through tax treatment for SPVs. A double taxation, first of the returns to the SPV and then on the distributed income to investors, would render insurance securitization impractical. This problem was solved by Congress for securitization of mortgages by passing REMICs.[46] Congress also resolved the issue for securitization of other financial assets, such as receivables.[47] SPVs do not fit comfortably within either statute. The problem of double taxation can be solved, at least in part, if catastrophic event bonds are viewed as debt for tax purposes. In such a case, SPVs can deduct from the income they receive through investments and premiums the payments they make to investors (as return on debt).

This is a partial solution if the SPV must keep reserves which cannot be distributed. The returns on these reserves cannot be deducted from the SPV's income tax bill. However, even assuming that the reserves can be deducted, the status of the bonds as debt and the payments on the bonds as interest is not free from doubt. The payments on the bonds are not related to the face amount of the bonds, as interest payments would be, but are linked to the occurrence of certain events. If the bonds are not deemed to be debt, the payments on the bonds cannot be deducted from the SPV's income. Double taxation will rear its ugly head.

SPVs could be organized as grantor trusts and other organizational forms that allow pass-through tax treatment. However, each of these forms poses problems and would render insurance risk securitization less advantageous as compared to other investments.

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45 It seems that such SPVs invest the proceeds of the bonds in debt instruments tied to a LIBOR measure, which would be of low risk. Their investments of annual premiums may be more aggressive, but not necessarily equity.

46 *See* Tax Reform Act of 1986, Pub. L. No. 99–514, sec. 671, §§ 860A–860G, 100 Stat. 2085, 2308–18 (codified as amended at 26 U.S.C. §§ 860A–860G (1994 & Supp. III 1997)).

47 *See* 1 FRANKEL, SECURITIZATION, *supra* note 2, §§ 8.15.1, 8.15A.1. In August 1996, Congress passed the Financial Asset Securitization Investment Trust (FASIT) as part of the Small Business Job Protection Act of 1996, Pub. L. No.104–188, sec.1621(a), §§ 860H–860L, 110 Stat. 1755, 1858–66 (codified as amended at 26 U.S.C. §§ 860H–860L (Supp. III 1997)).

F. The Status of SPVs and the Bonds They Issue Under The Commodity Exchange Act of 1934

The Commodity Exchange Act of 1934 ("CEA") regulates a "futures contract" or a "commodity option," which it defines as a security in which principal and or interest payments are dependent on changes in the value of a commodity.[48] The definition of a commodity is broad, and includes financial instruments and intangibles such as interest rates and indexes. Consequently, there is a question whether the sale of bonds, which provide for payments based on an index (combined damages from possible events), is regulated under the CEA.

Arguably the bonds are not included in the definition and escape the regulation of the Act. This result, however, is unlikely. All instruments, including all Chicago Board of Trade insurance options and over-the-counter insurance derivatives, defined as "futures contracts" will be subject to the Commodity Futures Trading Commission ("CFTC") regulation and the CEA's exchange-trading requirement.[49]

Alternatively, narrow exemptions in the CFTC's rules may cover securities issued by the SPV.[50] One possibility is that these transactions will fall under the "Shad-Johnson Accord," which vested in the SEC jurisdiction

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48 Section 1a(3) of the Commodity Exchange Act defines the term commodity as "all . . . goods and articles . . . and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1a(3) (1994). It should be noted that this term is defined broadly.

49 With limited exceptions, all individuals and organizations that intend to do business as futures professionals are required to be registered with the CFTC and to become members of the National Futures Association. Consequently, the categories of industry professionals subject to the CFTC's registration requirement include most parties to futures transactions, including but not limited to futures commission merchants, brokers, commodity trading advisors, commodity pool operators, floor brokers and floor traders.

50 *See*, for example, the CEA's cash forward contracts under section 1a(11) of the CEA, 7 U.S.C. § 1a(11) (1994), may apply; the CFTC's Statutory Interpretation Concerning Forward Transactions (September 25, 1990); the "Treasury Amendment" relating to transactions in foreign currency and other instruments such as security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgage and mortgage purchase commitments not traded on an exchange (Section 2(a)(1)(A)(ii) of the CEA, 7 U.S.C. § 2(ii) (1994)); a limited exception from the exchange-trading requirement for "trade options" (CFTC Regulation 32.4(a), 7 U.S.C. § 32.4(a) (1999)).

over options on securities.[51] The Shad-Johnson Accord divides jurisdiction between the CFTC and the SEC with respect to futures, securities, and options. The CFTC has exclusive jurisdiction over futures contracts with respect to groups or indices of securities and options on such futures contracts while the SEC has exclusive jurisdiction over securities and options on securities. However, under the Shad-Johnson Accord, if a product creates both a "security" and a "contract for future delivery," the CFTC has exclusive jurisdiction.[52] Also, the CFTC has exemptive authority,[53] which authorizes the CFTC to exempt from any provision of the CEA any agreement, contract, or transaction that is otherwise subject to the exchange-trading requirement, if the CFTC determines that the exemption is consistent with the public interest. The SPV's bonds may merit such an exemption because they are not the type of obligations for which Congress designed the CEA.

III. SEARCH FOR SOLUTIONS

A. The Cell Structure

To attract insurance risk securitization business, states such as Rhode Island and Illinois passed comprehensive legislation ("Protected Cell Acts") this past year aimed at promoting insurance securitization onshore.[54] These Acts offer not only reduced burdens on SPVs but marketing advantages to SPV sponsors. In December 1999, the NAIC adopted a Protected Cell Company Model Law, similar to the Illinois act.[55]

The Protected Cell Acts passed in Rhode Island and Illinois allow insurers to tap the capital markets directly by selling catastrophic event

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51 *See* section 2(a)(1)(B) of the CEA, 7 U.S.C. § 2a(i) (1994), and section 9(g) of the Securities Exchange Act of 1934, 15 U.S.C. § 78i(g) (1994) (collectively, the "Shad-Johnson Accord").

52 *See* CME v. SEC*,* 883 F.2d 537, 544 (7th Cir. 1989).

53 *See* Section 4(c)(1) of the CEA, 7 U.S.C. § 6(c) (1994).

54 *See* Protected Cell Companies Act, 1999 R.I. PUB. LAWS ch. 22 (to be codified at R.I. GEN. LAWS, §§ 27–64–1 to 27–64–12); Protected Cell Company Law, 1999 ILL. LAWS 278 (1999) (codified at ILL. COMP. STAT. ANN. §§ 5/107.06a, /179A–1 to –40 (West Supp. 1999)).

55 *See Protected Cell Company Model Law* (visited Jan. 25, 2000) <http://www.naic.org/1papers/models/1299docs/protected_cell_company_model_law.htm>; *NAIC Adopts Catastrophe Bond Protected-Cell Model,* BESTWIRE, Dec. 7, 1999, *available in* LEXIS, News Library, Curnws File (noting that Model Law is similar to the Illinois act).

bonds using a Protected Cell within the insurance company.[56] Protected Cells offer a number of advantages. First, a Protected Cell would retain the accounting advantages offered to insurers. Second, the Cell would protect investors from any liabilities incurred by the insurance company of which it is a part.

Third, under the Rhode Island and Illinois laws, the Cell's assets are separate from those of the insurance company. Therefore, a domestic insurer can protect the assets in the Cell from its own creditors or its receiver, should the insurer become insolvent. For investors, the new laws' features offer a number of advantages. Investors seem to have their cake and eat it. The Cell's assets are part of the insurance company's assets. Therefore, they are not subject to state or federal bankruptcy acts, but rather to state laws regulating insurance companies' insolvency. Moreover, if the host insurance companies become insolvent, policyholders (including the bondholders) can resort to state funds that support insurance companies' obligations.

Additionally, the law relieves the insurance company issuing catastrophic event bonds of the need to show a "true sale" of assets to an SPV that would normally issues the bonds. These assets include insurance policies, if any, and cash and investments that are due from the insurance company to an SPV. Thus, the Protected Cell solves the difficulty of rendering an SPV "bankruptcy remote." Finally, the Protected Cell is likely to solve the problem of double taxation. Absent an SPV there is no entity to be tax from the insurance company.

Arguably, the Protected Cell is specially designed for insurance securitization, and is more efficient than the traditional SPVs that are currently situated offshore. The offshore SPVs involve administrative and office costs while the Protected Cell is held domestically, and is created within a domestic insurance company involving no additional administrative costs.

A number of issues remain. The Protected Cell structure within a U.S. domiciled reinsurer raises an accounting question of whether the ceding insurer could take credit for the transaction using reinsurance[57] or hedge

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56 In addition, insurers may sell to investors exchange traded futures and options, and over-the-counter traded options and swaps, by using a Protected Cell.

57 *See* ACCOUNTING AND REPORTING FOR REINSURANCE OF SHORT-DURATION AND LONG-DURATION CONTRACTS, Statement of Financial Accounting Standards No. 113, § 33 (Financial Accounting Standards Bd. 1992); NAIC Accounting Practices and Procedures, ch. 22.

accounting.[58] In the 1980s, the NAIC changed the accounting rules for ceded reinsurance.[59] If reinsurance accounting is followed, FASB 113 requires that prepaid insurance premiums and reinsurance receivables be reported as assets, while it recognized estimated reinsurance receivables in a manner consistent with the liabilities relating to the underlying reinsured contracts.[60] Thus, the precise accounting treatment for insurance securitization must be resolved in all 50 states before these transactions can come onshore.[61]

Presumably, the treatment of a Protected Cell under these Protected Cell Acts would be analogous to the treatment of a separate account used by a life insurer. That may reduce tax-related problems with federal and state authorities.[62] Whether the Cells are investment companies remains to be seen. They may follow the model of separate accounts, or be excluded from the definition of the Act under rule 3a–7. Arguably, the bonds issued by the insurance company will be subject to the Securities Act of 1933 and the Securities Exchange Act of 1934, perhaps with future exemptions as to sales load limitations. In sum, Cells constitute bondholders as secured creditors to the insurance companies, avoiding bankruptcy, tax, and regulatory problems that arise when SPVs are viewed as separate entities. Of course, the Cell Acts subject Cells to safety and soundness of insurance regulation and to prudence requirements for reserves.

The Cell Acts allow insurance companies to set aside certain assets and subject them to the bondholders' priority claims. These holders will then have a first claim on the assets, and perhaps on reserves supporting the obligations, as secured creditors do. However, the claims will not be subject to the Uniform Commercial Code requirements, or to burdens usually designed to protect the creditors of the transferor of the financial assets to the

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58 *See* Gregory May, *Taxing Derivative Financial Instruments, in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS & RESTRUCTURINGS 1999, at 601, 610 (PLI).

59 *See* Reinsurance Intermediary Model Act (NAIC 1993).

60 *See* FASB 113, *supra* note 57, § 14.

61 A complete discussion of the accounting issues regarding insurance securitization is beyond the scope of this article. For a more detailed discussion of reinsurance accounting, *see* Subcomm. on Ann. Rev. of the Fed. Regulation of Sec. Comm. of the Am. Bar Ass'n, *Significant 1993 Legislative and Regulatory Developments,* 49 BUS. LAW. 948, 983–84 (1994). *See NAIC Delays Catastrophe Reserve Action,* INS. ACCT., June 14, 1999, at 1, *available* in LEXIS, Market Library, ABBB File.

62 *See generally* Gerald Kaplan et al., *Taxation Of Insurance Companies: Annual Survey*, 26 TORT & INS. L.J. 402 (1991).

SPVs. Instead, state insurance commissions would determine the priorities due to the bondholders under the terms of the bonds and the Acts.

The main problem of Cells, however, seems to be a business problem for insurance companies. The cell structure creates a preferred class of bondholders at the expense of other policyholders. If policyholders constitute the bulk of the insurance companies' business, the priority may not help their business. Further, the structure is unique and new. It goes beyond what insurance companies were allowed to do in the past. Insurance companies were allowed to offer segregated assets to policyholders as security, but in most cases the insurance companies did not guarantee payments from their general accounts.[63] In the Protected Cell case they will. The question is whether insurance companies will take advantage of the structure at the risk of losing other insurance business.

B. The NAIC Model Act

A second solution to the insurance risk securitization is the Special Purpose Reinsurance Vehicle Model Act of the Insurance Securitization Working Group of the NAIC, an Act designed to facilitate the issuance of catastrophic event bonds.[64] The Model Act's structure differs from that of the Illinois and Rhode Island acts. As of December 1999 the Model Act is "still a work in progress."[65]

Unlike the Cell structure, in the Model Act, the SPV is established as a separate entity (SPRV). One reason for a separate SPRV is to capitalize on the investors' familiarity with the structure. This structure is also doctrinally clearer, and politically more feasible. The choice of insurance state laws will bring predictability. But there is no free lunch. The choice of state laws will bring forum shopping as well.[66]

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63 Pro forma, insurance companies have segregated assets as separate accounts that funded variable insurance products, but guaranteed only the insurance component of the securities issued by these accounts. *See* Travelers Ins. Co., SEC No-Action Letter, 1990 SEC No-Act. LEXIS 1006 (Aug. 6, 1990) (stating that insurance regulators required full funding of the insurance obligations, and that the investment risks and benefits are transferred to the contract holders.); 1 FRANKEL, MONEY MANAGERS, *supra* note 18, § 18.

64 *See NAIC Addresses Reinsurance Regulatory Issues at Winter National Meeting*, INT'L REINSURANCE DISP. REP., Dec. 27, 1999, at 9, *available in* LEXIS, News Library, Curnws File.

65 *See id.*

66 *See* sources cited *supra* note 54. We believe that, in addition to addressing the bankruptcy issue, state laws should explicitly state that the assets of the SPV are separate from the primary insurance company. Whether federal courts will accept this statement or require proof of independence is an open question. Such a

The Model Act states that catastrophic event bonds are not insurance contracts. The Act does allow insurance companies to engage in issuing such bonds through a subsidiary by classifying the business as "insurance business."[67] The distinction between insurance contract and insurance business is important. While insurance companies have an exclusive power to issue insurance contracts, they do not have a monopoly over insurance business, although they may engage in that business. That business includes broker dealer transactions, investment advisory services and many other functions. Therefore, other entities may organize SPVs, buy and transfer policies to them, and engage in sponsoring and distributing catastrophic event bonds without encroaching on the exclusive territory of insurance companies and running afoul of insurance laws.

The Model Act requires SPVs to organize as a corporation, domiciled under state law. Corporate form, however, may present problems under tax laws, as discussed above. SPVs will not be able to organize limited partnerships or grantor trusts or other organizational forms that allow pass-through tax treatment. Congress has facilitated securitization of mortgages by passing REMICs and securitization of other financial assets such as receivables by FASIT. However, FASIT deals with SPVs organized as trusts and not as corporations. Thus, the question of whether an SPV under the Model Act is still feasible without congressional actions remains open, and unless that issue is resolved, there is little use for the Model Act.

The Model Act has addressed the bankruptcy issue by providing that the SPV enter into a reinsurance contract with the ceding insurance company, thus insulating SPVs from insolvency of the ceding insurance company, provided the SPV meets its obligations under the reinsurance contract, under normal conditions.[68]

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statement of law, however, is likely to shift some of the burden of proof in favor of separate existence of insurance SPVs. The Rhode Island and Illinois Protected Cell Acts do contain such provisions.

67 Most states have issued written interpretations of their statutes holding that investors in disaster bonds and the SPVs are not "insurers" and need not be licensed by the states as such. *See* Torchiana, *supra* note 4, at 671.

68 *See* Draft of SPRV Model Act (Nov. 1999). The reinsurance contract is comparable to a special purpose vehicle contract that would be used in standard asset securitization. The purpose of using a reinsurance contract is to clarify the intent that state liquidation laws prevail over federal bankruptcy laws and that the relevant contract and the SPRV are intended to be governed by state insurance laws. *See supra* I.B (dealing with bankruptcy issues).

IV. CONCLUSION

The future of insurance (and generally, risk) securitization is quite promising. So long as markets function, securitization makes sense. Insurance risk securitization is less likely to fail, given the size of potential catastrophe losses to the relative size of capital available in the securities markets, and the insurance industry. As catastrophic event bonds become more standardized, a public market is likely to develop, reducing transaction costs. Insurance securitization has grown from one deal of $84 million in 1994 to 18 deals involving $2.5 billion in 1998.[69] Operating enterprises that are exposed to catastrophic event risks or other risks may expand insurance securitization by issuing catastrophic event bonds directly to the capital markets. These issues add depth and liquidity to the markets in such bonds. Indeed, the first issue of a catastrophe bond by a non-insurer (Oriental Land Company) took place last May.[70]

Such direct issuances, however, will by-pass insurance companies and reinsurers altogether, thus dramatically affecting the industry.[71] While in the past, reinsurers have usually played the role of underwriters and ultimate risk bearers for the industry, in the future, reinsurers will continue to use their expertise to select portfolios of reinsurance contracts. However, they will bear a lesser part of the risk directly, and distribute a higher proportion of risk to the securities markets by buying and selling catastrophic event bonds.

Securitization of catastrophic events risks may result in broader coverage of the risks, and lower insurance costs. It may save taxpayers money. If the net costs of insurance exceed the net benefits, bondholders will limit their obligations to their investments and the premiums (unless investors forego limited liability and agree to assessments). Policyholders will also be covered by state insurance funds (in which the SPV must participate). Further, the calculation of the contingent liabilities of the SPVs and the reserves covering the liabilities should be regulated to prevent the problems that insurance companies have faced in the past, when long-term liabilities remained uncovered and reserves were spent on current (sometimes extravagant) expenses. Who should regulate these functions,

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69 *See* Alex Maurice, *NAIC Poised to Adopt Securitization Models*, NAT'L UNDERWRITER, PROP. & CASUALTY RISK & BENEFITS MGMT. EDITION, July 12, 1999, at S28, *available in* LEXIS, News Library, Curnws File.

70 *See* J. David Cummins, *The Insurance Link To Securities*, RISK MGMT., Aug. 1, 1999, at 17, *available* in LEXIS, News Library, Curnws File.

71 Such a development is remindful of the effect of securitization on the banking industry.

however, is another issue. There is no reason why bank regulators should not monitor the activities of banks in this area.

Risk securitization can radically alter risk management. If insurance risks can be securitized so can other risks. So long as the markets function as they should, and so long as investors are ready to bear risk for a return, risk securitization may offer great benefits that can be shared among the many. Innovative law making must address the attendant problems by accommodating the issuers and other actors in the new process, and ensuring investors' confidence. Most importantly, the problems and challenges that new hybrid financial innovations pose can be addressed by analyzing the existing laws as to their underlying policies and ensuring that the hybrids meet the objectives of these policies.