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PROTECTED CELL COMPANIES IN BERMUDA

by Michael N. Smith

In case you missed it, Protected Cell Companies (PCC) have arrived and are generating a high degree of interest in supporting complex reinsurance transactions. Bermuda is on the leading edge in developing this technology with applications in both the property and casualty and life and annuity worlds. This article will provide an overview of the development of Protected Cell Companies in Bermuda.

What They Are

Some jurisdictions call them Protected Cell Companies; Bermuda calls them Segregated Account Companies (SAC). Regardless of the name, these are handy vehicles that serve a variety of needs and possess an interesting duality.

In Bermuda, an SAC is a corporate structure composed of segregated accounts and a general account. A segregated account, or cell, is an account that contains assets and liabilities which, via statute, are separated from any other assets or liabilities within the SAC. This legal separation protects the assets of the cell from the liabilities of any other cell as well as from the general account.

Therefore an SAC has the interesting duality of being a single corporate body, but wrapped around a series of cells that do not have "legal personality" but can operate like mini-companies, where the liabilities of a cell can only be applied against the assets of that cell.

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SOCIETY OF ACTUARIES

Society of Actuaries
475 N. Martingale Road, Suite 600 Schaumburg, IL 60173
ph: 847.706.3500 • f: 847.706.3599 • Web: *www.soa.org*

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Where They Came From

Bermuda was at the forefront of the development of the SAC concept, due to Bermuda's deep experience in the development of captives. With captives came the development of rent-a-captives, which provided a single corporate "host" for clients who did not want the expense and governance of setting up their own captive. The SAC is a logical extension to the rent-a-captive concept, because the pioneer rent-a-captives used private contractual approaches for internal segregation that were not fully effective in creating absolute segregation, but the SAC concept perfected a legal division.

In Bermuda, the first SAC was created through the use of a private Act in 1991, and then the Segregated Accounts Companies Act was enacted in 2000.

The first public legislation was introduced in Guernsey in 1997, with the Cayman Islands following in 1998. Other jurisdictions with public legislation are Bahamas, Barbados, British Virgin Islands, Jersey and Mauritius. The NAIC has developed a Model Act for segregated accounts for the limited purpose of securitizations that has been adopted in Illinois, Rhode Island and South Carolina.

Their Rules

Assets in an SAC cell must be held in a separate fund that is not part of the general account, and it must be held for the benefit of the cell owners and counterparties. These assets cannot be used to meet the obligations of the general account, such as the general shareholders or creditors with claims that are not linked to the cell.

For commercial purposes, an asset (such as a bank account) may be held to the credit of more than one cell, or there may be (re)insurance contracts between multiple cells and/or the general account. Bermuda's Act allows for this, provided the records of the SAC clearly indicate this is intended.

Liabilities of the cell are linked only to that cell, and creditors of these liabilities have no rights against any other cell. Under Bermuda's Act, any creditor claim or liability that arises, but is not linked to a specific cell by default, is presumed to be a liability of the general account. The Act also prescribes specific priority positions upon insolvency of the cell.

However, the Bermuda insurance regulator seeks to prescribe that every (re)insurance contract with a cell must stipulate in its wording that the cell owes no obligation under the contract that goes beyond the resources of the cell. Under such a contract, it is believed that the cell can never technically be insolvent, but this may conversely jeopardize the cedent's ability to achieve full risk transfer unless the cell is adequately capitalized.

The rights and obligations of the owner of a cell must be set out in a governing instrument (similar to the articles or by-laws of an ordinary company), which cover various permissions and general management powers. Examples of governing instruments are a participation agreement and a preferred share agreement. But the Act governs the distribution of capital from the cells (such as dividends); the rules of which are consistent with the rules applicable to the distribution of capital of an ordinary insurance company.

Current Regulatory Issues

The Bermuda insurance regulator has indicated that the supervision of SACs will expand to the cell level to ensure a consistent application of the standards followed by stand-alone companies, such as (among other things) the existence in the SAC of adequate management expertise commensurate with the nature of the liabilities in the cell. This would serve as an indication that the SAC concept is growing in popularity as a risk management tool.

Their Uses

In general, whenever a company is established for a specific single purpose, the owner of that company faces the prospect of capitalizing and managing that company single-handedly, or they can utilize an SAC that already has capital and a management infrastructure. In the insurance world, the SAC has found many uses.

Rent-a-Captives

As noted above, an SAC is an elegant solution to providing rent-a-captive solutions. As the captive concept increased in popularity and captive entities began to proliferate, aggregating these entities into an SAC provides the client with expense and, most importantly, capital savings because the client is able to "rent" the capital in the general account. Such savings opened the market to smaller corporations who previously felt a stand-alone captive solution would have been too costly.

Transformers

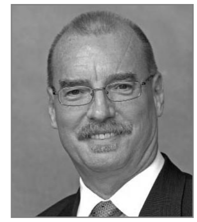
A transformer company transforms capital market risk into insurance risk. For example, an insurance company seeking to hedge their GMDB risk (capital market risk) but avoid the statutory accounting noise from directly holding capital market derivatives, may reinsure their risk to an SAC cell (insurance risk), which in turn hedges the risk by investing in derivatives.

Securitizations

An emerging application for the SAC concept is in the area of life securitizations, for either mortality catastrophe bonds, or for XXX collateral arrangements, where the cell assumes the risk through an incoming reinsurance treaty and issues notes into the capital markets or to a single, private investor. The duality of an SAC may provide the cedent with favourable statutory accounting treatment of the notes.

References

Further information on Bermuda's SAC Act can be found on the Web site of Appleby, one of Bermuda's leading law firms, at the following address: *http://www.applebyglobal.com/uploaded/Publication/390_File_5.pdf* ✷



Michael N. Smith, FSA, FCIA, MAAA is CEO of Wilton Re Bermuda, located in Hamilton, Bermuda.
He can be reached at msmith@wiltonre.bm