Sedgwick LLP

Reinsurance Sidecars – Don't Ride Without A Helmet

Reinsurance sidecars have become an established medium through which third-party capital is now accessing the reinsurance market, with more and more capacity being announced on an almost monthly basis. These special purpose reinsurers trace their history in Bermuda back to the early 1990s.

However, they did not rise to popularity until after the Atlantic hurricane season of 2005, which saw hurricanes Rita, Wilma and Katrina trigger an inordinate demand within the insurance and reinsurance markets for purposes of maintaining underwriting capacity, and satisfying regulators of the financial stability of several market participants.

Generally, sidecars reinsure a specific risk, loss portfolio, or a limited group or category of insurance policies ceded to it by a specific insurer, known as "the sponsor". They have historically existed for short periods of time — usually two to three years maximum.

Although a tendency toward longer life spans may be emerging, they are traditionally designed as short-tail investments. Sidecars rarely require their own infrastructure (relying instead on a service provider or the sponsor for underwriting and back-office expertise), are fully collateralized (being required to post collateral up to the limit of potential liability ceded by the sponsor), and typically do not require a rating.

In 2009, the Bermuda Monetary Authority, Bermuda's insurance regulator, extended its supervisory jurisdiction to include special-purpose insurers and reinsurers generally, establishing the legitimacy of sidecars as regulated and viable alternative risk-transfer vehicles.

This article will discuss sidecars generally, and will raise and analyze issues that may arise when dealing with these types of arrangements. In this regard, although sidecars typically posses novel and innovative characteristics, they still generally follow the core principals of traditional reinsurance. It naturally follows that where problems arise in connection with sidecars, those issues can involve both traditional and more novel issues of reinsurance law and practice.

Claims Cooperation and Control

The promise to fully fund potential losses should not give the reinsured carte blanche to settle any and/or all matters without regard to the terms of the contract between it and its reinsured. Investors should remain cognizant of the reality that a reinsured's decision to agree to cover a loss, or to agree the value of a loss, may be driven by commercial considerations, as opposed to the provisions of the reinsured's insurance contract.

To guard against the risk of a reinsured paying claims or sums that are not covered under its insurance, reinsurers have historically included cooperation and control provisions in their contracts. Doing so allows them to maintain oversight in connection with the steps taken by the reinsured to adjust and settle a loss.

Similar, or modified, provisions could serve to satisfy sidecar investors that amounts ceded under the reinsurance are in fact legitimate and at the very least provides something to point to in the event there is disagreement on coverage for a given loss.

Sidecar Management

Although some sidecars rely on the reinsured to provide administrative and back-office functions, others hire law firms or insurance managers to do so. In order to prevent perceived (or actual) conflicts, it may be preferable to retain an independent third party to perform these functions, which include monitoring the reinsurance arrangement, reporting on loss development, auditing and tracking adverse developments in connection with individuals claims, coordinating the calculation and timing of commission and premium payments, calculating loss reserves and verifying reserve adequacy, paying claims, and facilitating the commutation.

Independent sidecar management offers objective oversight in connection with the reinsurance relationship, and also provides the sidecar's investors with the comfort of knowing the transaction is being professionally monitored.

It is advisable that the sidecar's investors and reinsured have a common understanding with regard to how the sidecar will be managed (e.g., by an independent third party or otherwise). If it is managed by a third party, the parties should consider whether they possess any rights to review, and potentially have input in relation to, program management.

Originally published on Law360, Jan. 16, 2014. Posted with permission.

One particular area of complexity involving sidecar management relates to the timing and process of releasing collateral and returning it to the investors. It is advisable that the sidecar agreement makes clear, and that all those involved in its facilitation understand, the events that will trigger the return of collateral, as well as the mechanism for valuing reserves and resolving disagreements between the sponsor and investors regarding reserving.

Another area of concern is whether a given loss should be ceded to the sidecar (i.e., is the underlying insurance contact subject to the sidecar). These are two areas where having an independent third party handling the issue may help avoid disagreements and controversies.

Finally, any reinsured or third party that provides support services to a sidecar should be aware of the professional liability issues that may arise as a consequence of their role.

Risky and Noncore Business

Increasingly, reinsureds appear to be using sidecars for cosmetic reasons, by transferring risky and noncore business off their balance sheets in an attempt to satisfy shareholders and ratings agencies of the stability of their underwriting portfolios. While this practice may be legitimate, it nonetheless highlights issues of moral hazard that investors should be aware of.

Clearly, the reinsurer of the sidecar is entitled to full and frank disclosure regarding the business to be ceded under the reinsurance. To mitigate any apparent moral hazard, sidecars may require the sponsor to retain "skin in the game," usually by ensuring it maintains some financial interest in the risk reinsured. This can be achieved by utilizing various types of retentions, or using an excess of loss or quota share reinsurance structure.

The reinsurer of the sidecar can further reduce moral hazard by seeking to clarify in the reinsurance agreement the selection process for risks that are to be ceded. Obviously consideration will be given to whether risks are to be ceded automatically or facultatively. Where the risks are to be selected on a case-by-case basis, special consideration may need to be given to the wording of the sidecar in order to avoid issues arising from the selection process.

Full Funding of Losses

Despite the requirement that losses are generally fully collateralized, there are still risks that assets procured as security for reinsured obligations might not be sufficient to meet those commitments. One reason for this may be that the reinsurer's loss models might undervalue the actual exposure, requiring the reinsurer of the sidecar to "top up" security once the true potential loss exposure is more fully developed.

To guard against this, investors in the reinsurer or sidecar should ensure they fully understand and have carefully analyzed the reinsurer's valuation methods. They may also wish to reserve to the sidecar some oversight in relation to loss reserving, or the ability to independently verify the reinsurer of the sidecar's liability and reserving analysis by means of an audit or review of policies being underwritten and claims handling practices.

It should be noted that contingent assets (such as letters of credit, swaps, contracts for differences, etc.) are typically permitted as security for future reinsured liabilities. Their contingent nature means the economic value of these assets may vary from time to time as a result of unexpected events that are outside the control of both the sponsor and investors.

That said, it is important to keep in mind that unforeseen adverse developments, such as a drastic economic event, could reduce the value of the contingent assets considerably.

Reinsurers should carefully evaluate the proposed structure of the investments that are used to secure a sidecar's reinsurance obligations before entering into such an agreement. Further, reinsurers of a sidecar should carefully review and consider what rights they have in the sidecar agreement to review and monitor the value of the assets during the term of the agreement.

In this regard, even if the reinsurance agreement is silent as to monitoring, they are entitled to receive details of the investments that are being used to collateralize the sidecar's reinsurance obligations, as well as particulars of the credit ratings of any instruments that are being utilized.

Ideally, the sidecar reinsurance agreement should identify the steps that are to be taken by the reinsurer when the val-

Sedgwick LLP

ue of the security falls below an agreed level, and should explain the process by which the reinsurer of sidecar will "top up" the security.

The Appeal of Sidecars

Sidecar arrangements appear to be working well, and on the whole, have been profitable for sponsors and investors alike. No public issues appear to have arisen as yet regarding claim settlement or payment, as may sometimes be the case with traditional reinsurance products.

Whether this is a function of a relatively benign claims environment, or the fact that sidecar arrangements include alternative dispute resolution provisions in the form or arbitration or mediation clauses keeping disputes behind closed doors, remains to be seen.

Another possible explanation is that reinsurers of sidecars must commonly be fully collateralized at all times. So in theory, there should always be a ready source of cash (or other assets) to fund a loss.

While historical returns have been promising, they cannot, as with any investment, be guaranteed. The key for reinsurers and investors alike is to mitigate the financial risks associated with transferring risk to a sidecar. This requires that a careful yet pragmatic approach be taken to drafting reinsurance terms, and that due diligence be carried out both before and during the period of the reinsurance.

Given the short term nature of these arrangements, careful consideration must also be given to how the relationship ends and the potential for commutation if the parties choose to end the relationship prior to the natural expiration of the agreement.

Authors

Eric Scheiner
Parnter, Chicago
eric.scheiner@sedgwicklaw.com

Chen Foley
Associate, Bermuda
chen.foley@sedgwicklaw.com

Originally published on Law360, Jan. 16, 2014. Posted with permission.