February 3, 2012

Via Electronic Mail

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549
File Number S7-38-11

Re: Prohibition against Conflicts of Interest in Certain Securitizations

Ladies and Gentlemen:

The American Insurance Association ("AIA") and the Reinsurance Association of America ("RAA") appreciate the opportunity to comment on the Securities and Exchange Commission's ("Commission") proposed Rule 127B ("Proposed Rule") to implement Section 27B of the Securities Act of 1933 ("Section 27B"), as added by Section 621 ("Section 621") of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").[1] Section 27B prohibits certain "material conflicts of interest" in securitizations. AIA represents approximately 300 major U.S. insurance companies that provide all lines of property-casualty insurance to U.S. consumers and businesses, writing more than $117 billion annually in premiums. RAA is a national trade association representing property-casualty companies that specialize in assuming reinsurance. Our members have a significant interest in clarifying that the Proposed Rule will not apply to property-casualty insurance and reinsurance companies that currently engage, or may engage, in programs involving the transfer of the risk associated with catastrophic events to sophisticated investors through instruments referred to as "catastrophe bonds."

[1] 76 Fed. Reg. 60320 (September 28, 2011).

SUMMARY

AIA and RAA believe that Section 27B is intended to prohibit asset-backed transactions that are designed to fail in order to enable participants to profit at the expense of investors by entering into transactions that would essentially constitute a "bet" against the performance of the underlying assets without investors' knowledge. As described below, catastrophe bonds initiated by insurance and reinsurance companies are readily distinguishable from asset securitizations that are the subject of the proposed rule in that they are not designed to fail, but rather to transfer insurance risk associated with natural disasters to investors. As such, they do not conflict with the intent of Section 27B because investors are fully cognizant of the risks they are exposed to and information regarding risk that the underlying catastrophic event will occur is transparent to all participants, including investors. AIA and RAA believe that the Proposed Rule, if applied to catastrophe bonds, does not strike the appropriate balance between prohibiting the type of conduct at which Section 27B is directed and not adversely affecting the ability of insurance and reinsurance companies to use catastrophe bonds as a means of transferring insurance risk to investors. Catastrophe bonds do not present a conflict of interest with regard to investors. Accordingly, and for the reasons presented below, AIA and RAA believe that the Proposed Rule was not intended to apply to insurance-related or similar types of securities transactions. As a result, AIA and RAA request that the Commission clarify that the final rule will not apply to catastrophe bonds initiated by insurance and reinsurance companies.

BACKGROUND

Section 27B is intended to prohibit a securitization participant such as an underwriter, placement agent, initial purchaser or sponsor (or an affiliate or subsidiary of such parties) of an asset-backed security ("ABS"), including a "synthetic" ABS, from engaging in a transaction that would involve or result in certain material conflicts of interest to an investor in the security during the period ending one year after the date of the first closing of the sale of the ABS or synthetic ABS. The section provides exceptions for certain risk-mitigating hedging activities, liquidity commitments and *bona fide* market-making. The Commission has proposed Rule 127B to implement Section 27B. The Proposed Rule simply incorporates the language of Section 27B. However, to provide guidance to market participants, the Commission has proposed clarifying interpretations of the language of the Proposed Rule and examples of how the Proposed Rule would apply to certain fact patterns.

In its notice requesting public comment, the Commission describes the typical securitization process as a mechanism for pooling certain financial assets that have payment streams and credit exposures associated with them and converting the pool into a financial instrument (*i.e.*,

the ABS) that is backed by the pool of assets which are then offered and sold to investors.[2] The essence of a securitization is the origination or acquisition of financial assets such as mortgage loans, credit card receivables or automobile loans, by a sponsor, which subsequently transfers the assets to a special purpose entity ("SPE"). The SPE issues securities to investors supported by the financial assets held by the SPE. Investors receive a return through cash flow distributions generated by the pool of assets held by the SPE. The securitization process results in the sponsor exchanging payment streams derived from the financial assets for cash that may be used to make additional loans or acquire additional assets. In essence, securitization provides sponsors with the means to finance various types of assets.

The Proposed Rule also covers "synthetic" securitizations in which the SPE acquires credit exposure to a portfolio of financial assets without the SPE owning or controlling the assets. As described by the Commission, in a synthetic securitization, the SPE enters into derivatives transactions, such as credit default swaps ("CDS"), that reference particular assets. The counterparty to the CDS may be the sponsor who originated or selected the underlying portfolio. The SPE, as seller of protection under the CDS, therefore is exposed to credit risk on the assets as if it had purchased them.

According to its sponsors, the purpose of Section 27B is to prohibit "firms from packaging and selling asset-backed securities to their clients and then engaging in transactions that create conflicts of interest between them and their clients."[3] That is, "[t]he intent of section 621 is to prohibit underwriters, sponsors and others who assemble asset-backed securities, from packaging and selling those securities and profiting from the securities' failures."[4]

CATASTROPHE BONDS

In the 1990s, insurance companies developed financial instruments referred to as "catastrophe bonds" to transfer insurance risks relating to natural disasters to the capital markets. Catastrophe bonds complement other methods, such as traditional reinsurance, used by insurers to spread risks they assume and, as a result, reduce their exposure. Catastrophe bonds enable insurance companies to write affordable insurance coverage for catastrophic events such as earthquakes and hurricanes by increasing capital available to support such insurance. Catastrophe bonds were first issued in 1997. Annual issuance has increased from $633 million in 1997 to $4.8 billion in 2010. Approximately $3.34 billion of catastrophe bonds have been

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[2] 76 Fed Reg. at 60321.

[3] *See* letter to the Commission from Senators Jeffrey Merkley and Carl Levin (August 3, 2010).

[4] 156 *Cong. Rec.* S5899 (daily ed. July 15, 2010) (statement of Sen. Levin).

issued in 2011 through October and the outlook for 2012 is positive.[5] It is reported that over $10 billion in catastrophe bonds are currently outstanding.[6] Domestic insurance companies sponsoring catastrophe bonds include The Hartford, Liberty Mutual, USAA, Allstate, Travelers and Chubb, as well as certain reinsurers and state insurance pools in California, Massachusetts and North Carolina.

Catastrophe bonds are issued through SPEs sponsored by an insurance or reinsurance company. The insurance or reinsurance company enters into a reinsurance or other risk transfer contract with, and in return, pays premiums or makes contractual payments to, the SPE for undertaking the risk. The SPE then issues debt securities (*i.e.*, catastrophe bonds) to investors. Catastrophe bonds typically are offered only to qualified institutional investors under the Commission's Rule 144A and are not available to retail customers. The specific catastrophic events that will trigger a loss and a subsequent payment to the insurance or reinsurance company are extensively disclosed in the offering material. Typically, the risk covered is the remote likelihood of a severe hurricane, earthquake or other natural disaster. Proceeds from the SPE's sale of debt are maintained in a trust or secured collateral account and typically invested in highly-rated funds that own U.S. Treasury money market instruments or in high quality trust arrangements. Since the collateral supports the SPE's obligations to the insurance company as well as the obligations to return funds to investors, the insurance company shares the investor's concerns about the safety and soundness of the investments. Premiums or contractual payments made to the SPE by the insurance company initiating the transaction, as well as earnings from the investments, are used to make periodic interest payments to investors. When the catastrophe bonds mature, the SPE distributes funds remaining in the trust or collateral account to investors. The ultimate return to investors is dependent upon whether or not the catastrophic event covered by the bonds has occurred, and if so, the severity of the event. In the event the catastrophe occurs, investors face the prospect of losing a substantial portion or all of their investment. Catastrophe bonds may be structured such that investors may hold different risk tranches having various likelihoods of incurring loss.

The purpose of catastrophe bonds is to provide coverage for the insurance company's expected losses resulting from a catastrophic event. Some "non-indemnity" catastrophe bonds tie payments to an estimate of insurance industry losses made by an independent third party or to

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[5] "*ILS Market Update*," Willis Capital Markets & Advisory, November 2011; http://www.artemis.bm/blog/2011/11/22/steady-flow-of-new-catastrophe-bonds-forecast-for-2012/

[6] Investment News (September 11, 2011). Available at http://www.investmentnews.com/article/20110911/REG/309119997

objective measures such as wind speed experienced during a hurricane or extent of ground movement during an earthquake, as may be reported by governmental authorities. In contrast, catastrophe bonds with an indemnity feature provide for payment up to a specified amount based upon claims arising from the catastrophe that are actually incurred by the insurer in excess of a specified level that makes the likelihood of payment remote. In indemnity transactions, the SPE is licensed and regulated as a reinsurer in its domicile jurisdiction.

An insurer typically initiates a catastrophe bond transaction to secure risk protection from the capital markets relating to its insurance exposure, which originally arises in connection with policies issued or risks assumed in the ordinary course of business. Catastrophe bonds provide insurance companies with an important additional tool with which to manage risk associated with exposures to natural catastrophes. Catastrophe bonds complement insurers' reinsurance programs and provide reinsurers as well with a method of transferring a portion of catastrophic risk they have assumed. Catastrophe bonds also enable insurers to transfer risk when reinsurance may not otherwise be readily available at reasonable prices or in requested amounts to cover certain risks (*e.g.*, California earthquakes). Companies that have engaged in catastrophe bond transactions report that they have lowered capital associated with catastrophic events as a result of transferring a portion of the risk to investors.

Catastrophe bond programs offer the following benefits to insurance companies:

- Claims against issuers are fully collateralized, thereby minimizing credit risk;
- Insurers are able to diversify access to capital to cover natural disaster risk;
- Insurers typically carry reinsurance capped at a lower amount on the same risk covered by the catastrophe bonds. As a result, catastrophe bonds cover losses above the reinsurance cap amount. The presence of additional risk protection helps insurers manage reinsurance costs;
- Experience demonstrates that, after a catastrophic event, the availability of reinsurance is likely to be lower and extremely costly. Catastrophe bonds facilitate the ability of insurers to manage risk from post-event disruptions in reinsurance capacity; and
- Catastrophe bonds typically mature 3-4 years after they are issued and thus provide multi-year protection to insurance companies, which is generally not available in the traditional reinsurance markets.

Investors are attracted to catastrophe bonds because they provide an opportunity to earn a rate of return for exposure to insurance risks that are not correlated to other traditional

investment risks, such as interest rate, credit or market index volatility. Catastrophe bonds also offer a low beta asset whose yield is higher than similarly-rated corporate bonds.

Although the amount of catastrophe bonds issued to date has been relatively modest, issuances are growing as insurers recognize that the instruments play a useful role by providing an additional option to traditional reinsurance and by lowering costs of coverage, which also benefits consumers, businesses and other insureds. In this regard, the National Association of Insurance Commissioners has stated that "U.S. insurance regulators should encourage the development of alternative sources of capacity such as insurance securitization . . ."[7]

DISCUSSION

Catastrophe Bonds are Not ABS or Synthetic ABS

AIA and RAA believe that catastrophe bonds do not meet the definition of ABS or synthetic ABS. Section 3(a)(77) of the Securities Exchange Act of 1934 ("Exchange Act") provides that the term "asset-backed security":

> (A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including:
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> (i) a collateralized mortgage obligation;
> (ii) a collateralized debt obligation;
> (iii) a collateralized bond obligation;
> (iv) a collateralized debt obligation of asset-backed securities;
> (v) a collateralized debt obligation of collateralized debt obligations; and
> (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and
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> (B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities

[7] M. Moriarty (former Director, Capital Markets Bureau, the New York State Insurance Department, testifying on behalf of the NAIC), *Catastrophe Bonds: Spreading Risk, Hearing Before the Subcomm. On Oversight and Investigations of the House Comm. On Financial Services*, 107th Cong. (Oct. 8, 2002) at 7.

issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

Catastrophe bonds do not come within any of the above provisions because they do not involve the transfer of assets. Rather, catastrophe bonds represent the transfer of an insurance company's exposure to liability arising from natural catastrophes. Further, catastrophe bonds are not collateralized by a pool of self-liquidating financial assets and do not allow the holder to receive payments that depend primarily on cash flows from such assets. The only sources for payments to investors are the interest earned on the investment of their proceeds, the premiums or contractual payments made by the insurance company sponsor, and the amounts realized from liquidation of the investments at maturity.

Moreover, catastrophe bonds are not synthetic ABS. The Commission has stated that synthetic securitizations:

> create exposure to an asset that is not transferred to or otherwise part of the asset pool. These synthetic transactions are generally effectuated through the use of derivatives such as a credit default swap or a total return swap. The assets that are to constitute the actual 'pool' under which the return on the ABS is primarily based are only referenced through the credit derivative.[8]

Catastrophe bonds do not come within this language because they do not involve credit exposure to a portfolio of income-producing assets, and the SPE has not entered into a derivatives transaction with regard to any risk of the failure of any asset pool or any other financial asset.

Catastrophe bonds do not present the same opportunity for conflicts of interest as traditional ABS or synthetic ABS. Insurance companies cannot control the occurrence of natural disasters and therefore cannot "bet against" investors. In fact, insurers typically maintain a portion of the risk to which their catastrophe bonds are exposed.

Although the collateral, consisting of high quality investments, creates some risk for the bond investor, this risk is shared by the insurer. If the value of the collateral diminishes, the amount of reinsurance coverage for the risk associated with the trigger event is reduced commensurately. This is because recourse of the insurer against the SPE under the risk transfer contract is limited to the value of the collateral maintained by the SPE. As a result, the interests of investors and the insurance company are directly aligned.

[8] Asset-Backed Securities, Release No. 33-8518 (Dec. 22, 2004), 70 Fed. Reg. 1506, 1514 (Jan. 7, 2005).

Accordingly, AIA and RAA believe that the Commission should clarify that catastrophe bonds initiated by insurance or reinsurance companies are not ABS or synthetic ABS covered by the final rule.

The Scope of the Proposed Rule is Uncertain

AIA and RAA believe that the vagueness of the Proposed Rule makes it difficult in many instances to know precisely who is a covered person, the types of securities that will be subject to the rule, and what constitutes a material conflict of interest. As indicated above, catastrophe bonds do not come within the term ABS as defined in Section 3(a)(77) of the Exchange Act. Moreover, as previously indicated, AIA and RAA do not believe that catastrophe bonds come within the term synthetic ABS as the term is commonly understood by market participants. Because of their inherent nature, as indicated below, AIA and RAA do not believe that Section 27B covers, nor is it intended to cover, catastrophe bonds. Accordingly, AIA and RAA request that the final rule expressly state that catastrophe bonds do not come within the scope of its coverage.

AIA and RAA believe that the interests of insurers or reinsurers initiating catastrophe bonds are closely aligned with those of investors. Section 27B is intended to address conflicts that arise when a securitization participant bets against the securities at the expense of investors. In a catastrophe bond transaction, the insurer or reinsurer is unable to bet against investors. That is, there is no readily available means for insurers or reinsurers to take a position in favor of the occurrence of the catastrophe. Neither the company nor the investor profit from a catastrophic event; in fact, the occurrence of a catastrophe has adverse consequences for both. Moreover, the underlying purpose and intent of the transaction is for the insurance or reinsurance company initiating the transaction to transfer risk to investors, who are fully cognizant that the insurer or reinsurer benefits from the receipt of investors' funds if the catastrophe occurs. Section 27B could not possibly have been intended to apply where the essence of the transaction is a transfer of risk of which the parties are fully aware. Accordingly, AIA and RAA do not believe that transactions involving catastrophe bonds should be regarded as conflicts covered by Section 27B.

For investors, a catastrophic event, if sufficiently severe, can result in the partial or full loss of principal. For the insurer or reinsurer, while a portion of its claims are covered by the bonds, the company will also incur a loss because, in the majority of catastrophe bond transactions, it retains a portion of the risk securitized. For example, in an indemnity transaction, the company typically retains at least 5%-10% of the catastrophe risk. Investors insist on this to ensure that there is incentive to mitigate losses. Even where transactions are not structured on an indemnity basis, there is an expectation by investors that the insurer or reinsurer initiating the transaction retain some risk. The company in non-indemnity transactions also bears the basis

risk, that is, the risk that the actual loss will be greater than the loss covered by the principal from the bonds. In addition, non-indemnity transactions often contain a provision requiring that the losses for which the company is paid not exceed losses it experiences.

Further, probabilities assigned to catastrophic events (which are used to price and rate catastrophic bonds) are determined by independent third party experts, whose reports are available to investors as part of offering documents or otherwise. Neither the company nor investors know whether a catastrophic event will occur. While a company may seek to reduce its risk exposure, it does not do so because of information suggesting that the risk it seeks to transfer will perform poorly. Treating this risk transfer mechanism as giving rise to potential conflicts of interest covered by the Proposed Rule is not consistent with the letter of Section 27B or with Congressional intent. Accordingly, AIA and RAA request that the Commission clarify that catastrophe bonds are not ABS or synthetic ABS.

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AIA and RAA appreciate this opportunity to provide their views on the Commission's proposal regarding conflicts of interest in certain securitizations.

Sincerely,

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