CONSIDERATIONS ON THE REINSURANCE OF PUERTO RICO RISKS BY INTERNATIONAL INSURERS

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The approval of the International Insurers and Reinsurers Act of Puerto Rico in 2004 (Chapter 61 of the Puerto Rico Insurance Code), and enabling regulations subsequently promulgated by the Office of the Insurance Commissioner of Puerto Rico (Rules 80, 81 and 82 of the Puerto Rico Insurance Code Regulations) achieved the creation of the Puerto Rico International Insurance Center ("CIS," by its Spanish acronym), aimed at stimulating the formation of international insurers by leveraging the long-existing US income tax exemption generally applicable to Puerto Rico corporations with the adoption of new and supplementary local tax incentives, paired with a prudent and flexible regulatory regime.

The CIS successfully gave rise to a new sector within Puerto Rico's insurance industry, dedicated to underwriting insurance and reinsurance for "offshore" (i.e., non-Puerto Rico) jurisdictions. While the CIS has succeeded in attracting foreign investors to avail themselves of its platform, it also features less noted and exploited provisions that may not only further contribute to the sector's growth, but may also increase market capacity for the reinsurance of Puerto Rico resident risks while encouraging increased participation from local entrepreneurs.

The International Insurers and Reinsurers Act, since its adoption twenty years ago, contemplated that in addition to the acting as insurers and reinsurers of offshore risks, international insurers could engage in reinsurance (as opposed to direct underwriting) of Puerto Rico resident risks. While the Office of the Insurance Commissioner ("OIC") then quickly promulgated and enacted the regulatory guidance and framework to enable offshore operations, it took longer to do the same with regards to the reinsurance of domestic Puerto Rico risks. The subsequent (2013) enactment of enabling regulations by the OIC (Rule 100 of the Puerto Rico Insurance Code Regulations), and certain (2014) amendments to the Insurance Code, currently allow international insurers to reinsure Puerto Rico resident risks, and further allow Puerto Rico domestic insurers to take credit for reinsurance ceded to international insurers.

This decades-old legal framework in turn provides Puerto Rico residents the opportunity to invest either directly or indirectly (i.e., through a qualified international insurer holding company as defined in the CIS legislation) in the underwriting of reinsurance of Puerto Rico resident risks, via a stake in an international insurer or in a segregated assets plan ("SAP") operated by an international insurer.

A key feature of the CIS is that it allows organizations to utilize the facilities of an international insurer (underwriting, ratings, claims management, accounting, reinsurance, and expertise) to participate in the underwriting of certain risks, including their own, without incurring in the financial or administrative commitments of organizing and managing an international insurer (or, for that matter, a captive insurer in another domicile). Subject to prior approval, international insurers may establish and operate one or more SAPs. A SAP is not a separate legal entity, but is instead a distinct unit of the international insurer that maintains legal and accounting separation of its own assets and liabilities, in accordance to the international insurer's plan of operations of SAPs submitted to the OIC for its approval.

Assets attributed to one SAP are not available to satisfy the liabilities of another SAP or the "general account" liabilities of the international insurer, and vice versa. This separation and allocation subsist even in the event of the insolvency of either the SAP or the international insurer's general account. Participation as, for example, the owner of preferred shares of an international insurer, through a contractual agreement tying the dividends or other proceeds to be earned by such shares to the performance of one or more SAPs, is one method through which a Puerto Rico investor can derive benefits from the tax incentives provided under the CIS legislation.

Specifically, the current framework allows certain categories of international insurers (Class 3, for property and casualty risks excluding catastrophic; Class 4, for property and casualty risks including catastrophic; and Class 5, for life and disability risks) to reinsure, for their own general account or through a SAP, Puerto Rico resident risks in accordance with a "Special Category Authorization." Pure and association captive insurers (Classes 1 and 2) are excluded from transacting insurance or reinsurance of Puerto Rico resident risks. Thus, Puerto Rico residents do

not have an option, under the CIS legislation, to create a captive insurer for their own enterprise risks.

THE CIS LEGISLATION ALLOWS INTERNATIONAL INSURERS TO ESTABLISH SEGREGATED ASSETS PLANS, WHICH OFFER PUERTO RICO INVESTORS UNIQUE OPPORTUNITIES.

Other than the fact that the underlying Puerto Rico risks must be insured by a Puerto Rico admitted insurer, the main requirement to exercise such special category authority is that the majority (51%) of the international insurer's premiums (excluding premiums ceded in reinsurance) derive from offshore (non-Puerto Rico) business, while only 49% may originate from reinsurance of Puerto Rico risks. Furthermore, fair competition safeguards require that international insurers adhere to additional requirements, otherwise inapplicable for the insurance or reinsurance of offshore risks.

Essentially, these safeguards require that international insurers comply with the statutory standards generally applicable to insurers authorized to reinsure Puerto Rico risks (i.e., involving minimum capital and surplus, fiduciary deposit, investment in eligible Puerto Rico securities, among others). Accordingly, Puerto Rico resident risks insured by duly authorized insurers, whether domestic or foreign, may be reinsured by international insurers or SAPs operated thereunder.

Puerto Rico domestic insurers may obtain credit against their reserves for reinsurance ceded to international insurers wielding the special category authorization. Moreover, Puerto Rico domestic insurers may, within Puerto Rico's credit for reinsurance framework, obtain a reduction of liability for reinsurance ceded to international insurers that do not exercise the special category authorization, provided that such international insurers' contractual obligations to the ceding insurers are secured by funds held in trust, for the sole benefit and withdrawal of the ceding insurers, and consisting of eligible assets held at a qualified financial institution.

Subject to the legal framework described above, Puerto Rico residents, legal or natural persons, that invest in an international insurer or in a SAP established thereunder, may receive dividends and similar profit distributions (including liquidation distributions) paid out by the international insurer on account of such investments.

Such dividends or other profit distributions are fully tax exempt; the statutory provisions granting such exemption do not make any distinction for such purposes between resident or non-resident stockholders.

Puerto Rico-chartered international insurer holding companies, organized in accordance with the International Insurers and Reinsurers Act, may enjoy certain tax benefits in addition to the full tax exemption on dividends or similar profit distributions received from international insurers.

As mentioned, Puerto Rico businesses are barred from creating captive insurers to insure their own enterprise risks under the CIS legislation. Even through ownership of a non-captive international insurer, they would still be limited to reinsuring their owns risks directly subscribed by an admitted carrier, and only after generating enough offshore premium to cover the 51/49 ratio.

A more feasible option for a Puerto Rico business entity, applicable to all sectors, could be to invest in a SAP within an already established international insurer whose offshore premiums are sufficient to cover the reinsurance of Puerto Rico risks under the special category authorization or by collateralizing its obligations with funds in trust.

Such investor would still need to leverage its commercial relationships with a Puerto Rico admitted insurer to reinsure a portion or all its enterprise risks with its SAP. An incentive for the direct carrier is that the SAP owner would be motivated to manage its own risks more effectively.

To sum up, for various reasons the capacity of international insurers to underwrite reinsurance of Puerto Rico risks represents an important and sometimes overlooked feature of the CIS legislation.

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