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Briefing note | Wednesday 23 November 2016

A UK Framework for Insurance Linked Securities

Today the UK's Chancellor of the Exchequer, Philip Hammond, delivered his Autumn Statement which includes a reference to the Government's plan to make London an international centre for insurance-linked securities ("ILS"). To bring the Government's plan into effect, two consultation papers have been published today – a HM Treasury consultation on the Risk Transformation Regulations 2017 and the Risk Transformation (Tax) Regulations 2017 which will create the legal and tax framework to bring ILS business onshore and a PRA consultation on a Supervisory Statement that sets out guidance on the regulation of Insurance Special Purpose Vehicles ("ISPVs") used in ILS transactions.

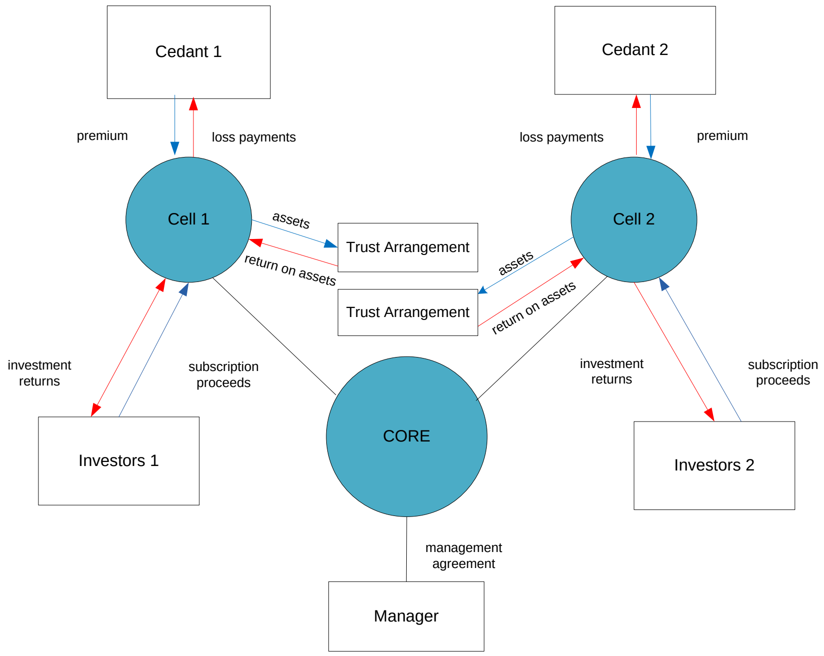
The consultations published today follow significant input from the London Market Group ("LMG") ILS Taskforce, a group of industry practitioners with expertise in specialist risk transfer business. As legal advisors to the LMG and members of the ILS Taskforce, Clifford Chance has been active in the preparation of the ILS legislation and, in this briefing paper, we consider the new legal and regulatory framework.

Background

London has a long history in the international insurance and reinsurance markets and, more recently, has become the world centre of the capital markets. The idea, first proposed by Philip Hammond's predecessor, George Osborne, is for London to serve these existing markets as they converge through ILS. Accordingly, HM Treasury issued an initial consultation in March 2016 which set out proposals on key ILS areas, including authorisation, corporate law and taxation.

In developing an approach to authorisation, HM Treasury's first consultation made reference to the Solvency II requirements that a Special Purpose Vehicle ("SPV") is subject to. It proposed to use these as the legal basis for UK ISPV structures but to include a Protected Cell Company ("PCC") structure to enable greater efficiency in the approvals process and operation. ISPVs will constitute SPVs under the Solvency II Regime.

Following the implementation of Solvency II, the PRA Rulebook already contains rules on SPVs. However, as the current authorisation process is complex and there is no PCC structure available, the regime is underutilised and has not been



able to compete with other ILS markets such as Bermuda, Guernsey and Gibraltar. Today's consultations are intended to radically change that by introducing a new tax regime and an onshore Solvency II compliant PCC regime which has an authorisation process and operational flexibility more suited to current and developing ILS structures and their marketing.

ILS structures

ILS provides an alternative method of risk mitigation for insurers and reinsurers. This is achieved through the transferring of risk to institutional investors and/or the capital markets. The two most common forms of ILS are catastrophe bonds ("CAT bonds"), which usually involve a public capital raising, and Collateralised Reinsurance products, which tend to be privately placed with a small number of institutional investors.

The typical ILS arrangement involves an insurer or reinsurer (the "cedant") entering into a risk transfer agreement with an ISPV. The ISPV then issues securities to investors (i.e. the ILS) - usually in the form of debt instruments or preference shares to raise sufficient capital to collateralise the insurance risk which it has taken on. A trust or similar security arrangement will be established to safeguard the assets of the ISPV. The activities of the ISPV will be limited to entering into one or more such risk transfer agreements and associated investment activities.

In return for putting their capital at risk, investors will receive a return on their investment and a return of the capital invested once the risk transfer agreement expires, minus any amount which becomes payable by the ISPV to the cedant under the risk transfer agreement. Investors in ILS will typically be sophisticated investors, including specialist ILS funds. Holders of debt securities or preference shares are subordinated to all other creditors of the ISPV including, in particular, the cedant of the ISPV.

The use of ILS and ISPVs is a recognised risk mitigation technique for insurers under Solvency II and credit can be given for such risk transfer arrangements for the purposes of the Solvency Capital Requirement ("SCR") calculation provided that Solvency II requirements are met.

The Regulations

The draft Risk Transformation Regulations 2017 (the "Regulations") are a stand-alone set of rules that will apply to ISPVs (referred to as 'Risk Transformation Vehicles' in the Regulations), separate from the Companies Act 2006. The tax framework for these vehicles is set out in the draft Risk Transformation (Tax) Regulations 2017 (the "Tax Regulations").

The focus of the Regulations is the creation of a UK regime for incorporating PCCs for use as ISPVs. Under the Regulations, a PCC is a corporate vehicle which allows for pools of assets and liabilities (known as "cells") to be segregated within a single limited company. Although each cell does not have a separate legal personality, the assets of one cell cannot be used to discharge the liabilities of another, and so are essentially ring-fenced. Each PCC will also have a "core" which manages and operates the PCC.

Collateralised Reinsurance products in particular can benefit from using the PCC structure, rather than the traditional limited company structure, as it enables the same ISPV to issue ILS to fund a series of separate risk transfer agreements, with varying risk profiles, and multiple cedants but with investors only exposed to the experience of the cell in which they have invested.

The Regulations provide a framework for the governance of the PCC by ensuring a clear distinction between the core and each individual cell. The Regulations also provide greater flexibility than the Companies Act for mechanisms such as distributions and buybacks by taking a light touch approach on the required process. This permits the PCC to return capital to investors efficiently at the end of an investment cycle. However each cell must be "fully funded" to meet its obligations and the capital financing the cell must be fully paid in. Distributions and returns of capital will only be permitted if the cell remains "fully funded" after the distribution or return of capital.

Authorisation and supervision of ISPVs

Under the Regulations, the PCC will require authorisation from the PRA (with the FCA's consent) and will be subject to the dual regulation of the PRA and the FCA. The FCA will also maintain a register of PCCs.

'Fully Funded' Requirement

In line with Solvency II requirements in (Article 319 and 326 of the Solvency II Delegated Act), the ISPV will be required to be "fully funded". This essentially means:

- the assets of the ISPV must be equal to or greater than its liabilities;
- the aggregate maximum risk exposure of the ISPV under the risk transfer agreements entered into with the cedant(s) must not exceed the amount of its assets at that time;
- the ISPV's debt securities or preference shares must be fully paid in; and
- the investors must be fully subordinated to the cedant and have no right of recourse to the assets of the ISPV or apply for the ISPV to be wound up.

The above definition is designed to ensure that the transfer of risk from the cedant to the ISPV is effective and 'clear and incontrovertible'. This principle is important given that an ISPV does not to meet a solvency capital requirement. However, some of the concepts in the Solvency II Delegated Act (including at 'all times', 'fully paid in' and eligible assets) are ill defined and could create uncertainty which would be unhelpful to the development of the ILS market in the UK. This has been a focus of the LMG task force in its discussions with HM Treasury and it was hoped that through a combination of the Regulations and the PRA Supervisory Statement there would be sufficient clarity in the interpretation of the Solvency II requirements.

However, the PRA's Supervisory Statement still leaves room for uncertainty in respect of assets that can be counted towards 'fully funded' – particularly around the way in which contingent assets are treated. In addition, the draft Statement says that, for the purposes of authorisation, limited recourse clauses will be "irrelevant to their initial assessment of whether the ISPV is fully funded". The PRA's final position on this may be critical to the success (or not) of the UK ILS offering.

In light of the above, we encourage interested parties to respond to the consultations and we look forward to a constructive dialogue with the government and the regulators to refine their proposals.

Tax Considerations

Broadly, provided certain conditions are met, the Tax Regulations specify that ISPVs will not be liable for corporation tax on profits relating to the ISPV's insurance risk transformation activities. In addition, no withholding taxes should apply to interest payments made to investors in relation to insurance risk transformation investments.

The special tax regime applying to ISPVs will, however, be disapplied in certain circumstances (for example, where the vehicle has failed to comply with certain reporting requirements or where the anti-avoidance condition is met). Significantly, the exemption is disapplied where an investor connected with the undertaking from which the risk is assumed holds more than 20% of the ISPV investments.

How we can help…

As members of the London Market Group ILS Taskforce, Clifford Chance has been closely involved in the development of the UK ILS regime reflected in the consultation published today. We will feed further comments into the consultation and will continue to work with HM Treasury, the PRA, the FCA and HMRC in finalising the regime following the consultation. We would be happy to discuss the new regime with you and to help you plan to benefit from the opportunities it will create for innovative risk transfer in both the non-life and life insurance sectors.

In delivering ILS solutions, Clifford Chance can draw on the knowledge and transactional and regulatory experience of our leading global insurance practice. Our insurance practice works closely with our tax and capital markets groups and is well placed to deliver tax efficient and market leading ILS solutions in the UK.

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