CLIENT MEMORANDUM

Proposed ILS Regime for the UK

Corporate, tax and regulatory consultation and regulations released by the UK government for insurance linked securities

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As part of the Autumn Statement 2016 delivered recently by the Chancellor of the Exchequer, Philip Hammond, the UK government reiterated its commitment to implement an Insurance Linked Securities (**ILS**) regime in the UK. The reasoning behind this, according to HM Treasury, is to *"help cement London's position at the forefront of the global reinsurance business*" by contributing to the growing ILS market and enhancing the UK's global reinsurance offering.

To further the ILS initiative, HM Treasury has subsequently issued a new consultation complete with two sets of draft regulations aimed at implementing a new regulatory and tax framework for ILS in the UK. In conjunction with this, the Prudential Regulation Authority (**PRA**) and the Financial Conduct Authority (**FCA**) have issued their own proposals on the authorisation and supervision of the ILS market. These documents describe the background to the consultation and the responses received to the first ILS consultation by the UK government in March 2016 (which included our Willkie team as one of three law firm respondents, out of a total of 21), and set out the proposals in key ILS areas such as: the corporate structure of ILS vehicles to be set up as protected cell companies (**PCCs**), the tax treatment of ILS vehicles and their investors, and the approach to authorisation and supervision of ILS vehicles by the PRA and the FCA.

Background

HM Treasury initially signalled its intention to explore implementing an ILS regime in the UK in the March 2015 Budget. By working with the London market, the PRA and the FCA, HM Treasury said that it wished to develop a new competitive corporate, tax and regulatory framework for ILS vehicles. It subsequently issued an initial consultation in March 2016 whereby it asked the industry to comment on what it considered should be the regulatory, tax and corporate structure for ILS business and how ILS vehicles should be authorised and supervised.

Using the responses to this initial consultation, HM Treasury has now prepared two separate draft regulations under which it is intended the ILS regime will operate. These are:

1. The Risk Transformation Regulations 2017 – introducing a new corporate structure for multi-arrangement Insurance Special Purpose Vehicles (**mISPVs**) namely, the PCC, and a new regulated activity under the Financial Services and Markets Act 2000 (**FSMA**) for "insurance risk transformation"; and

2. The Risk Transformation (Tax) Regulations 2017 – which set out the tax treatment of mISPVs and investors.

As noted above, the PRA and the FCA have separately issued a consultation paper on their approach to authorisation and supervision of the mISPVs from a UK regulatory perspective.

These new proposals have again been put out to consultation, for comment by **January 18, 2017 with respect to the two new regulations** and **February 23, 2017 with respect to the PRA and FCA approaches**.

As before, Willkie intends to respond in detail to the government's current proposals and to help shape the way that this market could develop in the UK based on our team's ILS experience.

The Risk Transformation Regulations

The responses to the March 2016 consultation all concurred with the suggestion that the new ILS framework should be built around a PCC structure. However, since this type of segregated cell structure is not available under the current UK Companies Act 2006, the new Risk Transformation Regulations will amend UK company and insolvency law to allow for PCCs.

Under the new regulations, a PCC will be a private company limited by shares. PCCs will not be available as public limited companies. Each PCC will have a "core" which administers the company, manages each cell and enters into transactions on behalf of the cells. While each cell will not have a separate legal personality, the statutory segregations and ring-fencing of assets and liabilities in a cell means that the assets of one cell cannot be used to discharge the liabilities of another.

As in other ILS jurisdictions with PCC structures, this structure should save time and money by allowing sponsors to manage a number of ILS deals through one mISPV. Instead of setting up a new vehicle for each transaction, the intention is that the mISPV can quickly set up a new, entirely segregated cell by way of a simple board resolution (subject to regulatory approval discussed further below). Investors can fund a cell (in exchange for non-voting securities or debt) in respect of distinct risk transfer arrangements. As mentioned above, the funds associated with one cell will be ring-fenced and not available to be used to meet the liabilities of another cell. Further, it is intended that each discrete cell and therefore each discrete risk transfer arrangement should be assessed separately against the capital requirements of Solvency II (the EU's harmonised insurance regulation and capital regime).

In terms of the items that are still open for further discussion, HM Treasury have asked for views on the following:

- *Directors duties* – The main thrust of HM Treasury's argument with regards to directors duties is that these should remain the same as those for a conventional company under the Companies Act 2006 with "appropriate modifications" such as a requirement to comply with the Risk Transformation Regulations. However, HM Treasury has invited comment as to whether this provides a suitable framework for PCC companies.

- *Reports and accounts* – These will be in line with the UK Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 and relevant audit provisions of the Companies Act 2006, again with "necessary modifications". However, HM Treasury has solicited views on whether (i) amendments to the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 will be needed to accommodate PCC companies; and (ii) reduced disclosure obligations may be more preferable to alleviate concerns raised in the previous consultation that market sensitive information would need to be published by the cells under current reporting and audit requirements.

- *Insolvency* – Each cell should be capable of being wound up separately without affecting the solvency of the other cells. The suggestion is to allow for each cell to be put into administration or liquidation only. Each cell of an insolvent core will also each be treated as a separate entity for this purpose. HM Treasury has asked for comment as to whether their suggestions provide a suitable framework to allow insolvency of the separate cells in line with current insolvency legislation.

On the whole, the proposed approach to amending the UK's company and insolvency laws to provide for new PCCs seems coherent and should create a sound structure under which the ILS market can develop. However, the caveat to this pragmatic approach from HM Treasury is that a similarly pragmatic approach will be required with respect to the regulation of these PCCs in order for the structure to be flexible enough to meet the needs of a global reinsurance community already conducting ILS business in jurisdictions that are generally viewed as commercial and stream-lined from a regulatory perspective. The proposals from the PRA and the FCA regarding the authorisation and supervision of the PCCs will therefore likely form the most important element of this new consultation, as discussed below.

The Risk Transformation (Tax) Regulations

The responses to the March 2016 consultation made it clear that in order for the UK to create a competitive ILS market, the tax treatment of the mISPVs would need to be attractive to domestic and non-UK investors alike. With this in mind, the government has proposed a bespoke tax regime for ILS vehicles operating in the UK. The key features of the tax regime are:

- Exemption from corporation tax for the insurance risk transformation profits of mISPVs; and
- A complete withholding tax exemption for non-UK investors.

This means that non-UK investors (whether the mISPV issues debt or equity) will be taxed according to the tax rules in their home country and UK investors will be taxed on their investment return as normal, according to their facts and circumstances.

The profits (in the PCC core) arising from the management of the mISPV will still be subject to corporation tax, calculated on usual principles. The rate of tax will be the standard UK rate, due to fall to 19% from April 2017 and 17% from April 2020. This approach is consistent with the objective of recognising the mISPV as essentially a conduit or fund, investment in which does not drag the investors' return within the UK tax net. Instead, the UK government is focusing on the enhancement to the UK economy from attracting additional (taxable) business activity for London's specialist insurance and capital market experts and other professionals servicing the ILS market.

There are some detailed comments (for example, in relation to the anti-avoidance triggers for removal of the favourable tax regime and in relation to the tax treatment of collateral trusts) that the Willkie team will make in our response. However, the proposals represent significant progress for the industry and should mean that the UK is well placed in tax terms to compete with the likes of Bermuda and the Channel Islands in the ILS space.

PRA and FCA Authorisation and Supervision

In order to carry out the activities of a mISPV, entities will need to include a PCC application to the PRA as part of their application for approval under Part 4A of FSMA. The PRA and FCA consultation paper sets out in detail the process that firms will need to comply with in order to make this application to carry out the new activity of "insurance risk transformation" under FSMA. If the PRA approves the application and certain other statutory requirements are met, the FCA will register the new PCC and issue a certificate of incorporation.

The PRA and FCA suggest that the turnaround for initial mISPV authorisation applications will be between six and eight weeks (though, once authorised, the establishment of new cells of a PCC is intended to be much quicker); however the UK regulators have indicated that they will allow as much as six months for consideration of initial applications where necessary. In Willkie's response to HM Treasury's initial consultation, we noted that other jurisdictions have the ability to approve the set-up of new special purpose entities used in ILS deals within a period of just one to two weeks, and therefore the UK may not be as competitive as a result of longer times periods or any delay by the PRA and the FCA in assessing applications. Market participants will need to plan ahead when first considering setting up a PCC to be used as an mISPV, but we consider that it would be beneficial to the UK ILS market if regulators could commit to a shorter time frame for consideration of new applications and we will look to raise this point in our response to the PRA on this consultation.

Each time a PCC wishes to set up a new cell, it will be required to provide a further notification to the PRA who will consider this notification in conjunction with the FCA. The proposals state that a new cell should not be established until either the PRA has confirmed its non-objection in writing or 10 working days have elapsed since submission of the application, provided that neither regulator has raised any objection. These time scales are encouraging but there is still some concern that this approach could limit the flexibility of the new regime if the PRA and the FCA routinely raise objections. If a cautious approach is taken to approving new cells, this could slow down business and discourage reinsurance sponsors and investors from using the UK as an ILS hub.

Another part of the PRA's authorisation conditions that is causing some discussion among market participants is the requirement that the mISPV must be "fully funded". This is stated to be in line with the requirements of Article 326 of the Solvency II Delegated Regulation. In our response to the initial March 2016 consultation, the Willkie team raised concerns that this requirement should be explained in detail so that its application is certain.

The new proposals raise some further questions on the detailed rules concerning the fully funded requirement. The requirement to be fully funded essentially obliges the mISPV to have assets that are equal to or exceed its aggregate maximum risk exposure and requires the mISPV to be able to pay the amounts for which it is liable as they fall due. The PRA's statement leaves room for interpretation as to which assets can be considered by an mISPV as counting towards the requirement to be fully funded, in particular with respect to contingent assets. It says that contingent assets cannot be taken into account for the purposes of satisfying the fully funded requirement, but may (when actually paid-in) mitigate the risk that the mISPV fails to satisfy the fully funded requirement at all times. It appears that the regulators may recognise contingent assets when assessing the liquidity risk faced by an mISPV, even though contingent assets cannot be taken into account for the purposes of satisfying the fully funded requirement initially. As such, it will be important to have further regulatory guidance on the use of contingent assets by mISPVs for this purpose and the Willkie team will look to raise this point in our response.

Conclusion

The proposed ILS regulations, if adopted in the current form, would provide a significant step towards the UK being able to offer a legal, tax and regulatory environment that would be more conducive an ILS regime. The level of detail and the work that has gone into the process is indicative of HM Treasury taking seriously its commitment to offering appropriate conditions for an ILS market to become established in the UK. Of course, establishing the right legal and taxation framework is only part of what needs to be done in order to make the UK an attractive market, particularly compared with the already-established jurisdictions such as Bermuda. Therefore, the success of this initiative is ultimately likely to depend on whether the new proposals, once implemented, can be delivered in practice by the UK regulators in a timely and efficient manner and in a way that compares favourably to the offerings of the other jurisdictions.

As with the previous consultation in March 2016, our team intends to provide significant input into this further consultation early in 2017, to help shape the way in which the structural, tax and regulatory elements of the new regime will be formulated. We would be happy to consider and reflect any comments that clients and friends may wish to make on the proposals.

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