

CLIENT ALERT

UK ILS Regime: Proposed Final Draft of the Risk Transformation Regulations and the Approach of the PRA and the FCA

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In preparation for the commencement of the insurance linked securities (“**ILS**”) regime in the UK, both the Prudential Regulation Authority (the “**PRA**”) and the Financial Conduct Authority (the “**FCA**”), on 1 November 2017, issued final or near-final drafts of their supervisory statements and suggested amendments to the FCA Handbook. This followed the final draft of the Risk Transformation Regulations 2017 (the “**Draft Regulations**”) being laid before the UK Parliament, on 12 October 2017, for its approval.

The consultation process undertaken by HM Treasury, the PRA and the FCA in respect of the Draft Regulations and the PRA and FCA approach documents over the course of 2016 and 2017 (each of which Willkie has contributed to) has resulted in some welcome revisions to both the Draft Regulations and the PRA supervisory approach in particular, which we set out for your information below.

We discussed more generally the Draft Regulations and other documents in our previous reports on the developing UK ILS regime. These memoranda can be found using the following links: [The UK Government Releases Final Regulations for Establishing an ILS Regime in the UK](#), [An ILS Regime for the UK: Responses to UK Government Consultation Papers](#) and [Proposed ILS Regime for the UK](#).

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PRA and FCA approach statements

The following statements have been produced by the PRA and the FCA:

- i. PRA Policy Statement PS26/17 on the authorisation and supervision of insurance special purpose vehicles;
- ii. PRA Supervisory Statement SS8/17 on the authorisation and supervision of insurance special purpose vehicles (the “**PRA Supervisory Statement**”); and
- iii. FCA Policy Statement PS17/24 on Handbook changes to reflect the new regulatory framework for Insurance-Linked Securities – Feedback to CP16/34 and CP17/3 and near-final rules.

Notable amendments in the statements

The key amendments are as follows:

Timing of mISPV notification

The original version of the Draft Regulations and the consultation paper issued by the PRA and the FCA proposed that where there is a multi-arrangement insurance special purpose vehicle (“**mISPV**”) with a number of cells in respect of different risk transformation arrangements, the mISPV would be required to notify the PRA of its proposal to establish a new cell at least 10 working days before the cell would come online.

In our response to the consultation, we queried the commercial viability of this pre-notification process given that this was out of line with competing ILS jurisdictions. Nine other respondents had the same reservations and in light of the feedback received, the PRA has revised its approach.

The new proposal is that post-transaction notification to the PRA will be permitted if the new risk assumed falls within the “scope of permission” of the mISPV (discussed in more detail below). This notification must occur within five working days of the assumption of the risk.

This post-notification timing change is particularly welcome because this should put the UK regime on a competitive level footing with other ILS jurisdictions in terms of timing for establishing new cells.

Requirement for ISPVs to be fully funded

The market has been keen to see the final guidance on the PRA’s interpretation of the ‘fully funded’ requirement, and as a result of consultation responses, the PRA Supervisory Statement has been revised to include additional guidance on the fully funded requirement.

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The PRA has now outlined its expectation for insurance special purpose vehicles (“**ISPVs**”) not to include contingent assets for the purposes of satisfying the fully funded requirement (i.e., letters of credit, guarantees and other market or credit risk mitigation instruments), though it has indicated it expects ISPVs to be able to recognise payments expected to be received from the cedant (e.g., funds withheld or periodic premium payments) as assets once all the conditions in Article 326(4) of the Commission Delegated Regulation (EU) 2015/35 (the “**Delegated Regulation**”) have been met.

The PRA has further noted that under the Delegated Regulation an ISPV must at all time have assets exceeding its Aggregate Maximum Risk Exposure (“**AMRE**”), being the sum of the maximum payments *including* expenses that the ISPV may incur (unless those expenses satisfy certain conditions under the Delegated Regulation).

Since the AMRE will need to be supported by capital which the ISPV will likely draw from investors, such arrangements will need to be carefully documented and the managers of the ISPV will be required to be able to determine the AMRE at any point in time. We discuss below the role of managers under the UK ILS regime.

Authorisation timing

In the original PRA and FCA consultation paper, the PRA required that an ISPV have funds in place before being granted authorisation. In our response, we called attention to a possible timing issue in respect of this requirement, since in most other ILS jurisdictions, regulators permit ‘conditional’ applications to allow time for funding and reinsurance arrangements to be put in place. Our experience has been that key market participants would likely expect this kind of approach in the UK. Commentators therefore encouraged the UK regulators to take a similar view to other jurisdictions and allow authorisation before funding occurs.

Whilst the PRA has maintained its general approach in that “*the risk transfer to the ISPV should not become effective unless, and until, the corresponding funding is received*”, it has stated in the PRA Supervisory Statement that it would be prepared to approve an ISPV prior to receipt of funds provided that all other conditions for approval have been met and the ISPV can demonstrate that it will receive the relevant funding before the risk transfer to the ISPV becomes effective. This is a very helpful change and will be welcomed by practitioners.

Scope of Permission

The original Draft Regulations and PRA and FCA consultation paper required that applicants submit a detailed “regulatory business plan” as part of any mISPV application. The majority of respondents to the consultation considered that certain of the areas in which the PRA was proposing to restrict mISPVs within the regulatory business plan were “*unnecessary and overly prescriptive*”. We submitted that some of the information required might not be available to all ILS sponsors, for example, the details on the number of cells and aggregate risk exposure of an mISPV over its lifetime. Further, the detail required for the regulatory business plan might discourage or, at worst, prohibit third-party-managed mISPVs from establishing framework structures for multiple cedants in the UK market, as such participants are unlikely to know at the

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outset what the supply of insurance risk or the supply of capital might be as they seek over time to match risk to capital in a dynamic way.

The Draft Regulations and PRA Supervisory Statement have replaced the regulatory business plan with a formal “scope of permission”. This scope of permission will outline the arrangements, structures and mechanisms that the mISPV will be permitted to use in order to conduct risk transformation business. Again, this is a welcome change since it makes the application process much less prescriptive and therefore should reduce the regulatory burden on new applicants.

The Senior Insurance Managers Regime (“SIMR”)

Despite queries regarding the necessity of three mandatory Senior Insurance Management Function roles under SIMR, the PRA continues to believe that all three roles (being the Chief Executive SIMF1, Chief of Finance SIMF2 and Chair of the Board SIMF9) are “*appropriate and proportionate*” for ISPVs.

The PRA has however clarified that one person may be able to perform more than one of these roles, where appropriate, and that each role need not be held by an employee of the ISPV. As such, it will be possible for an ISPV to appoint managers to perform these functions on its behalf, provided of course that the outsourcing of these functions is properly managed, maintained and documented. This is a positive response to the concerns raised by the respondents to the PRA’s consultation.

As we have mentioned in our previous memoranda on the UK ILS regime, the proposed application of SIMR to ISPVs is distinctive when compared to other ILS jurisdictions, which generally rely on the insurance manager being subject to supervision. All persons holding SIMR roles (whether internal or outsourced) will need to take care to understand how the ISPV meets the requirements of the the Draft Regulations, new FCA Handbook rules and the relevant portions of the Delegated Regulation, so that this might be demonstrated to the regulators on request. This will include governance mapping to ensure compliance with SIMR. If these persons are not able to demonstrate sufficient oversight of the risk transfer mechanisms, they may be held personally responsible for breach of the PRA’s conduct rules applicable to their specific function.

Next steps in UK ILS

The PRA and FCA have both taken steps to ensure that they are ready to move on any proposed new ILS structures as soon as the Draft Regulations are given final approval by the UK Parliament. In fact, for those ILS sponsors looking to establish ILS vehicles in the UK to come online on 1 January 2018, it may now be challenging. Both regulators remain keen and indeed encourage contact before any Parliamentary approval in order to consider any applications or queries in good time. Beyond the 1 January renewal period, it is worth noting that the PRA encourages the opportunity for prospective ISPV applicants to discuss their proposals prior to application, and where effective pre-application

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engagement has taken place, the PRA advises that, notwithstanding the outside application time of six months, a six to eight week timeline to authorisation is more likely to be feasible.

Given the requirements to comply with elements of the Delegated Regulation and SIMR in particular, market participants and practitioners will have to pay close attention to ensure that the ILS vehicles and structures put in place under the new UK regime are accurately and clearly documented, so that parties can demonstrate compliance with all aspects of the Draft Regulations, new FCA Handbook rules and the relevant portions of the Delegated Regulation.

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