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CLIENT MEMORANDUM

An ILS Regime for the UK: Responses to UK Government Consultation Papers

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This memorandum gives an updated summary of the UK government's ongoing commitment to establishing an Insurance Linked Securities (**ILS**) regime in the UK as well as Willkie London's responses to the consultation. The UK's timetable is to set the new regime in place by mid-2017. By way of background, HM Treasury issued a consultation complete with two sets of draft regulations aimed at implementing a new regulatory and tax framework for ILS in the UK, and the Prudential Regulation Authority (**PRA**) and the Financial Conduct Authority (**FCA**) together also issued their own proposals on the authorisation and supervision of the ILS market in the UK.

Broadly, the approach of both the UK government and the regulators would provide an opportunity for one of the world's leading insurance hubs to develop a framework for ILS participants to consider the UK as a jurisdiction for transacting in ILS. We consider that the changes proposed are a welcomed and positive step forward for market participants. However, in a competitive landscape, the success of a UK ILS regime will depend on the UK's ability to contend with other jurisdictions such as Bermuda, Guernsey and Ireland, which have up until now dominated the ILS market.

There are five key areas that ILS sponsors and investors seeking to set up risk transformation vehicles consider in comparing available jurisdictions:

1. Corporate structure;

2. Applications – timing and submission of information;
3. Governance and reporting requirements;
4. Solvency requirements; and
5. Tax.

With these in mind, we set out below a summary of our key thoughts on the proposals, which the Willkie London team has provided to the relevant UK authorities as responses to their consultation papers.

Corporate structure

HM Treasury's consultation included draft Risk Transformation Regulations 2017 (the **Draft Regulations**) which will amend English company law to accommodate the new corporate structure of a protected cell company (**PCC**) which would be used by multi-arrangement Insurance Special Purpose Vehicles (**mISPVs**) to conduct "insurance risk transformation" activities.

This effectively creates a similar segregated cell structure to those seen in other jurisdictions, where the assets and liabilities of each cell are ring-fenced so that the assets of one cell cannot be used to discharge the liabilities of another. However, as currently proposed, the PCC structure has two possible drawbacks.

First, the Draft Regulations currently only refer to non-voting shares being issued on behalf of "part of the PCC". There is no clear indication in the Draft Regulations that either (i) multiple series or tranches of non-voting shares may be issued in respect of one cell; or (ii) cells may issue debt securities to third-party investors. If multiple tranches or debt issuances are not permitted, this would limit the use of PCCs and give the UK regime a practical disadvantage. Whilst it seems unlikely that this is the intended outcome, we have requested clarification from HM Treasury.

Second, the Draft Regulations restrict a PCC from holding shares in a subsidiary of such PCC. Some ILS market participants, drawing from a more traditional funds-type structure, favour a two-tiered approach, with third-party investors investing in a protected cell holding company owning a protected cell special purpose (re)insurer writing the relevant business. We have noted in our response that such participants could be put off from doing business in the UK if this structure is not permitted.

Applications

For the UK to have a regulatory regime that is comparable to ILS centres like Bermuda and Guernsey, we believe the PRA will need to match or improve on the timeframes employed by those jurisdictions for authorisation of an mISPV.

The proposed timeframe of 6-8 weeks for determination of simple applications, with a back-stop of 6 months, is outside the upper bounds of the timescales adopted by other jurisdictions, and as such is unlikely to be competitive. In addition, the PRA has allowed itself 10 working days to notify an applicant whether or not it deems that their application is complete. This could add, at minimum, a further 2 weeks onto the determination period and is not in line with the practice of other regulators within the ILS space. There is also a concern that the pre-application facility offered could further draw out the timeline if the PRA uses this to explore intended applications in detail, as it does now under the pre-application stage for (re)insurance companies.

Other considerations we have noted with the proposed approach to initial mISPV applications relate to the arrangements that need to be in place and the information to be provided on application. It would seem that the regulators expect risk transfer vehicles to be effectively ready to trade when making their application, i.e., that the terms of the relevant reinsurance/risk transfer agreement have been broadly agreed and that funding has been received from investors. Other ILS jurisdictions permit "conditional" applications to allow time for funding and reinsurance arrangements to be put in place and we have encouraged the UK regulators to take a similar view. Further, other information required for the "regulatory business plan" to be included within an mISPV application, such as details on the number of cells and aggregate risk exposure of an mISPV over its lifetime, may not be available to all ILS sponsors. In particular, this could discourage or, at worst, prohibit third-party managed mISPVs from establishing framework structures for multiple cedants in the UK market, as they are unlikely to know at the 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.

With respect to additional cells, the PRA has indicated that an mISPV may establish the cell 10 business days after submitting a new cell notification form, provided that no objections are received within this timeframe. We have noted that this would appear to be out of line with competing ILS jurisdictions, which typically afford parties with approval within 1-2 days.

It is hoped that the regulators (and the PRA in particular) will revise their approach to new mISPV applications generally to make the UK an attractive option for ILS market participants. They will also need to address staff resourcing around possible pinch points, such as the end of the year (in time for the 1 January renewals season), to ensure that they can adequately handle the greater influx of applications that they would likely receive around this time.

Governance and reporting requirements

The most favoured ILS jurisdictions employ a light touch approach to governance and reporting requirements. The current HM Treasury proposals require PCCs to adhere to reporting, accounts and audit requirements effectively equivalent to some of the largest private (re)insurance companies operating in the UK. In alternative jurisdictions, special purpose companies have the flexibility to, for example, prepare unaudited management accounts, where investors are comfortable with such an approach. This has benefits both from a time and a cost perspective, which we have noted in our responses.

Similarly, most insurance special purpose vehicles in other jurisdictions have efficient and rationalised board structures. Often, management is outsourced to a third-party via a management or administration agreement. The proposed imposition of the PRA's Senior Insurance Manager Regime and FCA controlled functions regime will likely mean an administrative and expense burden for UK operations beyond those seen in other jurisdictions. Whilst regulatory oversight of management may be desirable, imposing the same full regime as applies to other (re)insurers would seem to be disproportionate for managers of these special purpose ILS vehicles.

Solvency requirements

Under the current proposals, mISPVs are absolved from the requirement to meet a probability based "solvency capital requirement", but instead must be "fully funded" consistent with Article 13(26) of the Solvency II Directive[1] and Article 326 of the Commission Delegated Regulation (EU) 2015/35 (the **Delegated Regulation**). The PRA has stated that contingent assets will not count towards a mISPV's fully funded requirement.

To add flexibility in funding options, we have suggested to the PRA that they should consider whether Article 326 of the Delegated Regulation would permit letters of credit from issuers with particular financial soundness to meet the "fully funded requirement".

Tax

The key features of the proposed tax regime for mISPVs are:

1. an exemption from corporation tax for the insurance risk transformation profits of mISPVs; and

2. 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.

The government has made it clear that they do not want this favourable tax treatment to be available where risk is effectively retained by the cedant through its own investment in an mISPV. This limit is currently set at a 20% interest in the mISPV, but HM Treasury does note that this rule may need to be refined to accommodate temporary "seed" investment by the cedant group. In our experience, a cedant group may invest in order to assist its newly formed ILS

[1] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast).

initiative to develop a track record. Ideally, to allow maximum flexibility, any “seed” investment exception should accommodate a number of investment rounds before a cedant group’s stake in the mISPV must fall below 20%.

In addition, the “punishment” in the form of a complete forfeiture of the ILS tax treatment for both the mISPV and its investors for tax compliance administrative errors is disproportionate. In our view, the penalties already provided for any such default under existing tax legislation should be sufficient.

Finally, in order to meet the “fully funded requirement”, mISPVs may wish to establish a collateral trust. To maintain flexibility, we suggested in our responses that the inheritance tax implications of any collateral trust established by a mISPV should also be addressed so as to include an exemption from the definition of “relevant property”, similar to that for the premiums trust fund or ancillary trust fund of a Lloyd’s corporate member that is contained in section 248 of the Finance Act 1994.

Conclusion – ILS in the UK

Despite the concerns noted above, the approach of the UK government and regulators in supporting a UK ILS regime remains a positive development for the UK insurance market. One has to bear in mind that the PRA, in particular, is constrained by legislation including Solvency II and may therefore not be able to go as far as some market participants may want regarding, for example, the “fully funded requirement”. Nevertheless, there are points in the consultation where the regulators have gone further than it would appear is necessary within the bounds of current regulation, and we hope that they will be amenable to the market’s comments on these points.

Within the proposed framework, we believe that it will be possible to develop market practice that could facilitate ILS structures developing in the UK. As the details of the UK’s potential exit from the European single market become clearer, the UK will be looking to establish itself as an attractive independent third country jurisdiction outside of the European Union. Whilst it is hoped that London’s long history of insurance expertise will be enough to attract global firms, an ILS capability could act as a further draw to investors and insurance companies alike wishing to maintain or establish insurance businesses in the UK. Nevertheless, given that this will be a new venture for the PRA and the FCA, we believe it will take a few brave and innovative market participants to lead the charge, establish and gain approval for ILS structures and drive the evolution of the UK market, and the rewards for those first movers could be significant.

Next Steps

HM Treasury, the PRA and the FCA will all now consider the market’s responses to their respective consultation papers and finalise the new legislative instruments, rules and guidance. The FCA also currently has another consultation running on consequential amendments to the FCA Handbook which will need to be made to incorporate the new ILS regime with responses to be provided by 14 March 2017.

All indications point to a fast timetable from here on in, with HM Treasury stating that they expect to put the draft legislation before Parliament in "early 2017" and the PRA and FCA stating that they expect any rules and guidance will take effect from April 2017. It remains to be seen whether this timetable can be achieved, but if it is, it is possible that we could see new UK ILS structures in place in time for the 1 January 2018 renewals season.

In any case, the insurance team at Willkie London will continue to provide input for the consultations where appropriate and would be happy to discuss our responses to the UK government's proposals in detail with interested clients and other ILS participants.

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