HM Treasury

Insurance linked securities:

consultation

February 2016

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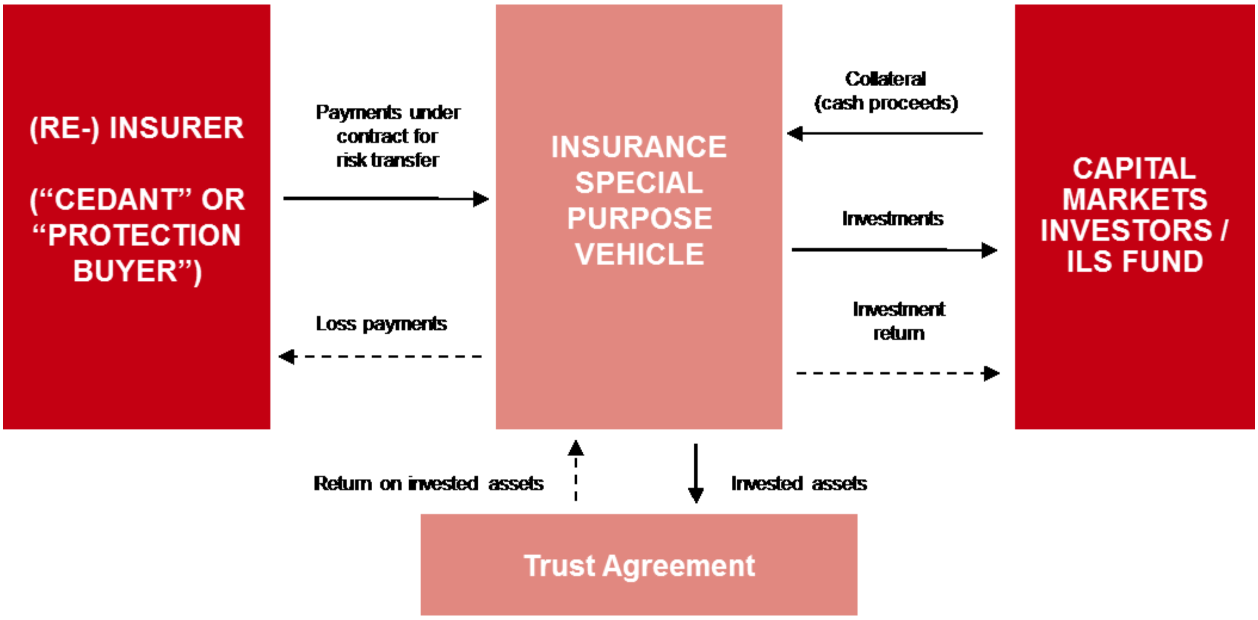
1 Introduction

The growth of Insurance Linked Securities business

1.1 Insurance Linked Securities (ILS) are an alternative form of risk mitigation for insurance and reinsurance firms. In contrast to conventional cover arranged with a reinsurance company, they offer insurance and reinsurance firms a means of transferring risk to the capital markets. ILS has helped to expand the capacity of the reinsurance market and it has also provided protection buyers with cover which is generally less exposed to counter-party default. For investors, ILS deals have offered attractive returns, and because ILS performance is considered to be uncorrelated with the economic cycle, they have provided helpful diversification for investment portfolios. Use of ILS has grown very significantly in recent years and is now an established part of the global reinsurance market. ILS or alternative reinsurance capital now stands at around $70 billion, about 12 per cent of overall reinsurance capital.

1.2 The basic structure for an ILS deal is illustrated in the following diagram:



1.3 An ILS deal typically involves an insurance or reinsurance firm (referred to as the 'cedant') transferring specified risks to a special purpose vehicle (referred to in the UK as an Insurance Special Purpose Vehicle or ISPV). The terms of this arrangement are governed by contracts for risk transfer. The vehicle issues securities to investors to raise sufficient capital to cover the insurance risk it has taken on, and investors receive a return for putting their capital at risk. Capital, minus any payments to the cedant triggered by the contract for risk transfer, is returned to investors at the end of the contract period. The rights of investors are always subordinated to the rights of the cedant under the contract for risk transfer.

1.4 ILS deals also typically include arrangements for the safe holding of capital as collateral to meet obligations to the cedant. It is common for ILS structures to include a trustee that is responsible for holding and investing the collateral, and for ensuring that any payments to the cedant or investors are made in line with the requirements of the contract for risk transfer.

1.5 While ILS deals are used in a number of ways, the development of the global ILS market has so far been dominated by two types of deal: the Catastrophe bond (or CAT bond) and Collateralised Reinsurance.

1.6 It was the CAT bond which established ILS as a significant technique for risk transfer in the 1990s. These bonds are used to raise capital to cover loss associated with natural catastrophe, such as extreme weather conditions, or other non-natural catastrophic perils. Following Hurricane Andrew in 1992, demand for property catastrophe cover from US insurers rose significantly and the use of CAT bonds increased dramatically to provide much needed additional reinsurance capacity. Outstanding CAT bond issuance currently stands at around $25 billion about represents about 15 per cent of all property reinsurance capacity.

1.7 Collateralised reinsurance transactions are similar in form to conventional reinsurance arrangements and deals tend to be smaller in scale when compared to CAT bonds. As such, rather than raising capital by public offering, these deals are privately placed with a small number of investors, often specialist ILS investors or ILS investment funds. Capital of around $33 billion is currently deployed in collateralised reinsurance deals, making up nearly 50 per cent of outstanding ILS captial.

1.8 As the ILS market has grown, so has the deployment of specialist expertise in the arrangement of ILS deals. Capital market investors have become increasingly sophisticated and are utilising specialist reinsurance expertise and sophisticated modelling techniques to select ILS investment opportunities. Of particular importance has been the growth of specialist ILS investment funds. These funds specialise in ILS deals and often act as intermediary between cedants and end investors.

The Government's Insurance Linked Securities project

1.9 The Government has been working with the insurance industry to help strengthen the sector's contribution to the UK economy and enhance the UK's position as a leader in a truly global industry. In *London Matters*, a report published in 2014 by the London Market Group on the competitive position of London, the rise of alternative risk transfer was highlighted as a significant challenge to London's position as a specialist insurance hub. The report concluded that alternative risk transfer is unlikely to be a temporary phenomenon and that London would need to adapt. The London Market Group subsequently recommended that the Government implement a fit-for-purpose regulatory and tax framework for ILS business to enable London to compete in the growing market for alternative risk transfer.

1.10 In the March 2015 Budget, the Chancellor announced that the Government would work with the London market and the UK's regulators to develop a new competitive corporate and tax structure for allowing Insurance Linked Securities vehicles to be domiciled in the UK. As a result, the London Market Group established the ILS Taskforce, a group of industry practitioners with expertise in specialist reinsurance and alternative risk transfer business. Since May, HM Treasury, HM Customs and Revenue (HMRC), the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) have been working closely with the Taskforce to understand the ILS market and the structures used in ILS deals.

1.11 The government believes that, with the right framework, London can make a major contribution to the continued growth and development of ILS business. London is the largest global hub for commercial and speciality insurance risks and can offer a cluster of specialist insurance and capital market expertise that is unmatched in the global market. By supporting innovation within a trusted and robust regulatory framework, London should be well placed to become a leading market for alternative risk transfer.

Developing an ILS framework consistent with Solvency II

1.12 The Solvency II Directive (the "S2 Directive") and directly applicable legislation made under it (the "S2 framework") set out the overarching regulatory framework for insurance and reinsurance business in the European Union and has applied from 1 January 2016. The Directive recognises ILS cover provided by Special Purpose Vehicles as a risk mitigation technique available to insurance and reinsurance firms. "Special Purpose Vehicles" (as defined in Article 13(36) of the Directive) must be authorised in accordance with the S2 Directive and the S2 directly applicable legislation. Details of the authorisation and supervision requirements are set out in Articles 318-327 of the S2 Commission Delegated Regulation (EU) 2015/35 ("the Delegated Regulation") and the S2 Commission Implementing Regulation (EU) 215/462 ("the Implementing Regulation").

1.13 Special Purpose Vehicles authorised in the UK under Solvency II will be subject to the dual regulation of the PRA and the FCA. In relation to dual-regulated entities, the PRA is responsible for prudential requirements, for example capital and liquidity, and the FCA for the conduct of business. The PRA is the lead regulator for all dual-regulated entities under Solvency II. Applicants for an Insurance Special Purpose Vehicle must therefore make a single application to the PRA. The PRA will pass the application to the FCA and both will assess it against the S2 requirements, with meetings arranged to discuss applications as appropriate. The PRA will make the final decision on applications, but it can only authorise a dual-regulated firm with FCA's consent.

Purpose of this consultation

1.14 This consultation document sets out initial thinking on the key features that will be needed to attract ILS vehicles to the UK. In particular, it examines what will be needed for an effective and competitive approach to the authorisation and supervision, corporate structure and taxation of ILS vehicles. The approach set out here will be subject to further development and refinement, and responses to this consultation document will help to develop the approach. We aim to produce draft regulations for a new Insurance Linked Securities framework later this year.

How to respond

1.15 The Government would welcome the views of all stakeholders on the issues raised in this document. The consultation begins with the publication of this document and will last for a period of eight weeks. Please respond by midnight on 29 April 2016. Responses to the consultation should be sent to:

Insurance Linked Securities Consultation
Insurance and Financial Regulators Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 0207 270 6436

Email: ILS.Consultation@HMTreasury.gsi.gov.uk

1.16 This document can be found on HM Treasury's website at www.hm-treasury.gov.uk. When responding please state whether you are responding as an individual or as part of an organisation. If responding on behalf of a larger organisation, please make it clear whom the organisation represents and, where applicable, how the members' views were assembled.

Consultation principles

1.17 This consultation is being run in accordance with the government's consultation principles. The government will be consulting for 8 weeks.

Confidentiality

1.18 All written responses will be made public on HM Treasury's website unless the author specifically requests otherwise. In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded for the purpose of publishing responses unless an explicit request for confidentiality is made in the body of the response. If you wish, part, but not all, of your response to remain confidential, please supply two versions – one for publication on the website with the confidential information deleted, and another confidential version for the team managing the consultation.

1.19 Even where confidentiality is requested, if a request for disclosure of the consultation response is made in accordance with the freedom of information legislation, and the response is not covered by one of the exemptions in the legislation, the Government may have to disclose the response in whole or in part.

Confidentiality Disclosures

1.20 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act (DPA) and the Environmental Information Regulations 2004). If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, among other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality will be maintained in all circumstances.

1.21 An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department. The Department will process your personal data in accordance with the DPA, and in the majority of circumstances, this will mean that your personal data will not be disclosed to third parties.

Freedom of Information

1.22 Any Freedom of Information Act queries should be directed to:

Correspondence and Enquiry Unit
Freedom of Information Section
HM Treasury
1 Horse Guards Road
London
SW1A 1HQ

Tel: 020 7270 4558

Email: public.enquiries@hmtreasury.gsi.gov.uk

2 Authorisation and supervision of Insurance Special Purpose Vehicles

2.1 This chapter sets out a possible approach to the regulation of ILS and the authorisation and supervision of ISPVs in particular. This approach has been developed in consultation with the PRA and the FCA, which have responsibility for the authorisation and supervision of ISPVs in the UK. The Treasury, PRA and FCA will continue to discuss the approach with the ILS Taskforce and other market participants. The PRA will then aim to produce a Supervisory Statement setting out further details on the authorisation process for ISPVs in the first half of 2016.

2.2 ILS transactions can cover a range of insurance risks using different approaches to the transfer of risk. In developing the initial approach set out here we have focussed on the most common forms of ILS deal: collateralised reinsurance and CAT bonds. The approach may need to be further tailored for other forms of ILS with features that are materially different to those of collateralised reinsurance and CAT bonds.

1. Are collateralised reinsurance and CAT bonds the right focus for initial development of an authorisation process for ISPVs in the UK?

2. What other forms of ILS should we focus on as we continue to develop the approach for supervision?

Rationale for the approach to supervision of ISPVs

2.3 ISPVs are materially different in substance and form to insurance or reinsurance firms. They are usually time-limited entities that exist to service a particular transaction or a group of transactions for risk transfer, with those risks typically being pre-funded. These structural features offer a significant amount of protection to insurers or reinsurers that cede risk to an ISPV. As such, many of the supervisory considerations that would normally apply to monitor the safety and soundness of insurance firms (for example, assessment of a solvency capital requirement with respect to a firm's fluctuating risk profile) are less relevant.

2.4 This distinction is reflected in the S2 framework, which establishes a separate authorisation and supervisory framework for SPVs (as defined in Article 13(36) of the Directive). This framework is designed to ensure the prudent authorisation and supervision of SPVs used for insurance purposes and we believe that this framework can be applied in a way which meets the needs of market participants and delivers a trusted framework within which the market can operate.

2.5 The core requirements for authorisation as set out in the S2 framework are:

- the transfer of risk to an ISPV must be in the form of reinsurance or "similar arrangements";
- the ISPV must be fully funded at all times, in other words that it must have capital available which is sufficient to meet its aggregate maximum risk exposure;

- the rights of investors must be subordinated to the ISPV's obligations to cedants;
- there must be an effective transfer of risk and the extent of the risk transfer must be clear and incontrovertible; and
- there must be appropriate systems of governance relating to the management, shareholders and administration of the ISPV.

2.6 The S2 requirements permit an ISPV to take on more than one contract for risk transfer from one or more cedants, and are referred to as a multi-arrangement ISPV[1] (referred to as an "mISPV"). For mISPVs, individual contractual arrangements must be fully funded at all times. To ensure this, contractual arrangements must be robustly ring-fenced from each other to ensure that the solvency of the mISPV is not adversely affected by the insolvency of any one contractual arrangement or the winding up proceedings of any of the individual cedants.

Ensuring the ISPV is fully funded

2.7 The PRA will apply the requirements in Articles 319, 326 and 327 of the S2 Delegated Regulation to ensure that ISPVs are fully funded and that the proceeds from selling investments to investors are fully paid in. This is consistent with our view that the fully funded and fully paid in requirements should be a core feature of ISPVs operating in the UK. As ISPVs will be fully funded, there is no requirement for them to meet a probability-based "solvency capital requirement" of the kind applicable to insurers and reinsurers.

2.8 During the authorisation process, the applicant will need to demonstrate to the PRA that its risk management and internal control systems are able to monitor the ISPV's collateral arrangements with a view to ensuring the vehicle remains fully funded and that the applicant will be able to promptly report to the PRA any inconsistency with the fully funded requirement.

2.9 Furthermore, to the extent that any investment risk is carried by the ISPV, the applicant will need to demonstrate that the ISPV has the ability to maintain compliance with the fully funded requirement. For example, this may be through the investment strategy to be used, requiring additional funds from investors, or the ISPV holding additional collateral as a buffer over its aggregate maximum risk exposure that appropriately reflects the investment, liquidity and other risks to which it may be exposed.

The rights of investors

2.10 Clearly linked to the fully funded principle is the concept that the rights of investors are subordinated to the ISPV's obligations to the cedant. The PRA will apply the requirement in Article 321 of the Delegated Regulation that contractual arrangements between ISPVs and investors must ensure:

- no payments will be made to the investors if the consequence of those payments would be that the ISPV would no longer be fully funded; and
- the investors have no rights of recourse to the assets of the cedant and no rights to apply for the winding up of the ISPV.

Appropriate investors

2.11 The Treasury and FCA believe that ILS deals offer specialist investment opportunities that are appropriate for knowledgeable and sophisticated investors only. As such, we envisage an ILS framework which restricts the purchase and trading of investments to sophisticated investors.

[1] As defined by in Art 318b of the Delegated Regulation and Art 7 of the Implementing regulation.

This will likely require deal arrangers to structure ILS deals so that investment offers are only available to 'Qualified Investors' as defined in EU securities law. We imagine in practice deal arrangers would also wish to restrict offerings to 'Qualified Institutional Buyers', as defined in US securities law.

2.12 If there is demand from the market for a UK venue or platform for the secondary trading of ILS instruments, we will consider what design of trading platform could meet the market's needs while ensuring that trading of ILS instruments can only be accessed by appropriate investors. A Multilateral Trading Facility (MTF) could provide a suitable trading platform to enable sophisticated investors to trade ILS. The MTF operator could establish rules which would limit the market to appropriate ILS investors. Its operator could then design a bespoke package of investor protection and issuance arrangements tailored to the specialist needs of ILS deal arrangers and the sophisticated investors participating in the market. Provided deals were not offered to the public (as defined in the Prospectus Directive), the requirements of the Prospectus Directive would not apply.

3. Do you agree that ILS investments should be restricted to sophisticated investors?

4. Do you think a UK secondary trading platform will be needed to facilitate the growth of ILS business in the UK? If so, what features should be considered for a trading platform?

Effective risk transfer

2.13 The PRA will apply the requirement in Article 320 of the Delegated Regulation, which provides that the transfer of risk to an ISPV must be effective. This means that the arrangements between the cedant and the investors must be robust, binding and enforceable. To ensure this requirement is met, the PRA will need to be satisfied that:

- The transfer of risk is effective in all circumstances;
- The extent of risk transfer is clear and incontrovertible with clearly specified contractual limits covering the extent of aggregate maximum risk exposure and the liabilities of the ISPV; and
- The ISPV is truly arms-length from the cedant such that it cannot be consolidated onto the cedant's balance sheet, or the transfer of risk cannot be otherwise undermined by connected transactions with the cedant or other parties.

2.14 For contracts of risk transfer authorised under the S2 Directive, ISPVs must take on risk from insurance or reinsurance firms through "reinsurance or similar arrangements". While the majority of ILS deals, and collateralised reinsurance in particular, use conventional indemnity triggers, some deals make use of other forms of risk transfer. For example, CAT bonds can make use of parametric triggers, whereby a payment to the cedant is triggered by some objective parameter of natural hazard, such as wind speed.

5. What do you think would constitute a similar arrangement under the S2 Directive?

6. How important do you think these similar arrangements will be to development of the ILS market?

Multi-arrangement ISPVs

2.15 The S2 framework permits the use of multi-arrangement ISPVs (mISPVs) consistent with the S2 Directive. The PRA is considering a two-stage authorisation and notification process for mISPVs as follows:

- Stage 1: Initial mISPV authorisation. Here the focus is likely to be on demonstrating that the mISPV complies with the S2 requirements on management, governance, reporting, investment and solvency and how meeting these requirements will ensure that each individual ILS contract remains fully funded at all times. The PRA will also wish to understand the expected cedants, the expected risk exposure associated with individual ILS deals and the total expected aggregate maximum risk exposure expected over the lifetime of the mISPV business plan.
- Stage 2: Notification of individual risk transfer contracts. Here we envisage a requirement to notify the PRA of individual ILS contracts shortly before they are concluded. The focus is likely to be on confirming the finalised terms and conditions of the deals, agreements and documentation between the mISPV, cedants and investors.

2.16 This kind of two-stage process should mean that the notification of new contracts for risk transfer can take place in a short period before the new contracts are put in place. Where new risk transfer contracts deviate materially from the original conditions of authorisation, the PRA may require additional time to review the proposed arrangements and, in extreme circumstances, could result in the PRA vetoing the ISPV entering into those new contracts.

7. Do you consider the two stage approach set out above feasible?

8. To what extent do you think that significant changes can occur to the intended use of a mISPV between Stage 1 and Stage 2 that may require more flexibility at Stage 2?

9. How long do you think the usual notification period at stage 2 should be and what would be the maximum period possible before the commercial viability of deals was threatened?

Governance and reporting arrangements for ISPVs

2.17 The PRA will apply the requirements in Articles 322 and 324 of the Delegated Regulation on 'fit and proper' requirements for persons who effectively run an ISPV. This is consistent with the PRA's Senior Insurance Managers regime ("SIMR"), under which certain requirements will attach to the personnel responsible for running ISPVs. In particular, the ISPV will have to demonstrate at the point of authorisation the fitness and propriety of management, including that "their professional qualifications, knowledge and experience are adequate to enable sound and prudent management" and that "they are of good repute and integrity".

2.18 The SIMR regime also sets out and defines the specific Senior Insurance Management Function (SIMF) roles that must be accounted for within an ISPV. These are:

- Chief Executive (SIMF1)
- Chief Finance (SIMF2)
- Chairman (SIMF9)

2.19 If the ISPV deems it necessary to appoint a Chief Actuary (SIMF20) function, they must be approved.

2.20 We note that most ISPVs have rationalised management structures. SIMR allows individuals to take on multiple SIMFs if applicants are able to demonstrate their suitability for the role and are not conflicted (for example the Chairman and Chief Executive roles must be held independently). We would anticipate a minimum of 3 board members would be required for UK ISPVs.

2.21 Further it is important to note that those running an ISPV will be responsible for all aspects of its business, including internally managed or outsourced operations. The PRA will apply the requirements in the S2 Directive and the SIMR on the oversight of outsourcing.

10. Do you think that ISPVs would use a Chief Actuary? If not, why?

11. Which aspects of an ISPV's operations are typically outsourced and how would applicants ensure that oversight arrangements for outsourcing meet the S2 and SIMR requirements?

'Fit and proper' requirements for shareholders or members of ISPVs

2.22 The PRA and FCA will apply Article 323 of the S2 Delegated Regulation on fit and proper requirements for shareholders and members of ISPVs. At the point of authorisation, the PRA and FCA will need to assess the fitness and propriety of qualifying shareholders or members of the ISPV. Qualifying holdings are defined as "a direct or indirect holding in an undertaking which represents 10% or more of the capital or of the voting rights or which makes it possible to exercise a significant influence over the management of that undertaking."

2.23 As part of its assessment, the PRA and FCA will need to consider the reputation and integrity, financial soundness and level of influence the shareholders and members with such qualifying holdings will exercise over the ISPV. As with other aspects of the application, the PRA and FCA will take a proportionate approach to the assessment based on the risk the applicant poses to PRA and FCA objectives under the S2 Directive.

Reporting requirements for ISPVs

2.24 The PRA will apply Article 325 of the S2 Delegated Regulation and Articles 12 to 14 of the S2 Implementing Regulation on the systems for reporting of regulatory information. An annual reporting cycle is required with specific information requirements. We would advise that potential applicants review these requirements closely.

2.25 The PRA will have the power to request additional information to aid supervision and ISPVs will be required to report any breaches of the regulatory requirements to the PRA.

PRA's intended approach for authorisation of ISPVs

2.26 In order to authorise ISPVs, the PRA will apply the requirements set out in the S2 Directive as implemented in UK law. While the Implementing Regulation requires that authorisation decisions will be made within 6 months of application, the PRA would anticipate that for relatively standard forms of ISPV transaction, where it is relatively straight-forward to demonstrate the core requirements for ISPVs are met as set out above, an accelerated assessment is possible, for example within 6 to 8 weeks.

2.27 To help reduce the time taken to assess a formal ISPV application, the PRA envisages that potential applicants would have the option of engaging with the PRA prior to formal application. We would encourage applicants to do this as this is likely to make the application process more efficient. In this "pre-application engagement" period, the PRA would seek to:

- discuss with applicants the applicable requirements, the PRA's expectations in relation to the application, and any timelines that may apply;
- provide initial feedback on scope and structure of the intended ISPV, including the scheme identified for risk transfer, the fully funding strategy and the governance structure; and
- identify any major concerns the proposed application might pose in relation to the applicable requirements.

2.28 Applicants would also have the option to submit additional documentation that might facilitate a quicker decision on formal application. The PRA is considering the specifics of the documentation that may be relevant, but examples may include use of an independent legal opinion on the ISPVs compliance with the S2 requirements.

2.29 The PRA would anticipate that for relatively standard forms of ISPV transaction, where applicants are willing to (a) make use of this pre-application engagement phase and (b) provide additional documentation, an accelerated assessment can be achieved. The PRA's current view is that in such circumstances, a decision within 6-8 weeks of formal application should be possible. The PRA will need to test this proposition with market participants.

2.30 In addition, the PRA intends to provide supporting material to assist potential applicants in understanding the requirements and to help applicants provide the information needed by the PRA. This might include, for example, the publication of supplementary notes to the application form or Frequently Asked Questions.

12. What supporting material for the authorisation process would you find useful for the PRA to issue?

13. Do you think "pre-application engagement" as described above would be a useful part of the application process?

14. What is your view on a possible 6 to 8 week timeline for authorisation of relatively standard ISPV transactions?

15. Do you have views on additional documentation that could be submitted by applicants to facilitate faster review by the PRA?

16. Do you have a view on which ISPV transactions could be regarded as "standard" in the sense that it would be straight-forward for such transactions to demonstrate compliance with the core S2 requirements?

3 Corporate structure for Insurance Special Purpose Vehicles

3.1 This chapter considers the corporate structure needed for the effective and prudent operation of ISPVs, and in particular, whether a bespoke corporate structure would provide for the more effective operation of multi-arrangement vehicles.

3.2 ISPVs are usually bodies corporate, often with "orphan status", to establish the ISPV is an independent entity from the ceding insurer and the investors. The separate legal personality of a company helps to ensure that there is a genuine transfer of insurance risk from the cedant and that the solvency position of the insurer does not affect the ability of the ISPV to meet its obligations. It can also help ensure that investors are not liable beyond the level of capital they agree to provide. We understand that orphan status is often achieved in some jurisdictions by a charity or charitable trust owning the voting shares in an ISPV.

17. In designing a UK framework for ILS business, what ownership arrangements for the ISPV do we need to provide for?

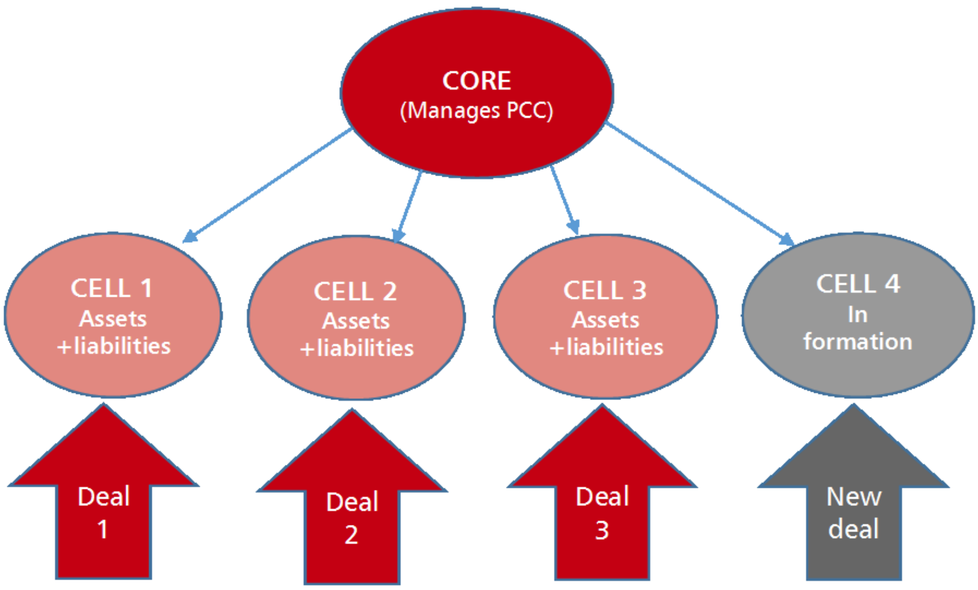
18. Are there circumstances in which investors or an investment fund might own the ISPV?

Protected cell companies for multi-arrangement ISPVs

3.3 Some ILS deals involve the ISPV taking on one contract for risk transfer. This is common with CAT bonds for instance. But with other forms of ILS, such as collateralised reinsurance, it has become common practice for ISPVs to take on more than one contract for risk transfer. Whereas a CAT bond usually involves marketing securities to a range of investors, collateralised reinsurance deals are typically smaller in scale and privately placed with a small number of investors. For this reason, cedants and deal arrangers often look to manage a group of collateralised reinsurance deals from one ISPV. This saves time and administrative expense as a new ISPV will not need to be established for each transaction. An ISPV which takes on more than one contract for risk transfer will be referred to as a multi-arrangement ISPV (mISPV).

3.4 As with any ILS arrangement, it is crucial to ensure that a collateralised reinsurance deal is fully funded. This means that all of the contracts for risk transfer must be managed within an ISPV in a way which ensures that the insolvency of any one transaction does not affect the solvency of the others.

3.5 Although a number of different ways of structuring an mISPV can be envisaged, we understand that it has become standard market practice to use a bespoke form of corporate entity. This type of entity is most commonly called a "protected cell company", but other names are used, such as an "umbrella company" and a "segregated account company". In this consultation document, we shall refer to it as a "protected cell company" or "PCC". The key feature of a PCC is that it allows pools of assets and liabilities to be segregated within the company. These pools are known as cells, and each ILS deal is allocated to its own cell. This means that if there is insufficient collateral available for one deal, none of the other deals are affected. The cell can, if necessary, be dissolved, with all of the other cells and the PCC as a whole remaining in place. The cells of a PCC are managed by the "core", which is in essence the management and administrative function of the company. We understand that it is usually the core that manages the cells and is responsible for entering into transactions on behalf of the cells. A PCC can be described in diagrammatic form as follows:



3.6 The Treasury therefore proposes to amend companies and insolvency law in the UK to allow for the creation of PCCs. Use of PCCs will be limited to ILS deals and will be optional for market participants. In other words, mISPVs may use PCCs but are not required to.

19. Do you agree that the UK framework for Insurance Linked Securities business would benefit from a PCC regime?

Incorporation, registration and authorisation of PCCs

3.7 PCCs would only be permitted for use with ILS business and incorporation of a PCC will not be effective until the PRA has authorised an mISPV for a proposed PCC. We aim to design an application process covering both the registration and incorporation of a PCC and the first stage of the authorisation process for mISPVs described in paragraph 2.15 of Chapter 2. This is intended to be quick, efficient and proportionate and will ensure that PCCs can only be used for ILS business.

3.8 As the mISPV enters into new ILS deals, the PCC would create new cells so that each deal is allocated to a different cell. This is the second stage of the authorisation process described in paragraph 2.15 of Chapter 2. As the cells are segregated from each other within the PCC, the failure of any one deal would not affect any of the others and the PCC structure would enable the mISPV to comply with the requirements set out in the S2 Delegated Regulation and Implementing Regulation. The PRA's supervision of an mISPV will involve a requirement to notify the PRA of any new ILS deal entered into by the mISPV and the PRA will have the ability to veto a particular ILS deal if it represents a material divergence from the terms of the original authorisation for the mISPV.

Internal structure

3.9 The PCC itself would constitute a single legal entity with separate legal personality. The core and cells are parts of the PCC, but do not themselves have legal personality separate from the PCC. We are aware that some jurisdictions have created corporate structures which are similar to PCCs, except for the fact that each individual cell has a separate legal personality which is distinct from the PCC itself (these are sometimes called "incorporated cell companies"). We are not proposing to create "incorporated cell companies" in the UK, but are willing to reconsider this if there is a demand for them.

3.10 We understand that a PCC would usually create a new cell by way of a board resolution and envisage following this approach in the UK. Similarly, a cell could be dissolved by a board resolution, as described below.

3.11 We also understand that the core enters into arrangements with the cells which allow the core to be funded, possibly with fees being paid upfront to the core. We would be interested in learning more about these arrangements. If fees are paid to the core upfront when an ILS deal is put in place, we can see how such arrangements work. But if not, are these funding arrangements set out in contracts between the core and the cells, or are the funding arrangements usually established in the PCC's Articles of Association? And are rules needed to regulate this relationship between the cells and the core?

21. Do you think it sensible for a PCC to create new cells by board resolution?

22. What should the respective responsibilities of a PCC core and cells be?

23. How should arrangements be made between the core and cells so that the core is funded to manage the PCC as a whole?

24. Should regulation cover how the core is funded by individual cells?

Directors

3.12 A PCC would have one board of directors. In many respects, the duties of the directors would be no different to directors' duties in relation to a conventional company incorporated under the Companies Act 2006. As with companies incorporated under the Companies Act 2006, the Companies Directors Disqualification Act 1986 will apply to directors of PCCs.

Shareholders

3.13 We envisage that a PCC would be able to issue different classes of shares. The core will issue ordinary shares that confer voting rights in relation to the company. The core may also issue the other types of securities that may be issued by a company incorporated under the Companies Act 2006. However, given that individual cells exist to segregate ILS deals and would not be expected to have any management or control functions, we envisage cells only having the ability to issue securities to investors which do not confer voting rights, such as bonds or preference shares.

25. Do you agree with the approach described above on how the core and cells of a PCC should be able to issue shares and securities?

PCC dealings with third parties

3.14 The unique legal nature of a PCC must be clear to all those that deal with it. This gives rise to a number of different issues. A company registered under the Companies Act 2006 must use the words "Limited", "Ltd" or "PLC" at the end of its corporate name in order to alert those dealing with it to the fact that it is a limited liability company. A PCC should do the same, so that a PCC could put the words "Protected cell company" after its name. The obvious abbreviation for this is "PCC" but this carries the risk that it could be easily confused with "PLC". We would therefore be interested in views as to the appropriate style for the name of a PCC.

26. What do you think would be an appropriate style for the name of a PCC? Is "PCC" too similar to "PLC"?

3.15 A PCC will need to enter into contracts with third parties. The contract may be on behalf of the core, for example, contracts for services that the core needs for the operation of the PCC, such as an IT service contract. Or it might be an ILS deal where the PCC needs to contract with a cedant and investors on behalf of one of the cells. It is critical to those entering into a contract with a PCC to know that they are contracting with a PCC and whether they are contracting with the core or a particular cell. We would therefore propose to place a duty on the directors of the PCC to make it clear to third parties that they are entering into a transaction with a PCC. The duty would include a requirement to be clear on whether the contract is with the core or with a particular cell of the PCC.

3.16 We will need to develop an approach for dealing with PCC directors that fail to discharge this duty. We understand that in some jurisdictions, the directors are made personally liable for a contract if they fail to discharge their duty, but we are not sure how appropriate this would be in the case of ILS deals where the potential liabilities are likely to vastly exceed the directors' personal assets.

27. Do you agree that the directors of a PCC should be subject to a duty to inform third parties that they are contracting with a PCC, and whether they are contracting with the core or a cell of the PCC?

28. What should happen if directors fail to discharge this duty?

Non-contractual liabilities

3.17 Since we plan to restrict use of PCCs to ILS business, we envisage that nearly all of a PCC's liabilities will be contractual. However, we need to consider how non-contractual liabilities should be allocated within a PCC. In some cases, non-contractual liability may be closely associated with a particular contract, for example a claim for misrepresentation arising out of a particular deal. Such a liability is likely to be connected with the activities of a particular cell and there may be an argument for making the cell liable for any non-contractual claim which is clearly connected with the activities of that cell. However, it may not always be clear when non-contractual liability is connected with a particular cell and it may raise issues in relation to jurisdictions outside the UK.

3.18 An alternative approach might be for the core to be liable for any non-contractual liability so far as the claimant is concerned. That avoids confusion for potential claimants and will probably fit better with laws in other jurisdictions which do not recognise PCCs. The core could then allocate that liability either to itself or the cells through the management arrangements which the core has with the cells. Those arrangements could be left to PCC users to agree and could be set out in the Articles of Association. Clearly they would need to be fair, or cedants and investors will be deterred from contracting with a PCC. They would also need to allocate any liability fully, as otherwise the core could become insolvent and trigger winding up proceedings for the PCC as a whole. Despite the possible advantages of this approach, we are concerned that it may offer participants in ILS deals insufficient clarity as to what a cell may be liable for.

3.19 We therefore invite views on how we address the allocation of non-contractual liabilities within a PCC.

29. Do you have any view as to how non-contractual liability should be allocated within a PCC?

30. Where a PCC contracts with a third party without making it clear which part of the PCC it is contracting on behalf of, how should any resulting liability be allocated within the PCC?

Segregation of assets and liabilities within PCCs

3.20 Effective segregation of assets and liabilities will be the central objective of the protected cell regime. Where a mISPV is established as a protected cell company and authorised by the PRA, the assets of each cell will belong exclusively to that cell and the liabilities of each cell may only be met from the assets belonging to that cell. Thus the insolvency of one cell should not lead to the insolvency of any other cell or of the mISPV as a whole.

3.21 Clearly the PCC must keep and maintain records and accounts that distinguish between the core and each individual cell. This is necessary not just to facilitate ILS business but also for taxation. As the parties to each contract attached to individual cells may be different in multi-arrangement ISPVs, we think it will be necessary to ensure that each cell is taxed separately. If the tax liability of individual cells was not segregated, the requirement that each cell remains fully funded could be compromised.

3.22 In addition to this, we think there must be adequate physical segregation of assets belonging to different cells. In the case of ILS deals, we understand that the proceeds from the investors are invested and those investments are often held in a trust arrangement. We would therefore propose a requirement that assets held for a particular cell cannot be commingled with assets held for any other cell or the core. This would, therefore, preclude omnibus type account structures.

31. Do you agree that the records and accounts of a PCC will need to distinguish between the assets and liabilities of the core and individual cells?

32. Do you agree there should be a requirement for the assets of a cell not to be comingled with the assets of any other cell?

33. Are there any other particular issues or challenges that we will need to consider in order to ensure that the segregation of assets and liabilities is robust?

34. Do you agree that the core and individual cells of a PCC should be separately liable for tax?

Contracts between constituent parts of a PCC

3.23 We understand from some stakeholders that it would be helpful if cells in a PCC could "contract" with each other. Unless specific provision for this is made in legislation, different parts of a PCC would not be able to contract with each other as they do not have separate legal personality. We think it should be possible to provide in legislation that different parts of a PCC can enter into contracts with each other as if they were separate legal persons. However, this gives rise to a number of issues. A PCC has only one set of directors and they would be responsible for negotiating and concluding the contract for all the parties. This could leave directors with a conflict of interest. It may be possible to resolve such conflicts quite easily in the case of an ILS deal by requiring the contracts to be ratified by the cedant and the investors connected with any cell which is a party to the contract. However, in the case of a dispute arising out of such a contract, it is not clear how the dispute would be resolved.

35. Do you think it necessary that different parts of a PCC be able to contract with each other? If so, for what purposes?

36. If different parts of a PCC should be able to contract with each other, how could the potential conflicts of interest described above be addressed?

Dissolution of PCC cells

3.24 One of the advantages of a PCC structure should be that the PCC is able to establish and dispense with individual cells as needed. As indicated above, we envisage a simple process whereby establishing or dissolving a cell can be achieved by a resolution of the board of directors.

3.25 Under UK law, a company registered under the Companies Act 2006 can apply to the Company Registrar to be struck off the companies register if the company is not carrying on business or is not in operation. A company is required to notify any creditors or other interested parties of the intention to apply for dissolution. We envisage a similar approach for PCC cells. Once a cell has met its obligations and exhausted its assets, the cell may be dissolved. The PRA would need to be notified of the intention to dissolve a cell and the PRA would, as an interested party, have the right to object to dissolution if it had reason to believe that a cell continued to have contractual arrangements in place with a cedant.

37. Do you agree with the proposed approach to the addition and dissolution of cells in a PCC?

Insolvency in the United Kingdom

Insolvency of individual cells

3.26 If ILS deals are structured in line with regulatory requirements, we do not expect there to be any prospect of a cell becoming insolvent. A cell will exist to give effect to a specific ILS transaction and that transaction will need to be fully funded at all times to meet its obligation to the cedant. The rights of investors will always be subordinated to the cell's obligation to the cedant. This is reflected in the standard terms used for ILS deals where investors agree to limited recourse with the ISPV or cell and waive rights to petition for insolvency. We therefore consider it likely that no proceedings for insolvency will be necessary in respect of individual cells within a PCC. If there are no assets left in the cell after payments have been made to the cedant, the cell may be dissolved. On dissolution, the cedant's claim to any balance and the investors' claims to be repaid will be extinguished. If the assets left in the cell are insufficient to pay investors, then the limited recourse arrangements presumably mean that the balance of their claims are extinguished and the cell can be dissolved. However, if there are no limited recourse arrangements then some form of process may be needed to reduce investors' claims *pari passu* if there are insufficient assets to pay their claims.

Insolvency of a PCC core

3.27 We would also expect that the risk of the core becoming insolvent is very small. As we noted above, we understand that the core's funding may come from fees paid upfront when an ILS deal is put in place. If this is correct, insolvency of the core is only likely to arise in the case of relatively rare events such as fraud. But insolvency of the core is nevertheless possible, particularly if fees for managing cells are not paid up front, so we need to make provision for how core insolvency should be dealt with. Clearly, a PCC cannot operate if the core is insolvent. However, the cell hosting an ILS deal cannot be wound up while it is still providing protection cover to a cedant. This is a matter we are still considering, but we would welcome views from stakeholders on appropriate arrangements for insolvency of a PCC core.

38. Do you agree that it will not be necessary to make insolvency proceedings available for individual cells of a PCC?

39. If not, what insolvency arrangements should be available for individual cells?

40. What approach to insolvency do you think should be used for the core of a PCC?

Cross border insolvency of a PCC

3.28 To the extent that any insolvency proceedings are available in relation to a UK PCC, we propose to apply them in a way which preserves the clear segregation of assets and liabilities within the PCC. However, given the possibility that some PCCs domiciled in the UK may hold assets outside of the UK, or will have contractual arrangements with third parties located outside of the UK, we need to consider cross-border insolvency.

3.29 There have been attempts to harmonise jurisdiction and choice of law in cases of cross-border insolvency, for example the EU Insolvency Regulation (Council Regulation 1346/2000/EC) within the EU and the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross–Border Insolvency outside the EU. Where a PCC is registered and administered in England and Wales, it seems likely that the UK courts would have jurisdiction to open insolvency proceedings in relation to the PCC and English insolvency law would apply. However, if a UK-based PCC is also established in another country, there is always the possibility that secondary or additional insolvency proceedings may be opened in that other country, particularly if the PCC has assets and creditors in that other country. If so, there is no guarantee that the foreign courts would recognise segregation of assets and liabilities within the PCC. This potential problem exists for all PCC structures wherever they are created, and we would be very interested in working with stakeholders to minimise the risks presented by cross-border insolvency and would be keen to hear of any problems or possible solutions.

41. What steps could be taken to ensure that UK PCC structures are recognised in non-UK insolvency proceedings?

Other considerations for design of a protected cell regime

3.30 The aim of this first consultation document is to cover the key issues that will need to be considered in designing an effective protected cell regime for ILS business. But it is likely that there will be other issues which need to be addressed. We are very interested to hear from stakeholders on any issue they think relevant to PCCs.

42. Are there any other issues in relation to PCCs used for ILS business that you think should be addressed?

43. Are there any particular features which are lacking in protected cell regimes used elsewhere that we should consider including in the UK regime?

4 Taxation of Insurance Special Purpose Vehicles

Background

4.1 ISPVs are primarily located in offshore jurisdictions such as Bermuda or Guernsey that have developed an attractive offering for ILS investors and cedants alike.

4.2 Whilst there are incentives for companies and individuals to use offshore jurisdictions to engage in aggressive tax planning and tax avoidance, the low-tax environment offered by these countries also offers a number of benefits to investment vehicles drawing investment from across the world, including ISPVs. Most importantly, such investors typically want their share of the vehicle's income to be taxed in their hands at their home country's tax rate (subject to any reliefs or exemptions their home country may provide).

4.3 Views provided by ILS practitioners so far suggest that in order to attract ISPVs to locate in the UK, we will need to design a tax treatment similar to those available in these offshore jurisdictions i.e. that taxes investors on their share of the vehicle's income and minimises direct tax loss in the vehicle.

4.4 The purpose of this project is to attract genuine investment vehicles to domicile in the UK. It is not to create an opportunity for aggressive tax planning or tax avoidance. As noted later in this document, the Government will need assurance that any proposed tax changes are robust against abuse before committing to implement them.

Policy objective

4.5 ILS deals are structured such that investors are exposed to the same risk profile as if they had entered the risk transfer contract directly but in a way that does not require them to be a regulated and licensed insurance company.

4.6 The role of the ISPV in the transaction is to transform insurance risk in to capital market instruments (such as debt or equity): it neither selects nor underwrites the risks it accepts; it is not exposed to the risk of the contract for risk transfer; and it outsources responsibility for investing the collateral and paying claims to trustees. It exists to deliver a return to investors linked to the performance of a risk transfer contract agreed with the cedant.

4.7 The project's focus on tax so far has been on designing an appropriate and competitive tax policy that better reflects the economic reality of ILS transactions.

Existing tax rules

4.8 This is not the first time the UK has sought to design tax rules to suit the specific circumstances of insurance securitisation vehicles. The Taxation of Insurance Securitisation Companies Regulations 2007 (SI2007/3402 – the "ISC Regulations") provided a separate regime for ISPVs designed to tax these entities on a similar basis to a securitisation company within the main securitisation tax regulations. The ISC Regulations apply with effect from periods of account beginning on 1 January 2007 and current on 3 December 2007.

4.9 The ISC Regulations made two key changes to the corporation tax rules for ISPVs. Firstly, the corporation tax profits of the vehicle were specified as being calculated in accordance with UK generally accepted accounting practice ("UK GAAP") as at 31 December 2006, with the exception of Financial Reporting Standard (FRS) 26. This enabled the ISPV to draw up its tax computation in accordance with accounting standards that excluded the rules on valuing financial instruments on a fair value basis. Secondly, qualifying ISPVs under the ISC Regulations benefitted from the removal of the UK's interest recharacterisation rules for limited recourse debt. This meant that the interest payments made on debt issued by the ISPV to investors are deducted when calculating the taxable profits of the ISPV. Together these rules allowed qualifying ISPVs to be taxed on a small, pre-determined profit recognised over the life of the transaction.

4.10 Notwithstanding this, we believe that the regulations have seldom been used since they were introduced (certainly not on the scale that was anticipated). Furthermore, the implementation of the new UK GAAP framework from 1 January 2015 has withdrawn all previous UK accounting standards, with the result that the ISC Regulations are now effectively obsolete.

4.11 It may be possible to update these regulations to reflect current accounting standards and deliver a similar tax outcome. Whilst demand from the industry for changes to the ISC Regulations has been limited, we believe the aim of these regulations is consistent with the ILS project and, combined with the project's wider objectives for a supportive regulatory environment, could make the UK an attractive location for debt-based ILS vehicles, such as those that issue CAT bonds.

4.12 Under these existing rules, investment returns from debt-based ILS vehicles will be treated as taxable income in the hands of UK investors and interest distributions to overseas investors are subject to withholding tax. The provisions of the Quoted Eurobond Exemption may enable withholding tax to be minimised (should the relevant criteria be satisfied).

4.13 Updating these regulations would be challenging, particularly within the wider project timeframe. We will need to be mindful both of ongoing work to update the main securitisation tax regulations and the ongoing consultation on implementing the OECD's best practice recommendations on the deductibility of interest expense (following the OECD report on Base Erosion and Profit Shifting, or "BEPS"). Both of these projects are expected to continue through 2016 and, given the government's wider agenda, it would be difficult to take action to pre-empt either.

44. Why do you think the UK did not attract any debt-issuing ISPVs following the introduction of the ISC Regulations in 2007?

45. Is the tax treatment offered by the ISC Regulations competitive when compared to other jurisdictions? Would an updated approach lead to more debt-based ILS ISPVs being located in the UK?

46. Do you think the approach taken in the ISC Regulations would work for multi-year ILS deals?

47. How do (a) funds and (b) corporate vehicles typically account for debt-based ILS investments (and the interest they pay) in their accounts?

Equity backed ISPVs

4.14 It is unlikely that updating the ISC Regulations will deliver a competitive tax outcome for ILS vehicles that issue equity to investors. This is because these vehicles (which we understand are common in collateralised reinsurance deals) are funded through the issuance of preference shares on which the ISPV pays a dividend return that is non-deductible when calculating the ISPV's taxable profit.

4.15 There are compelling regulatory and commercial reasons why the ISPVs in collateralised reinsurance deals are corporate entities. These reasons dictate that these vehicles are unlikely to be established as either funds, partnerships or contractual schemes to benefit from the existing UK tax rules for these entities (tax rules which could achieve the policy objective of delivering a competitive tax treatment for UK ISPVs).

4.16 In the absence of any policy change, an ISPV would therefore be taxed as a corporate entity, meaning it would be charged corporation tax on its taxable profits. Investors in the ISPV would then receive dividends on which they would be taxed according to their individual circumstances: for companies and (certain) funds this dividend distribution would not constitute taxable income; whereas for certain individuals this may be subject to income tax.

4.17 Consequently updating the ISC Regulations is unlikely to deliver a competitive tax regime for equity-backed ISPVs.

48. How do (a) funds and (b) corporate vehicles typically account for equity-based ILS investments (and the dividends they pay) in their accounts?

A possible approach for equity-backed ISPVs

4.18 Taxing an equity-backed corporate ISPV within the existing corporation tax rules may fail to accurately capture the economic reality of ILS deals. As noted above, the ISPV does not perform any of the functions necessary to generate the profit on which it is being taxed. Instead it is the investors who are directly exposed to the profits or losses arising from the underlying risk transfer contract as if they had entered the contract directly. Therefore it is the investors who should bear the tax consequences.

4.19 The principle behind this treatment is similar to that determining how Lloyd's members are taxed on their syndicate participations (albeit the mechanics of how it is achieved are different because of the different legal characteristics of the entities involved). Investors in Lloyd's are treated as if they had participated in the profit-generating insurance activity directly, rather than through an intermediary (i.e. the syndicate).

4.20 Where the ISPV is a corporate entity it may be that the only viable way to effect this tax treatment is to exempt the qualifying ISPV (or qualifying cells within an mISPV) from tax based on a specified set of criteria (the PCC as a whole, including the core and cells where the criteria were not met, would be otherwise subject to tax). The tax liability would then be transferred to investors by classifying the distributions they receive from the ISPV as taxable income, regardless of their individual circumstances.

4.21 This means that UK investors (companies, funds and individuals) in equity-backed corporate ISPVs would receive taxable income from their participation in the vehicle.

4.22 The treatment of distributions to overseas investors is more complex. Foreign investors would be taxed on these distributions according to the local tax rules in their home jurisdiction. Whilst we are not able to provide a comprehensive picture, we anticipate that equity distributions from equity-funded vehicles will be classified as dividends in the majority of overseas jurisdictions.

4.23 The UK does not charge a withholding tax on dividends paid by ordinary companies since those companies have been fully subject to corporation tax. In circumstances where we have exempted companies (or parts of companies) from the corporation tax regime – such as for UK Real Estate Investment Trusts – we have typically departed from this approach and sought to charge a withholding tax on dividend distributions from these entities.

4.24 Consequently, it is arguable that the UK should charge a withholding tax on dividend distributions from the ISPV to foreign investors, both to ensure consistency with the above approach and to deliver parity in the treatment of distributions to UK and foreign investors (and distributions from equity- and debt-backed ISPVs).

4.25 Nonetheless, we recognise that eliminating withholding tax has been a key focus of attention from stakeholders. We would therefore welcome views on both the extent to which a withholding tax could undermine the competitive value of tax exemption for the ISPV, and ways in which the fairness and avoidance risks of a withholding tax exemption could be overcome.

4.26 Although targeted at equity-backed ISPVs, we believe it is possible that the tax exemption approach outlined above could also be suitable for debt-backed ISPVs. If so, this would be beneficial, both in avoiding the need to operate two tax regimes (equity-backed ISPV tax exemption and updated ISC Regulations for debt-backed ISPVs) and possibly mitigating the abovementioned concerns around the BEPS work on interest deductibility. It would also avoid the potential time constraints in updating the ISC Regulations noted above. We welcome views on this point, and on any barriers there may be to collateralised reinsurance deals raising collateral through debt instruments.

49. Does the tax exemption approach outlined above offer a competitive tax treatment for ISPVs? Would this tax treatment be successful in attracting more ISPVs to locate in the UK?

50. To what extent would withholding tax undermine the competitive value of the tax exemption approach outlined above?

51. How might we overcome the fairness and avoidance risks of a withholding tax exemption?

52. Would the ISPV tax exemption approach outlined above also be effective for debt-backed ISPVs?

Detailed design

Qualification criteria

4.27 As noted above, we will need to specify a set of criteria to be satisfied in order for an ISPV, or a cell within an ISPV, to qualify for tax exemption. This is similar to our approach for a number of the UK's existing investment funds.

4.28 These criteria will need flexibility to encompass a variety of ILS deals but specificity to only capture appropriate vehicles and restrict the potential for abuse. Such criteria could include:

- The ISPV providing risk mitigation for risk that an insurance or reinsurance entity is exposed to as part of its insurance/reinsurance business;
- The existence of a clear and unambiguous transfer of risk from cedant to ISPV;

- The ISPV holding collateral to cover the full extent of that risk and not holding collateral for any other purpose;
- An ownership test whereby none of the investors in the ISPV belong to the same corporate group as the cedant; and
- Continued compliance with ISPV authorisation conditions set by the PRA.

4.29 The tax regulations for certain UK fund products contain reporting requirements for initial approval of the particular tax status, and ongoing requirements to maintain approval. The policy aim is to prevent contravention of one or more of the requirements automatically causing the vehicle to lose the tax status it was designed to achieve. The regulations establish different categories of breach, with the tax consequences of the breach depending on its magnitude. Whilst this creates an administrative burden, it provides some certainty that the fund should retain its tax status and prevents a cliff-edge for minor breaches. We intend to introduce a similar reporting requirement for this tax treatment.

54. Are the suggested criteria for obtaining ISPV tax exemption reasonable? What other criteria might be included?

55. Are additional reporting requirements in return for greater certainty about an ISPV's tax treatment sensible?

Collateral trust

4.30 The collateral in an ILS vehicle (i.e. the premium received from the cedant and the capital received from investors) is usually placed in a trust, held on behalf of the ISPV but with an obligation to pay claims to the cedant. The trust is managed by trustees according to the terms of the risk transfer agreement. This usually includes a pre-agreed investment strategy, typically for investment of collateral in high-grade sovereign debt.

4.31 In certain ILS structures, either the ISPV or the trust outsources collateral management. For example, under a tri-party repurchase agreement, a tri-party agent (usually a bank) sells collateral assets to the ISPV or trust and agrees to repurchase those assets at the price sold, either when a loss event occurs or at the end of the transaction. Such arrangements are used to ensure that the value of collateral does not fall below that required to meet a loss event or to meet obligations to investors.

4.32 Depending on the trust agreement in place, we expect that a trust established with a UK ISPV as the beneficial owner should: (1) mean gains arising on the assets held in the trust will be treated as arising in the ISPV for tax purposes; and (2) fall within the UK tax treaty network, meaning the assets held in that trust would benefit from lower rates of withholding tax on the returns they generate. We believe this could be a tax advantage for domiciling ILS ISPVs in the UK.

56. Does access to the UK tax treaty network represent an advantage for the UK over other jurisdictions as a location for domiciling ISPVs? If so, how significant is this?

57. What are the typical terms for collateral asset value derivative contracts and would this undermine any tax advantage of having access to the UK treaty network?

Anti-avoidance

4.33 Whilst we think it is appropriate for investors to be treated as if they had participated in the profit generating activity directly, it is essential that the mechanism for delivering this is proportionate and robust against abuse.

4.34 We will need to consider instances of overcapitalised ISPVs generating tax-free investment returns on the assets held as collateral. We believe this risk could be mitigated by restricting the tax exemption to: (1) PRA-authorised vehicles only; (2) investment returns on the value of the collateral required under the terms of the risk transfer contract; and (3) vehicles that are required to distribute the return from their collateral to investors after a certain period of time.

4.35 However, we may need to consider further anti-avoidance provisions to ensure that existing traditional reinsurance is not routed through ILS ISPVs to achieve outcomes that are not intended by the policy approach.

4.36 It is critical to note that the government will need assurances that any special tax treatment is not vulnerable to abuse before committing to introduce new tax rules.

58. Do you think the avoidance concerns outlined above are reasonable? If so, how do you think they could be mitigated?

59. How long are collateral assets typically held after an ILS cover period has ended? In what circumstances could they be justifiably held longer?

60. What other risks of abuse are there and how might they be mitigated?

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