HM Treasury

Regulations implementing a new regulatory and tax framework for Insurance Linked Securities:

response to the consultation

July 2017

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1 Introduction

The Insurance Linked Securities project

1.1 The government is committed to 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.

1.2 At Budget 2015, the Chancellor announced that the government would work with the London market and the UK's regulators to develop a new and competitive tax and regulatory framework, consistent with the Solvency II Directive, to facilitate the domiciling of Insurance Linked Securities (ILS) vehicles – or Insurance Special Purpose Vehicles (ISPVs) – in the UK.

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

1.4 Following the Budget 2015 announcement on ILS, the London Market Group established the ILS Taskforce, a group of industry practitioners with expertise in specialist reinsurance and alternative risk transfer business.

1.5 Since May 2015, HM Treasury has been working closely with the ILS Taskforce to understand the ILS market and the structures used in ILS deals, as well as working closely with HM Revenue and Customs (HMRC), the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA).

Purpose of this document

1.6 This document explains how the government has taken into account responses to the November 2016 consultation – "Regulations implementing a new regulatory and tax framework for Insurance Linked Securities" – as part of work to finalise the tax and non-tax regulations that will implement a new ILS framework in the UK.

1.7 Chapter 2 provides background and a summary of responses to the government's November 2016 consultation and to the earlier March 2016 consultation.

1.8 Chapters 3 and 4 set out the key issues covered by responses to the November 2016 consultation. Chapter 5 provides information about the authorisation and supervision of Insurance Special Purpose Vehicles.

1.9 Annex A lists the respondents to the November 2016 consultation.

1.10 For information, general background on ILS business is included at Annex B.

2 The government's ILS consultations

The March 2016 consultation

2.1 On 1 March 2016, the government published an initial consultation setting out the overall approach for designing an effective and competitive framework for ISPVs in the UK within the Solvency II framework and asked for respondents' views. In particular, the consultation set out the government's approach to the corporate structure, taxation and authorisation and supervision of ILS vehicles in the UK. The consultation closed on 29 April 2016.

2.2 The consultation document is available at: https://www.gov.uk/government/consultations/insurance-linked-securities-consultation

2.3 The government received 21 responses to the March 2016 consultation. All respondents were supportive of the government's intention to create a competitive framework for ILS to ensure that the UK is able to adapt and innovate in the very competitive global market for reinsurance. Respondents were broadly supportive of the proposals set out to implement a competitive regulatory and tax regime for ILS in the UK.

2.4 Respondents agreed that a "protected cell company" corporate structure was appropriate for a new ILS framework; that a bespoke approach to the taxation of ISPVs would be needed; and requested proportionate and risk-based authorisation and supervision of ISPVs from the PRA and FCA. The responses from the March 2016 consultation informed development of the draft regulations published at Autumn Statement 2016.

The November 2016 consultation

2.5 On 23 November 2016, the government published its proposed regulatory framework for ILS. In particular it published for consultation two sets of draft regulations: the Risk Transformation Regulations 2017, which will introduce a new regulated activity of insurance risk transformation under the Financial Services and Markets Act 2000 and introduce a new corporate structure for multi-arrangement ISPVs (mISPVs); and the Risk Transformation (Tax) Regulations which set out the taxation of ISPVs. The consultation closed on 18 January 2017.

2.6 The consultation document is available at: https://www.gov.uk/government/consultations/regulations-implementing-a-new-regulatory-and-tax-framework-for-insurance-linked-securities

2.7 The government received 19 responses to the November 2016 consultation. Responses were received from insurers and reinsurers, professional services firms, retail banks and industry groups. For a list of all respondents to the consultation, please see Annex A.

2.8 Respondents broadly agreed with the government's proposed framework, contained within the draft Risk Transformation Regulations 2017 and the Risk Transformation (Tax) Regulations. Respondents raised a number of policy and technical issues related to the regulations which will be detailed below.

2.9 Due to the detailed and technical nature of responses received to the questions asked in the consultation, this document will not list responses to each question. Where appropriate, references are made to particular responses.

3 Responses to the proposed corporate structure for multi-arrangement ISPVs

The proposed approach for protected cell companies

3.1 Part 4 of the Risk Transformation Regulations makes provision for the proposed protected cell company (PCC) regime. A PCC will be a private company limited by shares. Given the government's view that public offerings for investment in ISPVs would be not be appropriate, PCCs cannot be public companies.

3.2 A PCC will comprise the core and any number of cells needed to manage the ILS deals it takes on. The core and the cells do not individually have legal personality, rather it is the PCC as a whole that has legal personality. The core provides the administrative function of the PCC and the cells are (among other things) used by the PCC to assume risk, issue investments and hold property for ILS deals.

3.3 PCCs are designed to provide for the efficient and robust management of multiple ILS deals. Cells can be added as needed with a simple resolution of the PCC board of directors. Cells can also be dissolved by board resolution (subject to requirements imposed by the Regulations). No separate incorporation procedure is required for a cell. Nevertheless, the assets and liabilities assigned to a cell will be strictly ring-fenced from other cells in the PCC and also the core.

3.4 The PCC will be able to issue securities on behalf of the cells, whether equity or debt instruments, in order to fund the risk they assume. Given that ISPVs need to be operated in a way which delivers reliable protection for insurers and reinsurers (the cedants), it is standard practice for investors in an ISPV to have no voting rights and no means of influencing the management of an ISPV. This is reflected in the Regulations for PCCs which restrict shares that can be issued by a cell to non-voting shares.

3.5 PCCs introduced under the Risk Transformation Regulations will only be available for use as authorised multi-arrangement ISPVs (mISPVs).

Feedback on the Risk Transformation Regulations 2017

Application and registration process for a PCC

3.6 The FCA will be responsible for the incorporation and registration of protected cell companies in the UK and will maintain a register of all PCCs. The PRA and FCA are responsible for the authorisation and supervision of mISPVs (including ISPVs).

3.7 Applicants wishing to use a PCC will need to include an application for a PCC as part of their application to the PRA to carry out the regulated activity of insurance risk transformation. The decision as to whether to authorise the proposed PCC will be determined according to Solvency II requirements for special purpose insurance vehicles. If the PRA, with the consent of the FCA, is willing to grant authorisation for the proposed PCC to carry out insurance risk transformation, the FCA may then incorporate the PCC. Once incorporated, the PRA will authorise it in accordance with the decision it has reached on authorisation. If the PRA decides to refuse authorisation, the FCA will not incorporate the PCC.

3.8 A PCC must notify the FCA when it creates a new cell. When a PCC assumes a risk on behalf of a cell, the PCC must notify the PRA within 5 working days.

Annual accounts

3.9 For the filing of annual reports and accounts, respondents generally agreed with the government's approach to let the PCC use either the UK Generally Accepted Accounting Practice (UK GAAP) or International Financial Reporting Standards (IFRS) as the recognised accounting standards for PCCs.

3.10 The government's approach for PCC accounts replicates the Companies Act 2006 approach, with technical modifications to reflect the fact that shares in a PCC have a slightly different structure to companies incorporated under the Companies Act 2006.

3.11 Regardless of the approach used by ISPVs to satisfy the requirements for filing of accounts under the Companies Act, the Regulations place a duty on the PCC to keep records and accounts at all times which distinguish the assets held on behalf of, and obligations incurred on behalf of or attributable to, each individual cell.

Audit

3.12 Some respondents argued that the standard requirements for audit under the Companies Act would be onerous and that PCCs should be given the right to waive the auditing requirement.

3.13 The government believes that PCCs should be subject to the usual audit and accounting standards for companies in the UK as found in the Companies Act 2006, as the balance sheets of PCCs are often sizeable. Therefore, the approach to audit for PCCs replicates (with technical modifications) the approach found in the Companies Act 2006.

Arrangements between cells within a PCC

3.14 Some consultation respondents requested that the Regulations enable the use of arrangements between cells within a PCC. These respondents pointed out that arrangements between cells are permitted in other jurisdictions that use protected cell companies and are used in the ILS market. For example, such arrangements are used to provide tranching of risk between different groups of investors. While it may be possible for these kinds of outcomes to be achieved using the PCC structure via other contractual means, the government recognises that arrangements between cells may be useful to market participants and provisions to facilitate such arrangements have now been included in the Regulations. However, the government believes that providing for cells to enter into contracts with each other, as requested by some respondents, is not consistent with the fact that the cells will not have separate legal personality.

3.15 A key objective of the UK's PCC regime is to ensure that the cells within a PCC are segregated from each other, and there are therefore provisions in the Regulations which prevent assets being moved between cells. But in some circumstances, movements of assets between cells will be acceptable and the regulations include limited "gateways" which allow for this. The UK's approach to arrangements between cells is to allow assets to be moved between cells in accordance with arrangements made between the cells, subject to very strict procedural requirements. The following example illustrates how this works.

3.16 Suppose a PCC assumes a risk from a cedant. A premium is paid to the PCC which is allocated to a cell - Cell A. The PCC now has an obligation to the cedant which it has incurred on behalf of Cell A and is thus treated as being allocated to Cell A. The PCC funds its exposure to that risk by issuing investments to two pools of investors, a junior tranche which absorbs initial

losses and a senior tranche which absorbs residual losses. The PCC uses Cell B to issue investments for the junior tranche and the funding raised is held on behalf of Cell B (and is hence allocated to that cell). The PCC uses Cell C for the senior tranche in an identical way. In order to provide the link between Cells A, B and C, the PCC makes arrangements between: (1) Cells A and B; and (2) Cells A and C. In accordance with those arrangements, the PCC moves, for example, 80% of the premium from Cell A to cell B and 20% of the premium from Cell A to Cell C. If the cedant makes a claim, the PCC then moves assets from Cell B to Cell A in accordance with the arrangements. If the assets held on behalf of Cell B are exhausted, the PCC moves assets from Cell C to Cell A to pay the cedant.

3.17 As mentioned above, the PCC must keep records and accounts distinguishing the assets and obligations of each cell from the assets and obligations of every other cell. When two cells enter into arrangements with each other, the accounts must treat the arrangements as if they were set out in a contract made between the two cells. So the arrangements referred to in the example will be recorded in the accounts as creating "assets" of Cell A and "contingent liabilities" of Cells B and C. This reflects the fact that assets held on behalf of Cells B and C may be moved to Cell A to satisfy liabilities incurred by the PCC on behalf of Cell A. So as far as the cedant is concerned, the PCC's liability to the cedant remains a liability incurred by the PCC on behalf of Cell A.

3.18 Where cells are linked by arrangements made between them, they form a "group of cells" for the purposes of the Regulations. A group of cells can only be used to provide cover in respect of one separate contractual arrangement for risk transfer at any one time. The PRA may also impose limitations on how a PCC may use arrangements between cells or requirements relating to the use of arrangements between cells. This will ensure that arrangements between cells are used with care and are consistent with Solvency II requirements.

3.19 The Regulations permit such movements of assets to take place provided the use of arrangements between cells by the PCC is included within the scope of the Part 4A permission granted by the PRA, and the procedural requirements set out in the Regulations have been satisfied (which includes notifying the PRA).

3.20 These arrangements must be used with care and will need to be consistent with Solvency II requirements. In particular, they must not undermine the Solvency II requirement that each contractual arrangement for risk transfer should meet the fully-funded requirement, that the claims of the providers of financing mechanisms are at all times subordinated to the reinsurance obligations of the special purpose vehicle to the cedant, and that the solvency of one contractual arrangement must not be affected by the insolvency of any other contractual arrangement entered into by the mISPV.

3.21 If a PCC wishes to use such arrangements, a clear proposal for their use will need to be included in the mISPV's scope of permissions either at the authorisation stage or at a subsequent update to its permissions. The PRA will be required by the Regulations to place a limit on the permissions granted to ISPVs with reference to the activities described in the firm's application for Part 4A permission, and this limit will set the parameters of regulated activities which the PCC may carry out. Unless proposed arrangements between cells are included within the scope of the Part 4A permission granted by the PRA, the use of cell arrangements will not be available to a PCC. See Chapter 5 for further detail on the approach to authorisation and the requirement for the PRA to exercise its discretion to limit the scope of regulated activities a PCC may carry out.

Directors' duties

3.22 The majority of respondents agreed with the government's approach towards directors duties as set out in the Regulations, which replicates the duties on directors found in the Companies Act 2006.

3.23 However, the government agrees with the suggestion from some respondents that an additional duty of care should apply to the directors of a PCC. PCC directors are now required to exercise reasonable care, skill and diligence to ensure that a PCC complies with the Risk Transformation Regulations and they must act in accordance with any enforceable arrangements which are made between cells.

Offers to the public

3.24 The issue of the secondary trading of ILS shares was raised by a small number of respondents. Respondents were concerned that the restriction on offering ILS shares to non-qualified investors would cause problems when issuing ILS bonds on the global bond markets. This would be because global bond markets are not restricted to qualified investors. Respondents also raised concerns that the Regulations would restrict the ability of qualified investors to trade shares on an MTF.

3.25 In principle, the government is happy for ILS shares to be traded on a secondary market, providing that the trading venue is only accessible to qualified investors, as defined in the Regulations.

Regulated activity for managers of risk transformation

3.26 It is common practice in the ILS market for specialist insurance management firms to provide the management function for ISPVs. A small number of respondents asked for this management function to be made a regulated activity under the Financial Services and Markets Act 2000 (FSMA), authorised and supervised by the PRA and FCA. These respondents argued that making managers of risk transformation a regulated activity would help to streamline the authorisation and supervision of ISPVs.

3.27 The government considered this view, but concluded that introducing a new regulated activity for insurance managers would not make a material difference to the authorisation and supervision of ISPVs. As with any regulated activity under FSMA, the directors of an ISPV would still be wholly responsible and accountable for the activities of the PCC, regardless of whether the directors had contracted an external firm to provide management services for the ISPV. The UK's framework for ILS is designed to be consistent with the requirements for ISPVs that are set out in the Solvency II Directive and directly applicable regulations. These requirements apply to ISPVs and the directors of ISPVs will be responsible for ensuring they comply with these requirements.

Rules on appropriate investors for ILS

3.28 Respondents agreed with the government's view that retail investors should not be able to invest in ILS as ILS securities are complex financial instruments which require substantial financial resource and expertise. The Regulations therefore restrict investment in ISPVs to "qualified investors".

3.29 The definition of "qualified investors" draws on concepts set out in the MiFID II Directive at Annex II. This restricts investment in ILS to wholesale investors and persons who pass both a qualitative and quantitative test to ensure they are suitably qualified to invest in ILS.

Mergers and divisions

3.30 In line with feedback from some respondents, the Regulations now provide for a quicker procedure to transfer business from a cell to a separate company. While these transfer arrangements are generally available, it is envisaged that they may be of particular use where the core of a PCC has become insolvent. In such a case, all viable cells could be transferred out of the PCC to another PCC or to separate companies.

Use of protected cell companies for other purposes

3.31 Some respondents argued that a protected cell regime would add value across a range of financial services activities and expressed the view that protected cell companies should be available as a corporate structure for other regulated activities.

3.32 The government will keep the potential broader use of PCCs under review, but will not extend the purpose of PCCs at this stage.

4 Responses to the proposed tax treatment for ILS

Proposed tax approach

4.1 After careful consideration of the responses to the March 2016 consultation and engagement with stakeholders, the regulations published in November 2016 proposed to introduce a bespoke regime for the ISPVs that issue ILS in the UK. If certain conditions are met ISPVs have qualifying transformer vehicle (QTV) status which involves:

- the insurance risk transformation activity of the QTV not being subject to corporation tax
- investors being taxed as normal according to their facts and circumstances

4.2 The government's aim is to create a regime that is internationally competitive and in line with the UK's move towards a territorial tax system.

4.3 During the consultation process it became clear that subjecting the core insurance risk transformation activity carried on by the QTV to corporation tax would result in an uncompetitive tax treatment. With such a tax treatment, ILS vehicles would be very unlikely to establish themselves in the UK, meaning the UK would lose out on the growing ILS market. Therefore, the government has decided that the insurance risk transformation activity of the QTV should not be subject to corporation tax.

4.4 Furthermore, it was clear from the consultation that imposing a withholding tax on payments of interest made by the QTV would also make the UK less competitive than jurisdictions where ISPVs are already established.

4.5 In the UK there is already no requirement to withhold tax on dividend payments, while a number of exemptions apply to withholding tax on interest payments. The government's proposal here is to fully exempt from withholding tax debt and equity payments made from an ISPV to investors.

4.6 The government's proposed approach therefore means that UK investors would be taxed as normal on their investment income, with overseas investors taxed according to the regime in their home country.

4.7 The government will ensure that the regime is narrowly targeted and protected against abuse. The regulations ensure there is appropriate treatment of investment in these vehicles and that tax is paid at the appropriate level.

4.8 The tax treatment is strictly limited to QTVs and is contingent on regulatory rules being met and authorisation from the PRA and FCA. If an ISPV is not authorised to carry out insurance risk transformation under FSMA then it cannot be a QTV and the tax treatment will not be available.

4.9 Furthermore, the tax treatment under the regime will be fully switched off if a QTV is used to secure a tax advantage for any person.

Feedback on the Risk Transformation (Tax) Regulations 2017

4.10 Respondents all agreed that the tax treatment as set out in the Risk Transformation (Tax) Regulations was competitive and represented the correct approach to the taxation of QTVs.

Distribution of assets to investors at the end of an ILS deal

4.11 Respondents advised that 30 days is too short a period to allow for the distribution of assets from a QTV (or cell of a QTV) once the assets are no longer required to satisfy the fully funded requirement for an ILS deal. Holding assets for a longer period switches off the QTV tax treatment.

4.12 The government has considered the feedback from respondents and agrees that the 30 day limit is too short. Therefore, the distribution of assets must now take place before 90 days from the date on which all liabilities under the contract have been satisfied.

Removal of QTV tax treatment – conditions A, B and C

4.13 Respondents were concerned that the provisions which remove the QTV tax treatment in certain cases are too widely drafted and may inadvertently catch legitimate activity of QTVs. The government has considered these concerns and agreed that the removal of this tax treatment as proposed may penalise legitimate activity of ISPVs.

4.14 The government agrees with the points raised by respondents that the removal of the QTV tax treatment for an entire PCC is inappropriate if the condition is met by a cell rather than the PCC as a whole. The government has therefore decided that switching off of the QTV tax treatment should only be at PCC level if the PCC itself has incurred certain penalties (see 4.18).

4.15 Condition A provided for the tax treatment to be switched off if investors connected to the undertaking from which the risk was assumed held 10% or more of the securities issued by the QTV. This condition was designed to ensure that the risk was passed to third party investors.

4.16 Respondents argued that condition A precluded the existence of legitimate business models for ISPVs. The government agreed that legitimate business models could be ruled out by condition A. For example, the condition could have prevented ceding insurers from providing initial seed capital to certain types of funds which commonly invest in ILS, a restriction that ILS regimes in other jurisdictions do not have. This meant that the overall ILS regime in the UK would be less competitive.

4.17 Therefore, the government has removed condition A from the Regulations. The government believes that there is little incremental risk of abuse as a result of this change as the regulations still contain a targeted anti-avoidance rule which withdraws the QTV tax treatment if the purpose of the insurance risk transformation is to secure a tax advantage for any person.

4.18 Condition B was targeted at a breach of compliance, where a penalty was incurred in respect of a late or inaccurate corporation tax return. Incurring such a penalty removed the QTV tax treatment, including all the cells within a PCC. Respondents argued that this was too harsh an outcome and could unfairly affect the financial return for investors that have no influence over the management of the core and have no relationship with other cells in the PCC.

4.19 The government accepts this argument and has revised condition B to ensure that the tax treatment is switched off only for most serious matters, such as penalties incurred for a return submitted with a deliberate inaccuracy or higher level penalties charged because of repeated failure to submit a return on time.

5 The approach to authorisation and supervision of Insurance Special Purpose Vehicles

5.1 In the government's first ILS consultation published in March 2016, the government, having consulted the PRA and FCA, set out an initial overall approach to the authorisation and supervision of ISPVs under Solvency II. Taking into account responses from this consultation, the PRA and FCA further developed the approach and published a draft supervisory statement and rules for consultation in November 2016. The PRA and FCA are considering responses to their consultation and will respond in due course.

The approach to authorisation and supervision of ISPVs

5.2 It is recognised that ISPVs have a very specific and limited purpose. The government's view is that this should be reflected when granting authorisation for an ISPV to carry out the regulated activity of insurance risk transformation. When the PRA gives permission under Part 4A of FSMA for an ISPV to carry out regulated activities, the Regulations will require the PRA to exercise its discretion under Section 55F(4)(a) of FSMA to incorporate in the description of those regulated activities a limitation on the scope of the regulated activities which the ISPV may carry on. This requirement will also apply to any variation of the permission granted in that the PRA will be required to maintain a limitation, with the limitation on the scope of regulated activities amended as appropriate.

5.3 Feedback to the government's consultation raised concerns about the proposal to require pre-transaction notification to the PRA of new mISPV cells (or any new assumption of risk), and argued for an alternative approach involving post-transaction notification of new cells (or any new assumption of risk). At the same time, the UK has an obligation under Solvency II to ensure that mISPVs continue to meet the Solvency II requirements. The Government believes this can be achieved by ensuring that the terms of authorisation for an mISPV, including the mISPV's approach to the creation of new cells or risk transfer deals, is clearly defined and that the activities of the mISPV are limited to the purposes set out in the application for authorisation through a limitation on permissions imposed by the PRA under Section 55F(4)(a).

5.4 After consideration of the consultation feedback and the inclusion of appropriate safeguards outlined above, and after further discussions with the PRA, the government has decided to provide for a post-transaction notification regime in the Regulations, requiring mISPVs to notify the PRA within 5 working days of the assumption of a new risk.

5.5 In limiting permissions of an mISPV to the scope of activities set out in the application for authorisation, it will be proportionate for the PRA to give permission for the mISPV to enter into specified kinds of risk transfer deals in the future without needing further authorisation, provided that those future deals are in accordance with the limitation as set out in the mISPV's Part 4A permissions. The effect of this approach is that the permissions will limit the transaction structures the mISPV can enter into to those that have been set out clearly at the application stage. Any assumption of risk by a mISPV will need to be notified to the PRA in accordance with

the Regulations. Any assumption of risk that is not within the scope of the mISPV's Part 4A permission would require a variation of permissions, and sufficient time will be needed by the PRA to review these variations of permission applications.

5.6 The effect of this requirement is particularly important for the use of arrangements between cells within a PCC. It is important that such arrangements are not used in a way that undermines the segregation of contractual arrangements within a PCC, or in a way that prevents effective supervision. When combined with the restrictions set out in the Regulations, the limitation on permissions will ensure that use of arrangements between cells is only possible for clearly defined purposes which have been set out in the application for authorisation, and which have been included in the description of regulated activities which the PCC may carry on as part of the Part 4A permission granted by the PRA. Unless this is the case, a PCC will not be permitted to use arrangements between cells.

5.7 As already outlined in the government's previous consultation paper, while the PRA and FCA will endeavour to authorise non-complex, single-transaction ISPVs within 6-8 weeks, this timeframe may be extended for applications involving more complex vehicles or arrangements, including mISPVs. Further, where an application includes arrangements between cells this will require further scrutiny from the PRA.

5.8 The approach to authorisation and supervision of ISPVs and mISPVs will be new and untested, and as such, the Treasury, the PRA and the FCA will keep the requirements for authorisation and the supervisory approach under review. Treasury will consider any request from PRA and FCA to modify the Regulations or FSMA provisions in respect of the new regulated activity of insurance risk transformation, should existing provisions prove to be inadequate.

A Respondents to the consultation

A.1 The following were respondents to the November 2016 consultation on Insurance Linked Securities:

- Ashurst LLP
- Association of British Insurers
- Arca PRM
- City of London Law Society
- Horseshoe Group
- Hymans Robertson LLP
- Institute and Faculty of Actuaries
- KPMG LLP
- Leadenhall Capital Partners LLP
- Lloyd's
- Lloyds Banking Group
- London and International Insurance Brokers' Association
- London Market Group
- Maples Fiduciary
- Norton Rose Fulbright LLP
- PwC LLP
- Simmons & Simmons LLP
- Vario Partners LLP
- Wilkie Farr & Gallagher LLP

B Background information: overview of ILS

B.1 This annex gives an overview of the development of ILS and summarises the corporate structures commonly used in the ILS market.

Insurance Linked Securities: an overview

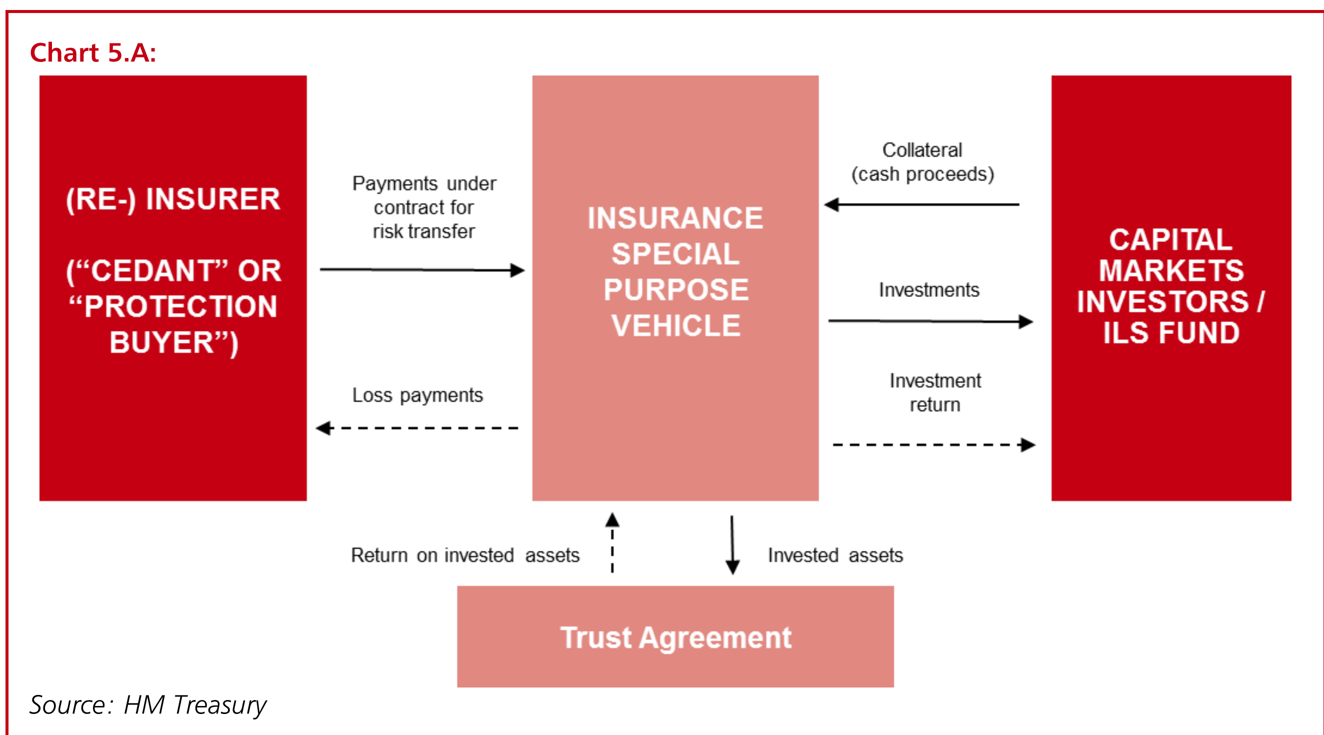
B.2 Insurance Linked Securities (ILS) are an alternative form of risk mitigation for insurance and reinsurance firms. In contrast to conventional cover arranged with a reinsurance company, they offer insurance and reinsurance firms a means of transferring risk to the capital markets. ILS has helped to 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 risk. For investors, ILS deals have offered attractive returns, and because ILS is considered to be uncorrelated with the economic cycle, they have provided helpful diversification for investment portfolios.

B.3 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 $80 billion. The University of St. Gallen in Switzerland has estimated that the ILS market could grow to a value of $87 billion by 2019.

Structure of ILS deals

B.4 The basic structure for an ILS deal is illustrated in the following diagram:

Chart 5.A:



Source: HM Treasury

B.5 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.

B.6 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.

B.7 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.

B.8 The CAT bond 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.

B.9 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.

B.10 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.

Developing an ILS framework consistent with Solvency II

B.11 The Solvency II Directive and directly applicable legislation made under it 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. "Special Purpose Vehicles" (as defined in Article 13(36) of the Directive) must be authorised in accordance with the Solvency II Directive and the Solvency II directly applicable legislation. Details of the authorisation and supervision requirements are set out in Articles 318-327 of the Solvency II Commission Delegated Regulation (EU) 2015/35 ("the Delegated Regulation") and the Solvency II Commission Implementing Regulation (EU) 215/462 ("the Implementing Regulation").

B.12 Special purpose vehicles authorised in the UK will be PRA-authorised and subject to the dual regulation of the PRA (in respect of prudential requirements) and the FCA (in respect of conduct of business). 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 Solvency II requirements. The PRA can only grant authorisation with the FCA's consent.

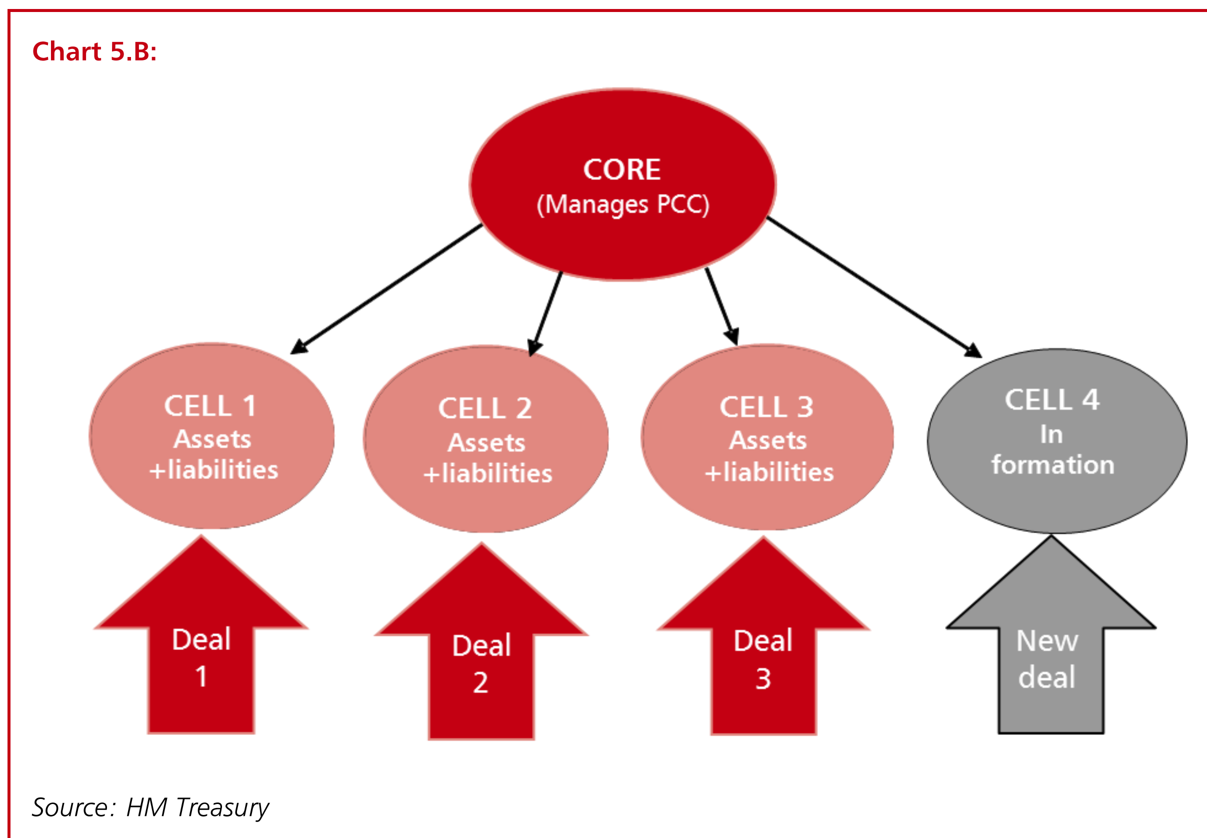
Multi-arrangement ISPVs under Solvency II

B.13 We understand that it is common practice within the ILS market for a group of ILS deals, often collateralised reinsurance deals, to be managed from one ISPV. For parties to ILS deals, this saves time and administrative expense as a new ISPV will not need to be established for each transaction. In managing a group of ILS deals in this way, it is crucial to ensure that the different contracts for risk transfer are segregated within the ISPV in a way which ensures that losses on any one transaction do not affect other transactions managed by the ISPV. Cedants and investors now routinely expect use of a protected cell company to ensure their interests are adequately protected through effective segregation of deals within an ISPV.

B.14 Multi-arrangement ISPVs are permitted under Solvency II, but it is a core requirement of the Directive for risk transfer contracts within a multi-arrangement ISPV to be strictly segregated. The proposed UK protected cell company regime is designed to meet the Solvency II requirement, provide confidence to cedants and investors that deals will be robustly segregated, and provide an administratively efficient means for managing multiple deals from one vehicle.

5.1 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 risk transfer arrangement is allocated to its own cell. This means that if there is insufficient funding 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:

Chart 5.B:



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