Hogan Lovells

Insurance Linked Securities

One Step Closer to Creating a London Hub

UK Government publishes consultation paper: March 2016

1. Introduction

1.1 On 1 March 2016, the UK government published a consultation paper announcing proposals to reform UK law as it applies to insurance linked securities. This is part of a strategy to allow London to retain its status as "a specialist insurance hub" and to participate more actively in the growth of alternative risk transfer transactions.

1.2 The consultation paper seeks views from the insurance industry on a number of key issues. The consultation phase is scheduled to run until the end of April 2016. If it decides to proceed, the government plans to produce draft legislation by the end of 2016.

2. Summary of Proposals

2.1 The paper makes some radical suggestions. The most striking is the proposal to amend UK company and insolvency law to allow the use of "protected cell companies". This type of corporate structure has existed for many years in several of the jurisdictions which have been the most active in the alternative risk transfer market. The paper proposes that use of UK protected cell companies should be limited to insurance linked securities transactions, but if it is adopted there will be wide interest in expanding it to allow application for many other types of transactions.

2.2 There is a clear intention to address the perceived regulatory and tax disadvantages of the UK. The government proposes a swift authorisation process, relatively simple ongoing governance requirements, and an exemption from UK corporation tax for the issuer of insurance linked securities (meaning that shareholders in the issuer would be taxed on their income from it, in the same way as they would be if investing in an investment fund).

2.3 The government acknowledges that not all difficulties can be easily overcome. In particular, interest payments on insurance linked securities would still be subject to withholding tax rules, where they are made to a jurisdiction not covered by an appropriate tax treaty. Although several exceptions exist, they would not always be applicable, and the government does not consider that a new exception for insurance linked securities can be made, at least in the near future.

2.4 Although radical in some respects, the proposals are cautious and practical in others. In particular, the government proposes that only "qualified institutional buyers" should be permitted to buy or trade in insurance linked securities. This restriction reflects the government's expectation that only knowledgeable and sophisticated investors are likely to be interested in buying these securities. It avoids the need to design a specialist investor protection regime, as might be necessary if a wider pool of investors were permitted.

3. BACKGROUND

3.1 Insurance-linked securities ("**ILS**") are financial instruments whose values are determined by events which cause losses to insurers. They allow insurance and reinsurance undertakings to transfer the risk of certain events occurring to the capital markets, as an alternative to using traditional reinsurance. They are therefore considered to be a form of "alternative risk transfer".

3.2 ILS transactions are beneficial for two main reasons:

(a) They provide insurers with access to greater reinsurance capacity than the traditional reinsurance markets can offer, thereby enabling them to provide more insurance at more competitive prices, and giving them more options to lay off risk in order to manage their capital requirements. This will be particularly important given increased capital requirements under Solvency II, which will continue to increase as transitional measures taper off.

(b) They allow risks to be spread more widely among global investors, rather than concentrating risk in the traditional reinsurance sector. This reduces the likelihood of several reinsurers becoming insolvent at the same time because between them they have accumulated too much exposure to a particular event. From the perspective of investors, ILS are seen as largely independent from the financial markets, and thus can enable investors to achieve diversification.

3.3 Since its beginnings in the 1990s, the international market for ILS has increased substantially, with securities currently in issue estimated at around $60 billion. The performance of other structured financial products, most notably the sub-prime collateralised debt obligations, during the financial crisis had a detrimental impact on the use of ILS, but the market has now strengthened considerably once again.

3.4 The best known type of ILS is a catastrophe bond (often called a "cat bond"), which provides cover for one or more specified natural disasters, such as an earthquake or a hurricane. The risk is passed to the capital markets by the issue of bonds to investors. The bonds pay interest and principal as normal if the relevant event does not occur. If the relevant event occurs, the interest and principal payments on the bonds are reduced, either partially or in full, so that money can be redirected to the insurer to cover the losses it has suffered as a result of the event. Investors only receive payment from what is left after the insurer has been paid.

3.5 As the ILS market has developed, the applicable terms and conditions have become more sophisticated and innovative, and the types of events covered has widened.

(a) Payouts to the insurer need not act as an indemnity for the insurer's actual loss, but may instead be determined by reference to an independent index, or by parameters related to the insured event (such as the strength of a hurricane). These types of payout trigger provide more certainty for investors, making the bonds more marketable, though at the cost of introducing basis risk for the insurer.

(b) The relevant event need not be a large-scale natural disaster. It might instead be a river flooding more than expected or it could be mortality rates generally increasing.

3.6 The development of more sophisticated ILS terms and conditions has become the market norm, and rating agencies now look for the inclusion of multiple cumulative payout triggers for the ILS as part of their rating criteria.

3.7 In tension with this development, EIOPA warned in 2015 that the reinsurance provided by the ILS transaction must properly transfer risk, and that the extent of the cover provided by it should not result in any material basis risk (a requirement now reflected in Solvency II). EIOPA has also previously pointed out the complex and non-standardised nature ILS transactions, and the difficulty in assessing the underlying risks, may lead to investors being wary of such instruments, thus leading to an illiquid market.

3.8 It is essential to balance all of these competing concerns in order to ensure a successful ILS transaction.

4. STRUCTURE

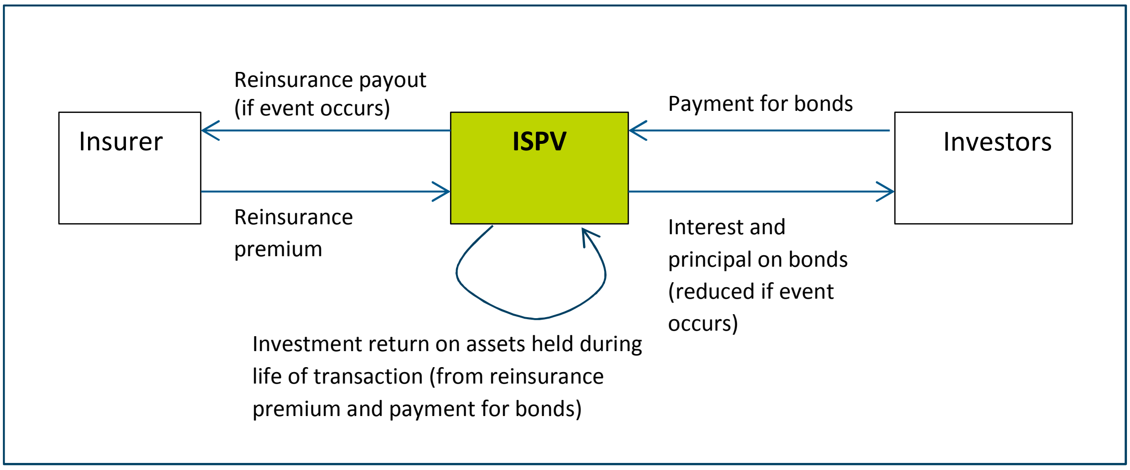
4.1 The key to an ILS structure is the intermediate company placed between the insurer and the capital markets investors (referred to by the government as an "**ISPV**", or "insurance special purpose vehicle"). The ISPV performs three functions:

(a) **Reinsurance**: It provides reinsurance to the insurer on agreed terms. In order to perform this function, it needs to obtain appropriate regulatory authorisations to carry on reinsurance business, and to comply with applicable reinsurance regulations on an ongoing basis. If the specified event occurs, it makes a claim payout to the insurer.

(b) **Bond issuance**: It issues bonds to capital markets investors whose terms allow interest and principal payments to be reduced in the event of a payout under the reinsurance. In order to perform this function, the ISPV needs to comply with applicable securities regulation in jurisdictions where the bonds are issued. It also needs to be able to pay interest and principal to investors with minimum leakage of cost and tax.

(c) **Investment of assets**: During the life of the transaction, it invests the assets it has received from the insurer (in the form of the reinsurance premium) and investors (in the form of payment for the bonds). The investment return generates a further source of income from which to pay interest and principal on the bonds and/or the reinsurance payout if the specified event occurs.

4.2 The structure is shown in the following diagram:



4.3 It is a regulatory requirement under Solvency II that the ISPV is "fully funded" from the outset, to the extent necessary to enable it to discharge all of its obligations under the reinsurance agreement. In addition, bond holders have to accept that payments to them are "limited recourse", so that they will only receive payment to the extent that the ISPV has assets available after any reinsurance payout has been made to the insurer.

4.4 The UK is perceived as falling behind in the ILS market, as not many ILS transactions have involved securities being issued from ISPVs based in the UK. Nevertheless, UK insurers have made use of ILS transactions involving ISPVs based in other jurisdictions.

4.5 The government's consultation paper proposes reforms which are intended to make the UK more attractive for these transactions. The main aim is to transform the law so that UK and international insurers will be attracted to use ISPVs based in the UK for their ILS transactions.

5. GOVERNMENT PROPOSALS

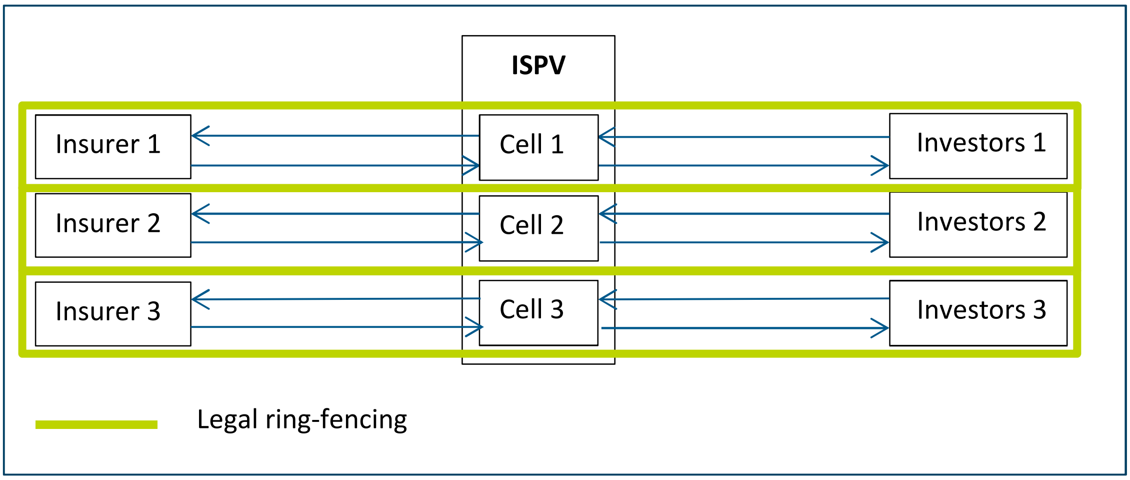
The proposals can be divided into six main categories:

(a) **Protected cell company reforms**: The government proposes to introduce amendments to UK company and insolvency law to allow "protected cell companies" to be created. A protected cell company is a single legal entity with a number of "cells" whose assets and liabilities are legally ring-fenced from one another. Each cell will be able to enter into a separate ILS transaction. Because of the legal ring-fencing, the insurer and investors who deal with one cell will be unaffected by losses that arise for a different cell, and each cell will be able to be wound up individually while other cells continue to operate.

This is a radical development for UK company and insolvency law, which until now has largely followed the traditional model that all of a company's assets are available for all of its liabilities, subject only to priority created by statute or security interests. It is a model that has been available for many years in the leading ILS jurisdictions (including Bermuda and Guernsey). UK law already has one example of the proposed model in the form of umbrella open-ended investment companies ("umbrella OEICs"), and it will be interesting to see how far the government follows the regulation that applies to them, as they are not mentioned in the consultation paper.

The main advantage of the protected cell company model is that it allows multiple transactions to be entered into without having to set up a new company each time, and without having to go through the regulatory authorisation process each time. The government refers to an ISPV used in this way as a multi-arrangement ISPV (or "**mISPV**").

Use of a protected cell company can also reduce operating costs, since the same set of directors and the same service providers can be engaged to take responsibility for all of the cells, and a single set of reports and accounts can be used for the company as a whole.



(b) **<u>Reform of authorisation process</u>**: The government proposes that new ISPVs will benefit from a fast-track process for obtaining the necessary authorisation to act as a reinsurer. It suggests that ISPVs could receive authorisation within 6 to 8 weeks of application.

This would compare very favourably with the process for ordinary insurers, for which the regulator has up to 6 months from the date of application. The fast-track authorisation process would give insurers and investors greater certainty about when their transaction would be entered into, and avoid significant delay.

In combination with the protected cell company reforms, this will be a major improvement on existing law. The government proposes that once a mISPV has been established and authorised, further transactions by additional cells would no longer require the new cells to be authorised. Instead, the regulator would be notified of the proposed transaction a short time before it is executed. In the absence of the regulator objecting, the transaction could then be executed without any further authorisation process.

(c) **<u>Governance and reporting</u>**: Solvency II rules allow a more simplified governance and reporting regime for ISPVs than applies to ordinary insurers. There is not much latitude in the application of these rules, so the consultation paper simply makes clear that the UK will apply them.

The government has said that it would expect the ISPV to have a minimum of three board members, consisting of a chairman, a chief executive and a chief finance officer. A chief actuary may also be required, although the government is consulting on whether that would be necessary.

(d) **Permitted investors**: The government has proposed that only qualified institutional investors should be permitted to invest in ILS issued by ISPVs established in the UK. This reflects the expected market for these securities, and avoids the need to consider the introduction of rules to protect less sophisticated and knowledgeable investors.

(e) **Withholding tax**: As noted above, interest payments from ISPVs established in the UK will be subject to withholding tax if they are made to investors in jurisdictions that are not covered by a tax treaty. Given other ongoing projects where this issue is relevant, the government does not consider that it can make an exception from withholding tax for ILS.

This will not be a problem where investors are based in the UK or other countries where a tax treaty allowing full withholding tax relief applies, or where the Quoted Eurobond Exemption applies, or where the recently introduced private placement exception applies. However, it is potentially a significant drawback if it is intended to market the ILS to investors based in other jurisdictions in circumstances where none of these exceptions can be relied upon.

(f) **Corporation tax**: ISPVs will be funded by an initial equity injection, represented by shares issued by it to its shareholder. The shareholder may be the insurer itself, or another company in its group, or it may be a third party.

Because Solvency II rules impose no capital requirement on ISPVs (beyond the requirement to be "fully funded" described above), this equity injection is unlikely to be significant in most cases. However, in particular cases, it might be significant, and the shareholder would expect ultimately to extract a profit from the ISPV. The government has considered how tax law might affect this profit.

Under ordinary corporation tax law, the ISPV would incur UK corporation tax on its profits, and the net profits would be distributed as income, on which the shareholder (if a UK company) would not be taxed. The government proposes to reverse this position for ISPVs. The ISPV would be exempt from UK corporation tax, but the shareholder would be taxed on the income it receives from the ISPV.

This would be significant where the investor was in another jurisdiction, since no UK corporation tax would apply and that investor would only be subject to tax on the income in accordance with its own local requirements.

In principle, this is a significant step for the UK government to take, and shows the commitment to ILS transactions. It is questionable whether it will make a large difference in practice, however, as in most cases equity investment in ISPVs would be expected to be minimal.

(g) **Stamp duty**: The consultation paper does not mention stamp duty. This will be an important consideration, as transfers of bonds issued by ISPVs would be subject to stamp duty at 0.5% unless certain conditions are met, or the government introduces a new exemption. The absence of a clear exemption would be a disadvantage for the UK when compared to the existing leading ILS jurisdictions. It may be that the government has not yet considered this issue.

6. Conclusion

In summary, the proposals are in some respects very radical, and show a genuine commitment to encourage more ILS transactions in the UK.

The willingness to introduce a protected cell company regime is a very significant step. This regime would have considerable value to many different types of structured transactions, well beyond ILS. Currently the government proposes to limit it for use only in ILS transactions. However, if it is introduced then there will be a flurry of activity to seek its extension for use in other transactions.

As a package, the reforms should address most of the obstacles that have traditionally been seen as preventing the growth of UK ILS transactions. The outstanding issues are withholding tax and stamp duty, which will be disincentives for an insurer who wants to have access to as many potential investors as possible, including those in jurisdictions which do not have a tax treaty with the UK.

However, where insurers know their potential investors, and assuming the government proposes a suitable exemption in relation to stamp duty, the proposals should be attractive to both UK and international insurers.

If you would like to discuss this note, please contact any of the following:

London insurance:	Steven McEwan or Neil Chisholm
London capital markets:	Tauhid Ijaz, Julian Craughan or James Doyle
London tax:	Philip Harle
New York:	Rob Ripin

Hogan Lovells International LLP
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