

## PRA AND FCA PUBLISH REGULATORY FRAMEWORK FOR INSURANCE SPECIAL PURPOSE VEHICLES

On 1 November 2017 the Prudential Regulation Authority ("**PRA**") and the Financial Conduct Authority ("**FCA**") published their final approach and expectations in relation to the authorisation and supervision of Insurance Special Purpose Vehicles ("**ISPVs**") which will be used to issue Insurance Linked Securities ("**ILS**") in the UK.

In general, we are pleased to see that the PRA and FCA have adopted a constructive approach for reviewing and approving ISPV applications, emphasising proportionality and a consideration of particular issues on a case-by-case basis. Such an approach is encouraging and should give sponsors confidence of a supportive environment and will go a long way to making London a competitive market for ILS. This briefing note looks at the key aspects of the PRA and FCA's final approach.

### BACKGROUND

The PRA's Policy Statement ([PS26/17](#)) and the FCA's Policy Statement ([PS17/24](#)) provide feedback to responses to the joint Consultation Paper ([PRA CP42/16 and FCA CP16/34](#)) 'Authorisation and supervision of insurance special purpose vehicles' published in November 2016, with the FCA also responding on its Consultation paper ([CP17/3](#)) 'Proposed Handbook changes to reflect the new regulatory framework for ILS' which was published in January 2017.

The PRA and FCA's rules and guidance (as set out in PS26/17 and PS17/24, respectively) are subject to the legislation introducing the legal framework for ILS, the Risk Transformation Regulations 2017 (the "**Regulations**") receiving parliamentary approval. The Regulations are expected to be approved before the end of November 2017. Nevertheless, the PRA (which acts as the lead regulator for assessing ISPV or multi-arrangement ISPVs ("**MISPV**") applications) encourages pre-application engagement. This gives those applicants interested in setting up a vehicle an opportunity, to discuss their application with the regulators ahead of a formal submission once the Regulations are in force and may make it possible for a small number of vehicles to be established in time for 2018 January renewals.

### How we can help?

- As members of the London Market Group ILS Taskforce, Clifford Chance has been actively involved in the development of the UK ILS regime and has worked closely with HM Treasury, the PRA, the FCA and HMRC in developing the regime. We would be happy to discuss the new regime with you and to help you plan to benefit from the opportunities it will create for innovative risk transfer in both the non-life and life insurance sectors.
- In delivering ILS solutions, Clifford Chance can draw on the knowledge and transactional and regulatory experience of our leading global insurance practice. Our insurance practice works closely with our tax, capital markets and private funds groups and is well placed to support our clients in delivering tax efficient and market leading ILS solutions in the UK.

## **PRA GUIDANCE**

The PRA's guidance in Supervisory Statement ([SS8/17](#)) 'Authorisation and supervision of insurance special purpose vehicles' contains some notable revisions, which are summarised below.

### **MISPV notification**

The PRA originally proposed that an MISPV must notify the PRA of a proposal to establish a new cell at least ten working days before the proposal takes effect. Should the PRA have maintained this position, then the UK would not have been able to compete with more established ILS jurisdictions which accommodate a shorter period or even post-notification of a new cell. The proposed ten working day period would have adversely impact the launch period for ILS transactions - in particular for Collateralised Reinsurance for which there is often little or no lead time before inception is required at peak renewal times - and so would have adversely constrained the commercial viability of UK-based ILS transactions compared with those elsewhere.

The PRA have accepted the business rationale against pre-notifications and have confirmed that post-transaction notification of a new assumption of risk is acceptable provided that the risk being covered is in line with the PCC's existing Scope of Permissions. The Protected Cell Company ("**PCC**"), the legal form which an MISPV must take, must now notify the PRA within five working days beginning with the day the PCC assumed the risk in the new cell.

### **Application review timeline**

The PRA proposed an application review time of 6-8 weeks for non-complex applications. This is an improvement on the Solvency II requirement, which stipulates that a supervisory authority must decide on an application within 6 months of receipt as for other insurer applications. The PRA has confirmed that it remains of the view that it may be able to arrive at a decision within 6-8 weeks for relatively straightforward, high quality applications, and possibly more quickly in some circumstances. The PRA indicated that it may revisit these estimated timelines in the future once it has actual experience. The timetable may also be accelerated by pre-application meetings with the PRA and FCA which both have confirmed that they are willing to arrange.

### **Documentation requirements**

As originally proposed, the PRA expects final documents to be submitted with applications where possible. Draft transaction documentation will however be accepted provided that only minor amendments are expected prior to the final transaction and such amendments are identified. For single-arrangement ISPVs, the PRA will expect to see details of the specific transaction. Similarly, for MISPVs, the PRA will expect to be provided with details of all transactions, including potential future transactions though it is recognised that full details of such future transaction may not be available at the outset. This will be an areas for case by case discussions with the regulators as the Scope of Permissions given to an MISPV will reflect the level of detail it can provide about its future business intentions but unless a future transaction is within that Scope of Permissions the post notification regime will not apply.

Although the PRA have not moved considerably on the substance of the documentation requirements, there is some additional flexibility compare with the original form, the information requests have been streamlined and it is

apparent which aspect of the structure and documents are of most interest to the regulators.

Applicants may also benefit from cost savings as the PRA have determined that external legal opinions and/or actuarial opinions are not required. However, the PRA did note that such opinions are helpful and applicants hoping for a timely progression of their application should therefore still consider obtaining such opinions. In any event the application will need to set out clearly how the proposed structure and documents meet the relevant Solvency II requirements for ISPV's.

### **Fit and Proper assessments**

Respondents requested guidance on what the PRA expect of ISPVs in relation to the fit and proper assessment of shareholders with a 'qualifying holding' (as defined in the Solvency II Directive). The PRA have now clarified that they will carry out fit and proper assessments of all shareholders who have 10% or more of the capital in the ISPV and either (a) at least some of those holdings include voting rights, or (b) the arrangements of the ISPV are such that the shareholder or member have significant influence over the management of the ISPV. The same assessment will also be carried out for MISPVs.

Since the regime is new, it is not yet possible to determine the rigour or benchmark of the PRA's fit and proper assessment. However, any potential shareholders should understand the purpose of the fit and proper requirements, and in particular the consequences of any breaches. For MISPV's the regulators have helpfully concluded that investors holding shares in cells only will not be considered to hold qualifying holdings as such shares are not regarded as shares in the company. They are also aware and supportive of the fact that in order to keep ISPV's and MISPV's off balance sheet the shares in the Core are likely to be held by a professional trust company on discretionary trust.

### **SIMR requirements**

The PRA have maintained that the three mandatory roles (Chief Executive, Chief Finance and Chairman) are appropriate and proportionate for an ISPV but have now confirmed that, depending on its assessment of the particular case, an individual with the relevant skills and experience may be able to perform more than one of these roles.

Further, the PRA regulated activity for managers (which respondents recommended given that ISPVs functions will, in fact largely be outsourced to a manager) will not be introduced. The Directors of the ISPV or MISPV will be responsible for proper oversight of its activities including oversight of the insurance manager but the regulators have recognised that the insurance manager will be "effectively running" the ISPV and will therefore have to satisfy the requirements for an approved person. This will be reviewed by the regulators as part of the application together with the terms of the management agreement as a material outsourcing agreement.

### **Fully funded**

Due to Solvency II requirements, the PRA cannot move away from the legal requirements for an ILS vehicle to be 'fully funded'. However, the PRA appears to be taking a more flexible and pragmatic approach than appeared to be the case originally in balancing these legal requirements and the funding practices commonly used for ILS vehicles. The PRA will also take a case-by-

case approach to understanding the proposed funding for the vehicle and whether this correctly corresponds to the assumption of risk by that vehicle, taking all relevant factors into account. If this approach is adopted then there is no reason why the UK cannot compare favourably to the approach of other jurisdictions which also need to satisfy this requirements in order for an EU cedant to be able to take credit for the risk transfer.

### ***Limited recourse clause***

The PRA has reiterated that an ISPV cannot rely on a limited recourse clause as an alternative to holding assets the value of which is equal to or in excess of its aggregate maximum risk exposure ("**AMRE**"), or in a way which undermines the effectiveness of risk transfer. The PRA's view is that limited recourse clauses should not be used to justify 'underfunding' of an ISPV on the assumption that off-balance sheet support may be available, or to deal with the risk of receipt of funds being delayed until after contractually agreed changes in the AMRE have become effective. However, the PRA do recognise that the limited recourse clause is a means of mitigating the risk of ceasing to be fully funded from a contractual perspective and can form part of the overall analysis.

The PRA has confirmed that the AMRE must be an amount that is determinable at any given time. The risk exposure taken on by the ISPV must be a fixed amount that is specified in the contract with the cedant but they have confirmed that it can also be an amount determinable in accordance with the terms of the contract with the cedant and is potentially variable by agreement (provided that it does not result in underfunding) – this is helpful for reinsurance of life risk and should be a welcomed inclusion by life insurers looking to set up ILS vehicles as a means of a obtaining much needed capacity. It should also facilitate reinstatements provided that they are properly structured.

### ***Renewals, rollovers and top-ups***

Provided that contractual provisions make clear that such arrangements do not result in the risk transfer becoming effective before the corresponding funds are received and that the same funds are not being used to cover more than one contractual arrangement at a time, the PRA consider that, in principle, these types of arrangements can be accommodated by the UK's ISPV regime. This practical approach has been welcomed by the market and provided the documents are correctly drafted should be relatively straightforward to comply with.

### ***Contingent assets***

In line with Solvency II requirements, contingent assets cannot form part of an assessment of whether an ISPV is fully funded. However, contingent assets (which remain off balance sheet until occurrence of the contingent event) will be considered by the PRA when assessing the effectiveness of risk transfer in combination with the actual assets of the ISPV and its risk management and investment strategies which will be of assistance to sponsors.

## **FCA REQUIREMENTS**

### **Principles for Businesses**

The FCA have confirmed that, as proposed, they will apply the Principles for Businesses (which are high-level requirements) to activities of the ILS

generally rather than limiting their application to ILS issuance. Although the FCA maintain that this will involve a proportionate application of the Principles to risks which may potentially arise, ISPV applicants should note this broad application of these already broadly drafted requirements as an area which is likely to require case by case discussions with the regulators.

### **Financial Ombudsman Service ("FOS")**

Given clear restrictions on marketing of ILS, it is highly unlikely that these will be issued to persons who may be 'eligible complainants' for the purpose of raising a FOS complaint. However, the FCA have introduced a rule offering FOS protection, including a new 'eligible relationship' which recognises a complainant as a 'client of the ISPV'. With this approach the FCA have ignored sponsor concerns regarding their potential exposure to the FOS, particularly in relation to more innovative products, which by their nature tend to be of higher risk but in practice this should be manageable through ensuring that all investors are in fact Qualifying Investors who would be outside the FOS regime.

### **Controlled functions**

In addition to the three mandatory PRA SIMR roles, FCA controlled functions may be required. This would depend on the type of business undertaken by the ISPV and the size of its board. For example, the FCA indicate that ISPVs taking on life risk must seek approval for a CF10 (Compliance). Additionally, the systems and controls (CF28) and senior management (CF29) roles are also likely to be relevant depending on how the ISPV proposes to allocate its governance responsibilities and to cover the activities of the insurance manager.

### **Client Assets ("CASS")**

Since most ISPVs will not receive/hold money for investors, the FCA's CASS rules will not apply. However, if an ISPV does receive money from or hold money for investors in the course of or in connection with issuance of ILS, this will be client money subject to CASS rules. Given the stringent segregation requirements in CASS, ISPV applicants should be clear as to whether client money will be held or not. If client money is held, the ISPV applicant will need to satisfy the FCA of CASS adherence or risk delay or even non-approval of their application.

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