EXPLANATORY MEMORANDUM TO

THE RISK TRANSFORMATION REGULATIONS 2017

2017 No. [XXXX]

1. Introduction

1.1 This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

1.2 The memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 This instrument implements a new regulatory and supervisory framework for Insurance Linked Securities ("ILS") in the UK, designed to attract ILS business to the UK. It creates a new form of regulated activity under the Financial Services and Markets Act 2000 for ILS. It also enables the creation of a new form of body corporate called a "protected cell company" to act as a special purpose vehicle in ILS transactions.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 Protected cell companies are comprised internally of segregated parts. In order to provide for the insolvency of those parts, the Insolvency Act 1986 and the Insolvency (Northern Ireland) Order 1989, and the subordinate legislation made under those enactments, are applied to protected cell companies with modifications. The key subordinate legislation in question is the Insolvency (England and Wales) Rules 2016, the Insolvency (Scotland) Rules 1986 and the Insolvency (Northern Ireland) Rules 1991. The Insolvency (Scotland) Rules 1986 and the Insolvency (Northern Ireland) Rules 1991 are in the process of being updated and revised, and due to Parliamentary timetabling, it may not be possible to update these Regulations to coincide with the coming into force of the revised rules. We have therefore included provision for subordinate legislation made under the Insolvency Act 1986 and the Insolvency (Northern Ireland) Order 1989 to apply with specified modifications and "any other necessary modifications". The Treasury does not consider that any other modifications are necessary at the moment, but they may become necessary once the revised rules come into force. The Treasury will, in any event, consider the revised rules when they are made to determine whether these Regulations need to be amended.

Other matters of interest to the House of Commons

3.2 Disregarding minor or consequential changes, the territorial application of this instrument includes Scotland and Northern Ireland.

4. Legislative Context

4.1 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 1st

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 directly applicable legislation made under the Solvency 2 Directive. Details of the authorisation and supervision requirements are set out in Articles 318-327 of Commission Delegated Regulation (EU) 2015/35 ("the Delegated Regulation") and Commission Implementing Regulation (EU) 215/462 ("the Implementing Regulation").

4.2 This instrument, together with the Risk Transformation (Tax) Regulations 2017 (S.I. 2017/***) provides a tax and regulatory regime which will allow the United Kingdom to become an attractive domicile for ILS Special Purpose Vehicles. The instrument introduces a new corporate structure for Insurance Special Purpose Vehicles (ISPVs) called protected cell companies (PCCs); creates a new regulated financial services activity of "Insurance Risk Transformation"; and provides for bespoke, streamlined authorisation and supervision of ISPVs by the FCA and PRA.

5. Extent and Territorial Application

5.1 The extent of this instrument is all of the United Kingdom.

5.2 The territorial application of this instrument is all of the United Kingdom.

6. European Convention on Human Rights

6.1 The Economic Secretary to the Treasury, Stephen Barclay MP, has made the following statement regarding Human Rights:

"In my view the provisions of The Risk Transformation Regulations 2017 are compatible with the Convention rights"

7. Policy background

What is being done and why

7.1 The instrument makes provision for a bespoke regulatory and supervisory framework for ILS business in the UK.

7.2 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. This additional capacity helps ensure that individuals and businesses across the world are able to continue to access affordable insurance cover.

7.3 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 $70 billion, about 12 per cent of overall reinsurance capital and continued rapid expansion in this business suggests that it will continue to grow in importance.

7.4 However, the UK does not currently have a fit-for-purpose corporate and regulatory framework to compete in the growing market for risk transfer.

7.5 The government's framework contains three main proposals: a new corporate structure for Insurance Special Purpose Vehicles (ISPVs) called protected cell

companies (PCCs); a streamlined authorisation and supervision process from the FCA and PRA; and a bespoke tax treatment of ISPVs which is found in the Risk Transformation (Tax) Regulations 2017.

7.6 Protected cell companies are companies which provide for the strict segregation of pools of assets and liabilities within a single company. Segregation is achieved by using cells within the company. The assets of a cell cannot be used to meet the obligations of any other part of the protected cell company. For ILS business, this enables the segregation of multiple ILS transactions so that protection buyers and investors are protected. Losses on any one ILS transaction will not affect any other ILS transaction within the protected cell company.

7.7 The streamlined authorisation and supervision process recognises ILS vehicles as entities that exist to service a particular transaction or group of transactions for risk transfer, with those risks being pre-funded. The process has been designed by the PRA and FCA to be as quick and efficient as possible, whilst maintaining robust supervisory oversight.

Consolidation

7.8 There are no plans to consolidate this legislation in the immediate future.

8. Consultation outcome

8.1 In its "Insurance Linked Securities: consultation" (1st March 2016) the government published an initial consultation setting out the overall approach for designing an effective and competitive framework for vehicles issuing ILS 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 vehicles issuing ILS in the UK. The consultation closed on 29th April 2016.

8.2 The government received 21 responses from insurers and reinsurers, professional services firms, investment banks, industry groups and private individuals. All responses were supportive of the government's intention to create a fit-for-purpose, competitive framework for ILS in the UK.

8.3 An overview of this consultation and a list of respondents is available at: https://www.gov.uk/government/consultations/insurance-linked-securities-consultation

8.4 On 23rd November 2016 the government published a further consultation on "Regulations implementing a new regulatory and tax framework for Insurance Linked Securities", which outlined in detail the regulations designed to introduce an effective and competitive framework for ISPVs in the UK. The consultation closed on 18th January 2017.

8.5 The government received 19 responses from insurers and reinsurers, professional services firms, retail banks, industry groups and one private individual. The responses broadly agreed with the government's proposed framework, contained within the draft Risk Transformation Regulations 2017 and the Risk Transformation (Tax) Regulations 2017.

8.6 An overview of this consultation and a list of respondents is available at: https://www.gov.uk/government/consultations/regulations-implementing-a-new-regulatory-and-tax-framework-for-insurance-linked-securities

8.7 Comments received as part of this consultation process were taken into consideration when preparing this instrument. In addition, this instrument was developed in co-ordination with the FCA, the PRA and industry stakeholders.

9. Guidance

9.1 HM Treasury will not be issuing guidance to accompany the instrument.

9.2 The FCA and PRA plan to provide supervisory statements explaining the authorisation and supervisory aspects of the regime.

10. Impact

10.1 The impact on business is negligible. This instrument will facilitate the growth of the ILS market in the UK through the removal of obstacles to that growth and will affect a small number of businesses who will incur negligible, one-off costs to familiarise themselves with the new rules. It is not expected that there will be any on-going costs. There is no impact on charities or voluntary bodies.

10.2 There is no impact on the public sector.

10.3 An Impact Assessment is submitted with this memorandum and will be published alongside the Explanatory Memorandum on the legislation.gov.uk website.

11. Regulating small business

11.1 The legislation does not apply to activities that are undertaken by small businesses.

12. Monitoring & review

12.1 The instrument does not contain a requirement to conduct a separate review in relation to it.

12.2 The Economic Secretary to the Treasury, Stephen Barclay MP, has made the following statement:

"In my view, and having had regard to "Small Business, Enterprise and Employment Act 2015 – Statutory Guidance for Departments", it is not appropriate to make provision requiring the review of the provisions of the Risk Transformation Regulations 2017. Such a provision would be disproportionate taking into account the economic impact of these Regulations."

12.3 HM Treasury will however work with the PRA and FCA to monitor the practical effects of the instrument.

13. Contact

13.1 James Usmar at HM Treasury (telephone: 020 7270 5838 or email: james.usmar@hmtreasury.gsi.gov.uk) can answer any queries regarding the instrument.