Institute
and Faculty
of Actuaries

Insurance Linked Securities

IFoA response to HM Treasury

29 April 2016

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Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

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

29 April 2016

Dear Sirs

IFoA response to HM Treasury Consultation: Insurance linked securities (ILS)

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to this call for inputs. Members of the IFoA who work in general insurance have contributed to this response. We have limited our response to those questions where we can offer specific comment.

General comments

2. The IFoA is supportive of the general recommendations of the consultation. However, there are areas that require further work to ensure the smooth operation of a market, in particular, the speed of the approval process and the functions undertaken by the core and the cells in a PCC. We would be willing to meet with HM Treasury and the PRA to discuss these matters further.

Q1: Are collateralised reinsurance and CAT bonds the right focus for initial development of an authorisation process for ISPVs in the UK?

3. Yes. The IFoA considers that development of a new authorisation process should commence with existing products. The figures quoted in paragraphs 1.6 (for CAT bonds) and 1.7 (for collateralised reinsurance) in the consultation show the significance of these products. There may be a need to consider longer tail non-life risks, or life risks, if the market develops further.

Q2: What other forms of ILS should we focus on as we continue to develop the approach for supervision?

4. The IFoA would encourage HM Treasury to consider including Sidecars as an initial focus. The following two other specific contracts may fall within the initial approach for supervision:

- Industry Loss Warranties (ILW) are of significant size; and
- Insurance based swaps could also be included, particularly if they are not fully collateralised.

Q3: Do you agree that ILS investments should be restricted to sophisticated investors?

5. Yes. ILS are complicated products. They are not easy to understand and would be beyond the understanding of most investors. In particular, there may be difficulty understanding the underlying risks of the securities.

Q4: 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?

6. The regulatory framework should not restrict development of the ILS market. Consequently, we would support the possibility of creating a secondary market within regulations and/or guidelines. It may be that enabling the possibility of such a market may allow market participants to develop it. Permitting a secondary market to develop would be worthwhile. However, the regulation would have to enable it to work, rather than making it restricted by dis-proportionate regulation.

7. We recognise that the current trading in ILS is more likely to be Over-the-Counter and is not liquid. Therefore, the trading platform may only function initially as a mechanism for matching buyers and sellers. As noted in the previous paragraph, the platform may be for future development.

8. In terms of specific features, we would suggest that HM Treasury and the PRA should establish the platform to reflect current practice. Yet, as we noted in the previous paragraph, we would also encourage consideration of how it could work. Other than recognising the overall look of a market, the IFoA would regard liquidity as the key feature of the secondary market.

Q5: What do you think would constitute a similar arrangement under the S2 Directive?

9. The IFoA believes there would be similarities between ILS and co-insurance, parametric/ industry triggers, or swaps. We would encourage Treasury to consider which of these would to the most suitable arrangement for ILS, although the triggers noted may be regarded as reinsurance.

Q6: How important do you think these similar arrangements will be to development of the ILS market?

10. Reinsurance seems to work efficiently for the current market, but we would draw your attention again to our comments in response to Q5. Parametric, or industry, triggers will often simplify analysis and settlement.

11. At a minimum, we would encourage HM Treasury to establish regulation that would allow the use of co-insurance or swaps. In the development of the market, it is possible that the initial vehicles used may not be the best long-term solution. Regulation that allows further innovation would be the most effective.

Q7: Do you consider the two stage approach set out above feasible?

12. We agree that the two stage approach is feasible. However, there is a risk that there may be a repetition of Stage 1 of the process. Given the nature of these contracts, there is a requirement to rapidly complete the work. This would require the PRA to approve specific contracts quickly. Any re-visiting of Stage 1 could hinder the timely completion of contracts, or, indeed, cause the abandonment of them.

13. We would encourage a comprehensive and robust approach to Stage 1 that would enable all parties to complete their Stage 2 responsibilities quickly.

Q8: 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?

14. Our response to the previous question placed a responsibility on the PRA to complete Stage 1 in the best manner possible. Stage 1 should be sufficiently comprehensive that would enable limited rapid Stage 2 completion.

15. If users of mISPVs depart from the agreed Stage 1 approach, they should not expect rapid Stage 2 conclusion. We would also encourage a flow of information between the PRA and users in order that Stage 1 changes could be dealt with in an efficient manner.

16. Our conclusion for the operation of a two stage approach is that all market participants should engage in very broad discussions around the nature of Stage 1. Such discussions would allow Stage 2 to be as efficient as possible. We also consider that if participants understood that their use of mIISPVs would develop over time, the two stage approach would encourage early discussion of possible changes to Stage 1.

Q9: 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?

17. We would not be too concerned about the exact nature of notification periods. However, 14 days would seem reasonable, provided all arrangements were within the agreed Stage 1 approach. The maximum period should not exceed 28 days, although we recognise that commercial viability could place downward pressure on that period. In any case, we would expect the PRA to have a specialist team in place in order to complete Stage 2 approvals in a timely manner.

Q10: Do you think that ISPVs would use a Chief Actuary? If not, why?

18. The liabilities within an ISPV are well defined. The ISPV would not function like a normal insurance company. Consequently, there would not be a need to have a Chief Actuary. However, that would not prevent the ISPV using one.

Q11: 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?

19. While an ISPV does not function like a normal insurance company, its day-to-day operations are not any different. Consequently, we would anticipate that normal outsourcing arrangements would apply. Typical examples of outsourced functions are claims, accounting and investment operations. We would not envisage any differences to oversight arrangements for ISPVs.

20. The oversight arrangements should include clarity around the contractual basis for outsourcing, ensuring that reliable providers have been chosen and that alternatives have been considered.

Q12: What supporting material for the authorisation process would you find useful for the PRA to issue?

21. We would encourage the issue of the following:
- Comprehensive templates for approval applications;
- Timetable requirements;
- FAQ documentation; and
- Guidance documentation (including responses to questions in the consultation paper).

Q13 Do you think "pre-application engagement" as described above would be a useful part of the application process?

22. We fully support the use of a "pre-application engagement." The detail set out in 2.27 of the consultation paper would form the basis of constructive discussions during that period.

Q14: What is your view on a possible 6 to 8 week timeline for authorisation of relatively standard ISPV transactions?

23. This time period would appear long for the conclusion of authorisation; particularly if users and regulators had engaged extensively in Stage 1 (our response to questions 7 and 8 provides the basis for this response). While this period could be commercially viable, it would be undesirable and could result in the use of alternative solutions, most likely reinsurance.

Q15: Do you have views on additional documentation that could be submitted by applicants to facilitate faster review by the PRA?

24. While there is no list that would cover every possible scenario to ensure fast completion, a useful starting point would be information typically provided to ratings agencies for CAT bonds. We would recommend the use of the following documentation:
- SIMR material;
- Detailed business plans;
- Structure; and
- Information on proposed counterparties.

Q16: 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?

25. The standard transaction should be between established market participants who use well-established, and understood, mechanisms, controls and outsourcing. The most obvious forms of transaction that would fall into the "standard" category are CAT bonds, or collateralised reinsurance transactions, covering standard perils. Such transactions would use indemnity triggers or well established indices.

Q17: In designing a UK framework for ILS business, what ownership arrangements for the ISPV do we need to provide for?

26. The aim of the consultation paper can be achieved by having a limited liability/limited purpose entity that does not necessarily have orphan status. Different jurisdictions provide for different structures of SPVs (not necessarily ISPV's). We would encourage HM Treasury to review how SPVs operate in a variety of jurisdictions to ensure the best outcome.

Q18: Are there circumstances in which investors or an investment fund might own the ISPV?

27. Yes; however, ensuring independence and bankruptcy remoteness from the ceding company are important principles to follow. In addition, investors should have a limit on their liability.

Q19: Do you agree that the UK framework for Insurance Linked Securities business would benefit from a PCC regime?

28. We agree with this proposal. If the structure of the framework is to attract ILS to the UK (as set out in 1.14 of the consultation paper) a PCC regime would be extremely beneficial.

Q21: Do you think it sensible for a PCC to create new cells by board resolution?

29. We agree that this is the best approach, but as we set out further in our response to Q23, there must be safeguards for existing cells.

Q22: What should the respective responsibilities of a PCC core and cells be?

30. We would support flexibility in response to this aspect to ensure that the market can develop. Failure of the core should not jeopardise reinsurance, or investor, claims on the underlying cells. If the core has responsibility for key tasks, or functions, for the cells, these should be as robust as any third party outsourcing.

Q23: How should arrangements be made between the core and cells so that the core is funded to manage the PCC as a whole?

31. We would encourage the PRA to set out "best practice". However, the exact arrangements should remain within the gift of the company. We would encourage inclusion of the arrangements within the company's Articles of Association to ensure they could not be altered. We also highlight our comments in the previous paragraph in response to this question.

Q24: Should regulation cover how the core is funded by individual cells?

32. We do not consider that regulation would be necessary here, but incorporating funding requirements in the Articles of Association would make them difficult to amend and would also provide clarity.

Q25: 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?

33. The IFoA agrees with the approach suggested.

Q26: What do you think would be an appropriate style for the name of a PCC? Is "PCC" too similar to "PLC"?

34. PCC is a common term in use. The investors who function in this market are professional investors; therefore, there is no clear need to change the name.

Q27: 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?

35. The IFoA agrees that this would be good governance.

Q28: What should happen if directors fail to discharge this duty?

36. The usual penalties for directors failing to discharge their duties should also apply in this situation.

Q29: Do you have any view as to how non-contractual liability should be allocated within a PCC?

37. The IFoA considers that this liability should be the responsibility of the core. These liabilities are likely to relate to tasks the core performs. However, any such allocation should be clearly set out, although professional investors should understand the structure of the PCC

Q30: 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?

38. As with our response to Q29, the core has a specific function to play. If there is a lack of clarity around contractual terms, the core (ultimately sponsors, owners and directors) should accept the responsibility. That reasoning does not provide counter-parties with a reason to fail to understand the terms of their contractual arrangement with the PCC.

Q31: 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?

39. The IFoA agrees with this proposal.

Q32: 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?

40. In order to maintain bankruptcy remoteness of each cell, there should be segregation of assets across cells.

Q33: 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?

41. Different cells should ensure there is confidentially between them. This would assist in ensuring that cells limit any conflicts of interest.

Q35: Do you think it necessary that different parts of a PCC be able to contract with each other? If so, for what purposes?

42. Cells may wish to co-insure, or jointly outsource. This would not suggest they had a contractual relationship to outsource to each other. In some circumstances, although alternatives would probably exist, cells may reinsure, or outsource to, each other.

Q36: 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?

43. Our response to Q35 indicates that there may be limited reason, if at all, to contract with each other. If they did contract with each other, the disclosure requirements to regulators, investors and the insured would provide a framework for this to happen.

Q37: Do you agree with the proposed approach to the addition and dissolution of cells in a PCC?

44. We generally agree with the proposed approach. However, there may be a requirement to enter into a Scheme of Arrangement to ensure that tail risk issues are addressed completely.

Q38: Do you agree that it will not be necessary to make insolvency proceedings available for individual cells of a PCC?

45. There must be a mechanism for to cells to continue. We would encourage HM Treasury to engage in broader discussion to determine the most effective means of a cell continuing to meet its requirements.

Q39: If not, what insolvency arrangements should be available for individual cells?

46. Cells should be in a position to close down the Core and to request transfer to another party that would be in a position to carry out the Core's obligations.

Should you wish to discuss any of the points raised in further detail please contact Philip Doggart, Technical Policy Manager (Philip.doggart@actuaries.org.uk / 0131 240 1319) in the first instance.

Yours faithfully

Colin Wilson
President Elect, Institute and Faculty of Actuaries