

KEY POINTS

- Three years after the implementation of the EU Reinsurance Directive, and the complementary tax regulations, UK Insurance Special Purpose Vehicles ('ISPVs') continue to be rarely used.
- Except for a few ISPVs which have been established in Ireland, the clear majority of special purpose vehicles used to reinsure catastrophic risk have (to date) been established outside the EU, principally in the Cayman Islands or Bermuda.
- A legitimate question may therefore be asked as to why do offshore jurisdictions such as Bermuda continue to be the jurisdiction of choice for these transactions?

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Sleeping giants: insurance alchemy and Insurance Special Purpose Vehicles

An area of capital markets that continues to evolve and elicit a healthy interest from investors is the market for insurance-linked securities and derivatives. This demand, coupled with the need for UK insurers to improve their regulatory capital positions has resulted in an increased focus on the UK's regulatory regimes. Traditionally, insurance companies have managed their risks using reinsurance contracts with regulated reinsurers. Beginning in the 1970s, offshore jurisdictions such as Bermuda grew into the primary global insurance centres focusing on reinsurance and insurance for large companies. This was primarily a result of the benefit afforded by the regulatory and tax regimes in these offshore jurisdictions. For instance, unlike insurance companies in some EU jurisdictions (including the UK), Bermudan insurance companies were permitted to take on additional risks using derivatives.¹ This led to the development of 'transformer' companies that allowed the intermediation between insurance and the capital markets risk transfer. However, with the implementation of the EC directive on reinsurance (2005/68/EC) (the 'Reinsurance Directive') in the UK and the development of Insurance Special Purpose Vehicles ('ISPV') the possibility of situating these transactions onshore has become a viable proposition, both when viewed in a regulatory and a tax context. The ISPV regime which has been established in the UK had its genesis in the Reinsurance Directive which was intended to harmonise the regulation of reinsurance across the EU, allowing member states to codify regulations which facilitated the establishment of ISPVs for the purposes of accessing the capital markets or to act as a traditional or financial reinsurer. For the purposes of the Reinsurance Directive, an ISPV is 'any undertaking, whether incorporated

This article traces the regulatory and tax evolution of Insurance Special Purpose Vehicles ('ISPV') in the UK. It examines the benefits these structures may offer to insurers and looks into why such vehicles have not yet attracted the attention of insurers in comparison with their offshore counterparts.

or not, other than an existing insurance or reinsurance undertaking, which assumes risks from insurance or reinsurance undertakings and which fully funds its exposure to such risks through the proceeds of a debt issuance or some other financing mechanism where the repayment rights of the providers of such debt or other financing mechanism are subordinated to the reinsurance obligations of such a vehicle'.² An FSA Consultation Paper, CP06/12 'Implementing the EU Reinsurance Directive' ('CP06/12'), was published in June 2006 setting out proposals for implementing the Reinsurance Directive and, among other measures, setting out proposals to facilitate FSA authorisation of ISPVs in the UK market.

Identical to offshore 'transformer' vehicles, ISPVs offer a type of alchemy whereby insurance can be transformed into an investment offering to the capital markets or vice versa notwithstanding the prohibitions contained in INSPRU 1.5.13. For example, an ISPV allows an insurer or pension fund to transfer pure longevity risk (using a swap) that can be otherwise only be reinsured in the traditional reinsurance market. This is possible because the ISPV, while fully authorised to write reinsurance, is subject only to certain minimum authorisation and prudential requirements which are proportionate to the risks posed by the structure, is required to be 'fully funded' and is subject to a simple solvency rule that the assets of the ISPV should always be greater than or equal to its liabilities. The Reinsurance Directive contains the preferential authorisation rules for ISPVs where they can be authorised relatively

quickly on the basis of less information and with greater emphasis on self-certification. The ISPV solvency is monitored by the FSA through its statutory accounts and it is not required to submit a separate regulatory return.

The FSA had expressly recognised in CP06/12 that regulatory changes under the Reinsurance Directive should be accompanied by corresponding changes to the UK tax regime.³ A different basis on which to tax the profits of a UK ISPV compared to other UK insurance companies was required partly because UK insurance companies are taxed by reference to certain entries calculated for the purpose of their regulatory returns, which UK ISPVs would no longer be required to produce in all cases. HM Revenue & Customs ('HMRC') at first contemplated bringing certain ISPVs directly within the UK's permanent securitisation regime under the Taxation of Securitisation Companies Regulations 2006 (the 'Securitisation Regulations').⁴ These regulations simplify the taxation of securitisation companies, disapplying the usual UK corporation tax rule for computing taxable profit in order to enable the securitisation company to achieve tax neutrality and optimal credit rating. However, the Securitisation Regulations require, subject to certain exceptions, that all payments received by a securitisation company to which the Securitisation Regulations apply must be paid out within 18 months of the accounting period in which they are received. In HMRC's view, this so-called 'payments condition' protects the UK tax base from 'money box' arrangements where cash is simply allowed to

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roll up, tax-free, in the securitisation company. The inclusion of the payments condition was seen by HMRC as the *quid pro quo* of applying the corporation tax charge only to the 'retained profit' of the securitisation company (ie the profit specified in the transaction documents – usually a small turn of a few thousand pounds). Such a requirement was not practical in the context of an ISPV (owing to the INSPRU requirements regarding an ISPV's assets and liabilities and the need for an ISPV to offer reinsurance over a longer period than 18 months) and a different approach was set out in the draft regulations published by HMRC in August 2007 to remedy this difficulty.

A separate regime for 'insurance securitisation companies' was introduced under the Taxation of Insurance Securitisation Companies Regulations 2007 (SI 2007/3402, the 'ISC Regulations') with effect for accounting periods beginning on or after 1 January 2007 and current on 4 December 2007, and subsequent periods of account.

"The ISC Regulations ... facilitate the issuance of listed securities into the capital markets by an ISPV."

ACCOUNTING AND TAX TREATMENT OF INSURANCE SECURITISATION COMPANIES IN THE UK

Under the ISC Regulations, the corporation tax treatment of insurance securitisation companies is based on the company's profits as calculated in accordance with UK generally accepted accounting practice ('UK GAAP') as it stood at 31 December 2006 (with the exception of FRS (Financial Reporting Standards) 26), thereby removing any volatility in an insurance securitisation companies' tax computation which would otherwise be caused by the fair valuation of financial assets and liabilities in accordance with IAS (International Accounting Standards) 39 (and its incorporation into UK GAAP under FRS 26).

The application of UK GAAP to insurance securitisation companies was

necessary to avoid some of the volatility created by the move towards IFRS (International Financial Reporting Standards). With effect for periods of account beginning on or after 1 January 2005, listed companies were required to use IAS for their consolidated accounts. For periods of account beginning before 1 January 2005, a securitisation company would generally recognise a small, predetermined profit over the life of the transaction in accordance with UK GAAP. The introduction of IAS 39, and with it the requirement to recognise financial assets and liabilities on a fair value basis meant that it would no longer be possible to achieve certainty in all cases as to the level of the accounting profit that would be realised by the securitisation company. For instance, fair value profits could have arisen on the movements in the market value of the financial assets held by the securitisation company in circumstances where the securitisation company did not have enough cash to meet its tax liability. The expected replacement of

IAS 39 with IFRS 9 is unlikely to alleviate these problems as derivatives held by ISPVs (and securitisation companies generally) will still have to be fair valued. The downside of continuing to apply UK GAAP, however, is that it is likely to become increasingly difficult over time to access the necessary expertise as to the application of UK GAAP.

The UK tax regime for 'insurance securitisation companies' mirrors the regime for other traditional securitisation companies by allowing note-issuing companies and intermediate borrowing companies to be creditors of 'insurance securitisation companies'. Importantly, however, an 'insurance securitisation company' can itself be a note-issuing company under the ISC Regulations. The ISC Regulations therefore facilitate the issuance of listed securities into the capital markets by an ISPV, but also

enable an ISPV to act as an intermediate company in a larger structure which may include other note-issuing companies within the Securitisation Regulations.

'Insurance securitisation companies' under the ISC Regulations are therefore, for tax purposes, a sub-set of ISPVs in general. The definition of an ISPV for the purposes of the ISC Regulations is 'any undertaking which assumes risk from insurance or reinsurance undertakings and which fully funds its exposure to such risks through the proceeds of a debt issue or some other financing mechanism where the repayment rights of the providers of such debt or other financing mechanism are subordinated to the reinsurance obligations of the undertaking'.⁵ This essentially reflects the regulatory definition given in the FSA Handbook and is ultimately derived from the Reinsurance Directive. An 'insurance securitisation company' is an ISPV:

- the debtor relationship liabilities of which are owed wholly or mainly to a note-issuing company or an intermediate borrowing company within the Securitisation Regulations; or
- which is a party as debtor to a capital market investment which is part of a capital market arrangement under which the total value of capital market investments made is at least £10m, and which issues securities which represent the capital market investment wholly or mainly to independent persons;

and, in each case, which does not have an 'unallowable purpose'⁶ at any time.

The effect of these rules therefore is to allow an ISPV falling within the ISC Regulations to be taxed on the small predetermined profit calculated in accordance with UK GAAP that is recognised over the life of the transaction.

BENEFITS OF AN ISPV STRUCTURE

An ISPV offers traditional insurers several benefits when seeking to access the capital markets:

- (a) it is authorised to write re-insurance;
- (b) it offers insurers regulatory capital relief;
- (c) capital markets investors can have

exposure to insurance risk without having to take on less transparent insurer solvency and credit risk;

Moreover, the concern with capacity for mortality and longevity risk has led to a number of bespoke solutions for the transfer of such risks using a blend of ISPVs, reinsurance and swaps. This has focused interest on the use of ISPVs as an important component in the wider process of achieving effective risk transfer.

The utilisation of ISPVs as an element of achieving such risk transfers might be complemented by the status of ISPVs under Solvency II. Under the current formulation of Solvency II it is possible that an SPV or ISPV will have a fixed limit on its liability rather than, at the present time, a liability limited to the value of assets held. The cedant may need to retain 5 per cent of the risk transferred to the ISPV. The Directive does permit ISPVs continuing post Solvency II but the detail still remains unclear.

USE OF ISPVs IN PRACTICE

The potential uses of ISPVs may be focused in two areas, namely to raise cheaper funds in the capital markets to underwrite catastrophic risk and to raise capital in a way which allows the monetisation of the value of in-force business of life assurers. Despite the obvious differences between using ISPVs in these two quite separate circumstances there are some attractions of ISPVs which are common to both. Raising funds in the capital markets can be significantly cheaper and easier than raising equity finance or obtaining traditional reinsurance for the same purposes, such as catastrophic risk. ISPVs also offer an opportunity to reinsure risks, provide retrocession (the transfer of risk between reinsurers) or offer contingent finance over a number of years as opposed to a traditional reinsurance treaty which might have only a one-year term.

WHY OFFSHORE JURISDICTIONS?

Despite being in place for a number of years now, the UK's ISPV regime has nevertheless remained relatively unutilised. Except for a few ISPVs which have been established in

Ireland, the clear majority of special purpose vehicles used to reinsure catastrophic risk have (to date) been established outside the EU, principally in the Cayman Islands or Bermuda. However, the UK ISPV regime as described above provides a tax neutral alternative onshore. For a UK insurer to obtain a regulatory capital benefit, an offshore ISPV must comply with the UK's regulatory and prudential requirements for ISPVs notwithstanding its establishment and tax residence outside the UK. A legitimate question may therefore be asked as to why offshore jurisdictions such as Bermuda continue to be the jurisdiction of choice for these transactions?

"ISPVs also offer an opportunity to reinsure risks, provide retrocession or offer contingent finance over a number of years ..."

UK insurers are likely to point to a customary practice of using offshore SPVs for reinsurance or retrocession of catastrophic risk. Historically, offshore jurisdictions offered tax neutrality, an essential requirement for effective securitisation that higher tax jurisdictions such as the UK previously lacked. However, the barriers to using a UK ISPV for such a transaction have been materially reduced. It is important to note that tax avoidance is rarely, if ever, the motivation of locating an ISPV in a tax haven. Yet the benefits of offering capital markets investors a tax neutral onshore solution without the potential 'taint' of an offshore tax haven may appeal to UK insurers, particular if there was to be negative publicity and criticism associated with the use of offshore financial centres by the insurance industry in the future.

A possible argument for the continued dependence on offshore jurisdictions is that the UK ISPV and insurance securitisation regime is untested in practice. The few authorisations that have been granted have been to group reinsurers. However, it appears that no transaction resulting in the issuance of insurance linked securities ('ILS') and utilising a UK ISPV established in accordance with

the Reinsurance Directive have been carried out to date. As such, this might just be a case of the historically prudent insurance industry preferring not to rock the boat. One could argue that such prudence is a direct result of certain quirks in the regulatory regime. For instance, in the area of ILS, a sponsor might choose to transfer risk into an issuer using a derivative. Derivative contracts are typically not considered contracts for insurance. If the risk transfer in to the ILS issuer were carried out by way of a derivative one runs the risk that the structure may not meet the requirements to qualify for regulation as an ISPV.⁷ This is a rather difficult argument to sustain given that the risk transfer in

such structures is typically carried out using reinsurance or counterparty contracts and not derivatives.

A technical argument might also be advanced that an offshore SPV employing certain offshore paying agents may fall outside the scope of the EC Savings Directive.⁸ However, this reason is unlikely by itself to be sufficient to dictate the location of the vehicle issuing ILS. Such an argument is likely to be discounted in practice given that the clear majority of subscribers for ILS are unlikely to be individuals and that customary practice is to use paying agents located within the EU and which are themselves subject to the EC Savings Directive regardless of the tax residence of the offshore SPV. Recent proposals by the European Commission to amend the EC Savings Directive with a view to closing some of the existing loopholes also militates against relying on structures designed to avoid the reporting of savings income or withholding tax imposed under the EC Savings Directive.⁹

From a cost perspective, locating an ISPV onshore could mean potential saving for a sponsor. Since all the parties are in the UK there would be no need for overseas counsel

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Biog box

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as all the documents would be governed by English law. Furthermore, with an offshore transaction there remains an important consideration regarding whether inadvertent actions may compromise the offshore tax residence of the SPV (through some element of central management or control taking place within the UK), or risk creating a permanent establishment in the UK. While both risks should be closely policed, the residual risk of an inadvertent action resulting in difficulties during the lifetime of the transaction remains very difficult to excise completely.

CONCLUSION

Tax and regulatory changes in the UK have meant that since 2007 there have been no significant impediments to prevent UK insurers from keeping ILS and other risk transfer solutions onshore. The continued use of offshore jurisdictions seems to have been driven primarily by a combination of custom and practice and the preference of UK insurers to continue in their use of

offshore jurisdictions for the issue of ILS. It is also possible that the absence of UK ISPVs being used for the issuance of ILS might also have something to do with a lack of familiarity with the onshore structures. Whatever the cause, three years after the implementation of the Reinsurance Directive, and the complementary tax regulations, UK ISPVs continue to be rarely used. The time for waking a sleeping giant seems to be at hand with its concomitant innovation and benefits. ■

- 1 In the UK, INSPRU 1.5.13 says that '...A firm other than a pure reinsurer must not carry on any commercial business other than insurance business and activities directly arising from their business. A pure reinsurer must not carry on any business other than the business of reinsurance and related operations ...'
- 2 Article 2.1(p) of the Reinsurance Directive.
- 3 See CP06/12 at para 3.3, p 17.
- 4 The Taxation of Securitisation Companies Regulations 2006, SI 2006/3296 as amended.
- 5 ICTA 1998, s 431(2) and the Taxation of

Securitisation Companies (Amendment No 2) Regulations SI 2007/3401, reg 2(1), (2).

- 6 An 'unallowable purpose' is one where the purpose for which the company is party to the capital market arrangement, any related transaction or any transaction in pursuance of the capital market arrangement is not amongst the business or other commercial purposes of the insurance securitisation company and which may include a tax avoidance purpose where securing a tax advantage for any other person is the main purpose or one of the main purposes of the arrangements or transaction (reg 5 of the ISC Regulations).
- 7 This is a rather strange outcome given that one of the primary legal concerns structuring an insurance linked derivative is to ensure that the derivative is not recharacterised as insurance.
- 8 Council Directive 2003/48/EC on Taxation of Savings Income in the form of Interest Payments.
- 9 Proposal for a Council Directive amending Directive 2003/48/EC, delivered 13 November 2008 (COM (2008) 727 Final).

Equity cures and waivers

STRATEGIC VALUE MASTER FUND LTD V IDEAL STANDARD INTERNATIONAL ACQUISITION S.A.R.L. & OTHERS [2011] EWHC 171 (CH) (CHANCERY DIVISION) (LEWISON J) (4 FEBRUARY 2011)

Ideal Standard International Acquisition SARL (the 'Company') is the parent company of the bathroom furnishings manufacturer. The Company is incorporated in Luxembourg and owned by private equity funds advised by Bain Capital Ltd ('Bain'). The Company and various subsidiaries entered into a senior facilities agreement ('SFA'). Bank of America ('BofA') and Credit Suisse ('CS') were the majority lenders. Strategic Value Master Fund Ltd ('SVMF') held approximately 10 per cent of the loan. BofA and CS sold their interests in the loan to two companies connected with Bain (the 'Bain Lenders'). Before the sale, BofA and CS had asserted that events of default had occurred under the SFA. Following the sale, the Bain Lenders had purported to withdraw the events of default notice and waive them.

The court held that the equity cure made by the Company was valid. SVMF alleged that the money used for the cure was 'round-tripped' within the Ideal Standard group of companies rather than being a true cure for the lenders by the injection of 'new money'. However, the SFA provided that the breach could be cured by additional borrowing and the recalculation was to be made solely for the purpose of ascertaining compliance with the undertaking. The equity cure was not designed to

improve the Company's financial strength and the cure wording provided for additional debt rather than 'new money'.

The court held that the balance sheet test of insolvency of a company was to be determined according to the system(s) of law relevant to that company, not necessarily English law. The service of an acceleration notice was to give the majority lenders a right to make demand; not to substitute repayment on demand for liability to make the scheduled repayments under the SFA.

In relation to the withdrawal of the acceleration notice by the majority lenders, the court held that a party may give up his own rights but not other people's. Giving up the right to rely on rights afforded to the majority lenders was not a waiver of that term and it was available to be used in the future. Therefore the notice withdrawal by the majority lenders was not an amendment to the SFA requiring all lender consent.

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