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LONDON'S ILS HUB TO HAVE A FAMILIAR LOOK AND FEEL

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They say that imitation is the sincerest form of flattery. If that is so then we can presume, following publication of its proposals to create an ILS industry, that London loves Guernsey. They have after all directly copied a number of aspects of our ILS and corporate law regime very closely indeed. However, can success be achieved in this space by simply attempting to replicate the tax, regulatory and corporate environment? And to what extent have these been successfully replicated by London's proposals?

At our ILS Insight event in Zurich earlier this month [July], the event's second panel considered both of these questions and produced some interesting observations, and arrived also at some positive conclusions.

Ever since George Osborne announced the initiative in his 2015 budget speech the Treasury has been looking to make London the centre of this not only in the provision of reinsurance (which has largely been done in London historically anyway) but now also in the formation and administration of the insurance special purpose vehicles used in the execution of the ILS transactions themselves. These have traditionally been undertaken offshore for a variety of reasons as we will discuss, but neither prospectively nor historically is the number of jobs (or income) involved material or significant in the wider London market, which makes Mr Osborne's enthusiasm for the project curious.

Of course, as a full purpose finance centre and world leader in insurance and risk capital it is arguable that London should offer all forms of financial structures but this would hardly seem to warrant the political profile of announcement in a Budget speech.

Giving effect to the Chancellor's plan involves three elements: revised regulatory processes; introducing a tax-exempt status for SPVs; and introducing the concept of protected cell companies into UK law. Between them these three changes replicate much of the environment in which ILS structures have been very successful in Guernsey.

In Guernsey, specific regulatory rules and processes accommodate both the speed of set up and provide crucial operational flexibility that is key for the efficiency of ILS necessary for them to compete with traditional forms of reinsurance capital. Importantly they do so without compromising critical regulatory rigour or giving rise to regulatory arbitrage between the alternative capital models.

London's proposals struggle to deliver these key features as they are working within the constraints of Solvency II and a regulatory regime which is not designed to enable the flexibility and speed of the offshore model. The regulatory regime reflects the scale of London's insurance market and, whilst well designed to handle the traditional large scale and high volumes that form the bulk of London's insurance business, it is less able to deliver the needs of ILS.

London, together with most onshore jurisdictions, also has a substantial regulatory gap as it does not regulate or supervise those providing fiduciary services (trustees, company administrators and directors). The administration of ILS in Guernsey is itself a licensed and regulated activity to which anti money laundering, "fit and proper" criteria and other provisions apply (such as minimum capitalisation and appropriate levels of PI insurance). This ensures a high level of professionalism, efficiency and quality of service, with dedicated IT systems and individuals well versed and qualified in corporate administration as well as professional infrastructure in support.

In contrast to London, Guernsey's bespoke ILS processes and guidance have been developed and designed over many years to deliver exactly the right balance of regulation appropriate for the business. ILS deals also require flexibility in the application of capital and solvency rules. The inability to apply a flexible capital model is likely to impose a substantial additional cost to onshore ILS deals.

In addition, many ILS arrangements are effectively bespoke and the sector is highly innovative. Regulatory oversight needs to be both accessible and responsive to keep up with the industry, something of a speciality of the Guernsey Financial Services Commission where Caroline Bradley and her team are readily available to discuss innovative insurance proposals at relatively short notice.

The second stage of introducing a tax-exempt status of SPV for ILS purposes is a recognition that such structures should not be tax bearing given that the business conducted, service providers and capital providers are all appropriately taxed. This keeps the structure in line with the tax position of conventional wholesale insurance. Whilst this is a natural feature of a tax-neutral environment such as Guernsey, it requires special tax treatment under UK Tax law to achieve the position. This is a provision which could be easily and quickly reversed by regulations passed by a subsequent chancellor less inclined towards mimicking offshore business or tax-free investment activity. In contrast, Guernsey's tax regime has remained largely unchanged and stable since WWII.

Thirdly the introduction of Protected Cell Companies (PCCs) as SPV platforms. These were originally designed and introduced in Guernsey in 1997. Since then the technology has been widely copied and utilised in many jurisdictions in a variety of corporate and finance contexts. In many people's view, it is high time the UK availed itself of this highly versatile corporate structure.

PCCs have been widely written of elsewhere and I do not intend going into detail about them here. Suffice to say that they provide for the segregation of liabilities and associated assets within a single corporate structure. This allows the segregation of the specific risks and assets of an ILS arrangement to be so segregated whilst allowing a single governance and corporate structure to oversee multiple disparate arrangements.

Here London has faithfully copied the essential elements of the basic PCC model developed by Steve Butterworth and Nic van Leuven 20 years ago. Given that it has proved robust across multiple legal systems (including the English law system in Guernsey) for so long a period there was little sense in reinventing the wheel.

However, most ILS structures now are using incorporated cell companies which offer a number of governance and segregation advantages. London might look at copying this to bring their offering into line with current preferences if the PCC is unsuccessful.

Of course, London as the home of Lloyd's could well innovate new structures based on their own core strengths. This could provide exciting new alternatives to the ILS industry.

Some years ago, the then Lord Mayor described the Channel Islands as 'London off-shore' and I have always been very comfortable with this description. As part of the London offering we have a number of key functions, and one of the main ones is as an innovator and as a laboratory location where new ideas can be developed and tested. ILS is another example of how this works in practice and a great demonstration of our symbiotic relationship with the City.

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