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Fifth Delegated Legislation Committee

DRAFT RISK TRANSFORMATION
REGULATIONS 2017

DRAFT RISK TRANSFORMATION (TAX)
REGULATIONS 2017

Wednesday 29 November 2017

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The Committee consisted of the following Members:

Chair: PHILIP DAVIES

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| † Barclay, Stephen (<i>Economic Secretary to the Treasury</i>) | † Mills, Nigel (<i>Amber Valley</i>) (Con) |
| † Blackman, Kirsty (<i>Aberdeen North</i>) (SNP) | † Murray, Mrs Sheryll (<i>South East Cornwall</i>) (Con) |
| † Drax, Richard (<i>South Dorset</i>) (Con) | † Philp, Chris (<i>Croydon South</i>) (Con) |
| † Frith, James (<i>Bury North</i>) (Lab) | † Reynolds, Jonathan (<i>Stalybridge and Hyde</i>) (Lab/Co-op) |
| Hodge, Dame Margaret (<i>Barking</i>) (Lab) | † Smith, Henry (<i>Crawley</i>) (Con) |
| Kendall, Liz (<i>Leicester West</i>) (Lab) | † Smith, Jeff (<i>Manchester, Withington</i>) (Lab) |
| Lammy, Mr David (<i>Tottenham</i>) (Lab) | † Stuart, Graham (<i>Beverley and Holderness</i>) (Con) |
| † Lee, Ms Karen (<i>Lincoln</i>) (Lab) | Gail Bartlett, Claire Cozens, <i>Committee Clerks</i> |
| † Lopez, Julia (<i>Hornchurch and Upminster</i>) (Con) | † attended the Committee |
| † Mercer, Johnny (<i>Plymouth, Moor View</i>) (Con) | |

Fifth Delegated Legislation Committee

Wednesday 29 November 2017

[PHILIP DAVIES *in the Chair*]

Draft Risk Transformation Regulations 2017

2.30 pm

The Economic Secretary to the Treasury (Stephen Barclay): I beg to move,

That the Committee has considered the draft Risk Transformation Regulations 2017.

The Chair: With this it will be convenient to consider the draft Risk Transformation (Tax) Regulations 2017.

Stephen Barclay: It is a pleasure, Mr Davies, to serve under your chairmanship. The regulations introduce a bespoke regulatory and tax framework for insurance-linked securities business in the UK, completing a process that was announced at Budget 2015.

Insurance-linked securities enable insurers and reinsurers to transfer risk to the capital markets. That is an important and growing part of the global specialist reinsurance market. As of 2017, more than \$90 billion-worth of insurance-linked securities have been issued. However, despite the importance of London as a global insurance hub, the rapid growth of the insurance-linked securities market has taken place elsewhere. That is why at Budget 2015 the then Chancellor announced that the Treasury, the Financial Conduct Authority and the Prudential Regulation Authority would work closely with the London insurance market to develop a fit-for-purpose framework for insurance-linked security business in the UK.

The regulations comprise four main elements. First, the regulations provide for UK regulators to apply a new authorisation and supervisory regime for the vehicles that issue insurance-linked securities in the UK. Secondly, the regulations introduce a new type of company called a protected cell company to enable multiple deals to be managed in a single company. Thirdly, the regulations set out the rules for the issuance of securities by protected cell companies, so that the interests of protection buyers and investors are protected. Finally, the tax regulations set out an appropriate and straightforward tax treatment for the transformer vehicles that issue these securities.

The Government are also introducing a new form of corporate body called a protected cell company in these regulations. A protected cell company allows for the efficient management of multiple insurance-linked security deals within a single company, rather than establishing a new vehicle for each individual deal.

The structure of a protected cell company requires each to be held in a cell, with each cell's assets and liabilities ring-fenced from one another. That type of structure is already common in the insurance-linked securities market but has not been available in the UK until now. The PRA and the FCA will carefully supervise protected cell companies, with the PRA ensuring that each cell is fully capitalised.

The regulations ensure that only sophisticated or institutional investors can be offered insurance-linked securities in the UK and take on this risk. These are complicated financial instruments and it would be wrong for retail investors to be able to purchase them. Finally, the risk transformation tax regulations set out an appropriate and straightforward tax treatment for transformer vehicles that issue these securities in the UK.

To ensure that UK transformer vehicles are competitive and straightforward to use, under the regulations tax is charged at the level of the investor rather than the transformer vehicle itself. For UK investors, tax will be charged as normal, according to their circumstances. Non-UK investors will be taxed according to the rules of their home jurisdiction.

That tax treatment follows the policy aim of the UK's existing tax regulations for insuring special purpose vehicles, which is set out in the Taxation of Insurance Securitisation Companies Regulations 2007, a document I know you are very familiar with, Mr Davies. The tax regulations we debate today provide for broadly similar outcomes but in a much more straightforward way.

In conclusion, Members have heard that insurance-linked securities are a growing market. Indeed, 2017 has seen record issuance of insurance-linked securities with more than \$11 billion-worth in this year alone. It is, therefore, the right time for the UK to improve its offer in this market. The regulations have been welcomed by the industry and by the London Market Group, which represents London's insurers and reinsurers. I commend the regulations to the Committee.

2.34 pm

Jonathan Reynolds (Stalybridge and Hyde) (Lab/Co-op): It is a pleasure as ever to serve under your chairmanship, Mr Davies, and it is always nice to find time to talk about insurance.

One of the first visits I made to the City after I became shadow City Minister was to the iconic Lloyd's of London building at the heart of the square mile. It is extraordinary modern architecture with a fascinating history, from simple beginnings as Edward Lloyd's coffee shop to the insurance behemoth we know today, underwriting £30 billion every year. As a country, we should be very proud of the history of the insurance industry and its potential for the future.

The question of opening the insurance market up internationally is therefore of significant importance to the UK. The London Market Group, which, as the Minister said, has contributed in considerable depth to the initiative, has said that greater tax revenues on the insurance-linked securities market may come from an expansion and updating of the legal regime that the regulations cover.

We should always bear in mind the potential risks around securities markets, with the insurance-linked securities market being particularly affected during the global financial crisis and the collapse of the collateralised debt obligations market a decade ago. We also cannot ignore the context. I could not help but notice that the Minister said that this package of measures was announced in the 2015 Budget—that is a long time ago in political terms. Now we face an entirely different landscape, due to our exit from the European Union. I find it odd that the Government are taking this approach to ensuring

the London market is well-equipped to compete globally, while ignoring the elephant in the room, which is that a “no deal” Brexit would cut off the industry at its knees.

We have already seen reports that Lloyd’s has picked Brussels as the location for its new EU subsidiary, given its concerns about retaining access to the single market. The success of the UK insurance market is inextricably linked to cross-border market access and so the sector is perhaps more dependent than any other on the need for sound transitional arrangements. The ongoing validity of insurance contracts across borders is vital to the economy, but we have no insight as yet on the Government’s proposals for mutual recognition.

I have spoken with industry representatives who have made it abundantly clear that Solvency II provisions on equivalence will fall short of what is needed. They have also said that a transition must be agreed by the end of this year to have real value and prevent them from needing to enact their contingency plans.

Without considering the wider context of how the industry will thrive outside the EU, this initiative seems to me to be hamstrung from the beginning. Therefore, I wish to ask the Minister some key questions. First, will he assure the Committee that safeguards will still be in place to secure the stability of the insurance-linked securities market following the adoption of the regulations? Is he comfortable that the processes are sufficient to ensure that there will be no contagion between different parts of the securities market and beyond? Most of all, will he say how the market will continue to operate in the absence of any deal with the European Union, and a hard Brexit taking place? Finally, will he commit the Government to reviewing the legislation after a short period and placing a report in front of the House on the operation of the insurance-linked securities market as a whole and the effect the regulations have had upon it?

2.38 pm

Nigel Mills (Amber Valley) (Con): I have a few words on the regulations before us, rather than generally on the insurance market. I warmly welcome the fact that we are trying to reform our regulatory rules and tax rules to make sure that this kind of work can be done onshore in the UK, rather than offshore in a collection of our overseas territories and Crown dependencies. The right answer for our economy has to be to try to have this work carried out in the UK, rather than risk it all being done offshore. I would hope it would be the right answer for all the investors who would like to get into the market: to realise they can now do the work in a well-regarded, well-reputed, transparent and clean financial market, rather than risk being tainted by the various scandals that sadly seem to exist in some of our overseas territories, where we cannot quite yet convince them to have the levels of transparency that we would like. Perhaps I will not drag the Minister down this line; we will leave it for another day.

I always get a little nervous when we create new tax exemptions. The important thing is to make sure that it applies only to those entities that are carrying out this work and which we intend this perfectly sensible tax treatment for. This market does not work if we tax the investment vehicle rather than the investors.

The definition in the regulations is that it is a company that

“carries out the activity of insurance risk transformation”.

Will the Minister confirm that he is happy that that definition is sufficiently tightly defined so that other people cannot pretend that another activity can be done by one of these companies and be done tax-free, and groups cannot reinsure their own costs and somehow disappear that money from UK tax? I am sure it all links to how the regulations works. The definitions are there, but I cannot see, from what is written in the order, that they are as strong as I would like them to be.

2.40 pm

Kirsty Blackman (Aberdeen North) (SNP): It is an absolute delight to be on a Delegated Legislation Committee. It has been far too long since I had the pleasure of coming to one of these rooms to discuss something incredibly technical. I have several questions for the Minister, following what the hon. Member for Amber Valley said about attracting this kind of work and these kinds of opportunities to the UK.

I am not exactly clear why this stuff does not take place in the UK already, or about the Government’s moves relating to the tax treatment and the enabling legislation that the Minister talked about. This measure was mooted in the Budget in 2015, and this is the follow-through. My concerns are about the assessment of its impact. The legislation has been presented to us, but I am not clear how much tax will come to the UK Treasury as a result of it and what the economic benefits will be. How many jobs will it create, if any?

I am also not clear about the issues that the insurance industry is set to face with Brexit, which the shadow Minister alluded to. It is incredibly concerned about dropping off the cliff edge because of the legislation that means that it can no longer communicate with customers who do not live in the UK if we do not have a deal that covers that with the EU. I am not clear whether this will do any good in countering those issues and concerns—particularly those relating to Brexit.

I am not clear about why this should be exempt from corporation tax. Like the hon. Member for Amber Valley, I have concerns about creating something new that is exempt from corporation tax. I would welcome the Minister’s views on how the Government will ensure that this statutory instrument is used only by the companies and organisations that should be using it.

The shadow Minister called for an assessment, to be published fairly quickly, of the impact of the regulations—an assessment not just of how many times the legislation is used, but of the tax-take that has been lost and the economic benefit that has arisen. Given the Government’s focus on job numbers, it is really important that that comes out more when we discuss new regulations and vehicles.

I think the Minister pretty much answered the question about the requirement to deduct income tax. I understood from what he said that the income tax will be paid by the people who receive it, whichever country they happen to be in. That is why the protected cell company does not need to deduct income tax.

[Kirsty Blackman]

My last question is about the consultation responses. The papers we have state that the 19 consultation responses were largely positive and in favour of the proposal. It would be useful if the Minister could tell us how many consultation responses were sought and/or received from organisations that are not set to benefit directly from the regulations. It would be useful to know how many people who do not have a beneficial interest in them responded to the consultation. If the respondents were all people who will benefit, of course they are going to write back and say, “It’s a wonderful thing.” It would be useful to have a bit more clarity about that. I am sorry I have given the Minister an absolute string of questions, but that is the technical nature of DL Committees.

2.44 pm

Stephen Barclay: I thank Committee members for their probing but very interesting questions about the rationale for this policy. The shadow Minister is right to say that we are proud of the insurance industry in the United Kingdom for its global reach and its potential. He mentioned the context of Brexit. These measures were initiated in the 2015 Budget, but Brexit reinforces the benefit of increasing the UK’s influence over this part of the market, which is already well established but is currently conducted offshore. Bringing it within the UK will give UK regulators—the Financial Conduct Authority and the Prudential Regulation Authority—more influence over it than they have under current arrangements. With Brexit, this is the kind of global business that the UK should be competing in. EU insurers already use these vehicles and deals outside the EU. We are discussing a business that is conducted outside the UK from which the UK has the potential to benefit, as opposed to a business that is currently conducted in Europe.

The shadow Minister raised safeguards. It is important to flag that, unlike conventional reinsurers, these vehicles do not pool risk; every deal must be fully collateralised. A transformer vehicle must raise and hold collateral that is at least sufficient to meet its insurance obligations, so an inherent safeguard is built into the design of these products. A further safeguard—it is important to reiterate this—is that the products can be accessed only by sophisticated or institutional investors, so there is no risk of retail investors failing to understand the products on the market.

Several Members raised the issue of tax. It is important to reiterate that the principle behind this tax treatment

is similar to the way Lloyd’s members are currently taxed on their syndicate participation, albeit the mechanics of how it is achieved are different because of the different legal characteristics of the entities involved. Investors in Lloyd’s are treated as if they had participated in profit-generating insurance activities directly, rather than through an intermediary—a syndicate. Also, a vehicle cannot qualify for this tax treatment without authorisation from the UK regulatory framework—the Prudential Regulation Authority and the Financial Conduct Authority. That is a further safeguard.

The hon. Member for Aberdeen North, who speaks for the Scottish National party, asked, legitimately, whether any tax would be lost as a result of these measures. I reassure the Committee that the UK will not lose any revenue from this tax treatment, as none of the deals concerned are currently domiciled in the UK. There is already a similar treatment for transformer vehicles in UK legislation—the Taxation of Insurance Securitisation Companies Regulations 2007—but that legislation has been too complicated for the industry to use, so the draft regulations simplify the treatment of those vehicles.

It is also worth pointing out that international competitors already offer a similar tax treatment. Without a competitive and appropriate approach to this tax, the UK would lose out on business that is important to the future of our global reinsurance industry and to our position as a world leader in specialist reinsurance business. That was the shadow Minister’s opening point. As I said, UK investors will be taxed in the same way as they would be if they received interest or dividends from any other company. There is not an issue of lost taxation, because this tax will be applied to entities that are not currently domiciled in the UK.

I hope that I have addressed Members’ questions. I commend the draft regulations to the Committee.

Question put and agreed to.

DRAFT RISK TRANSFORMATION (TAX) REGULATIONS 2017

Resolved,

That the Committee has considered the draft Risk Transformation (Tax) Regulations 2017.—(Stephen Barclay.)

2.48 pm

Committee rose.