Distributable profits of long-term (life) insurers

ICAEW welcomes the opportunity to comment on the *Distributable profits of long-term (life) insurers* published by HM Treasury on 15 October 2016, a copy of which is available from this link.

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MAJOR POINTS

1. ICAEW strongly supports the need for an amendment to the Companies Act 2006 (CA 2006) in respect of the distributable profits of long-term (life) insurers. ICAEW raised this issue with HM Treasury and the then Department for Business, Innovation & Skills in December 2014. We have subsequently worked with the Prudential Regulation Authority, the Association of British Insurers, HM Treasury and the Department of Business, Energy & Industrial Strategy to suggest amendments. ICAEW has a particular interest in this area as it, jointly with ICAS, produces the authoritative UK guidance on distributable profits under the Companies Act. In due course, we will update this guidance for the amendments.

2. We support the proposed amendment to the provisions of CA 2006 as a practical way of updating the legislation for the new regulatory regime under Solvency II, notwithstanding the comments we make below.

Urgent need for change

3. The provisions of CA 2006 stipulate that for life insurers profits are to be distributed from long-term funds. However the with the implementation of Solvency II from 1 January 2016 the concept of long-term funds do not exist anymore. This has caused uncertainty among long-term insurers about the legal position of their profit distributions. A change in legislation is needed to reconcile the apparent inconsistency and enable insurers make distributions ahead of 31 December 2016.

4. This is now an urgent issue. If the changes to CA 2006 are not in force before 30 December, life insurers may not be able to pay interim dividends before their financial year-end. This will have a number of consequences for their financial reporting.

Need to refer back to general CA 2006 provisions

5. The amended provisions calculate the distributable profits of long-term insurance business with reference to the Solvency II balance sheet. The existing provisions refer to realised profits and have a clear reference back to the general CA 2006 provisions. The amendments would be improved if they made clear that a dividend can only be paid if an insurer has an excess of net assets over capital and undistributable reserves in its accounting balance sheet.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Do you believe that the new approach is stricter than that laid out in section 831 and thus in the case of a public limited company, a distribution which satisfies the new approach will also satisfy section 831? If not, do the two approaches work together in a consistent way?

6. The amendment sets out an alternative basis of determining distributable profits to the general provisions in CA 2006. It does not set out to distinguish between realised and unrealised profits. We believe that this basis is potentially appropriate. However, an explicit reference should be added to the relevant accounts to make clear that the net asset restriction still applies to plc insurers with long-term insurance business, as explained below.

7. Once IFRS 17, the new accounting standard for insurance contracts is implemented, it may be desirable to consider whether that would provide an appropriate basis for insurers with long-term business to pay dividends and to reconsider whether it remains appropriate to continue to have special rules for this business.

Q2: Is it in fact possible to determine profits, losses, assets, liabilities and relevant deductions relate to which part (life or non-life) of the company? If this is not possible for some items, how would apportionment be possible for these?

8. It is possible to separate profits, losses, assets, liabilities and relevant deductions and determine to which part of the company they relate to. Where apportionment is necessary they are done on the basis of generally accepted accounting principles.

Q3: Are there any unintended consequences that arise due to the approach "A-L-D" (assets – liabilities – deductions) being equal to profits of the company which are available for the purpose of making a distribution, rather than equal to accumulated realised profits less accumulated, realised losses?

9. There is a potential unintended consequence resulting from the "A-L-D" approach using a Solvency II basis rather than an accounting basis for determining distributable profits. It is possible that there might be a surplus in "A-L-D" that is larger than the excess of net assets over capital and undistributable reserves in the relevant (Companies Act) accounts. We believe that a further constraint should be added so that distributions can only be made where there is such an excess in the relevant accounts. It may be possible that this could be achieved if s843A stated that s836 continued to apply, to make the link to the relevant accounts explicit.

10. We also believe that relevant deductions "D" (e.g. pension fund surpluses or gains on investments in qualifying undertaking) should be calculated net of any associated deferred tax.

Q4a: Do you believe the wording in subsection 7(d) achieves the objective of distinguishing between undertakings which carry out the life insurance or reinsurance business and undertakings which represent part of the insurer or reinsurer's portfolio of investments?

11. Notwithstanding our comments in respect of Q4b below, we believe the guidance is sufficient.

Q4b: Do you believe that "undertaking", given its definition within in subsection 8(e), that references "participation" (as defined in Solvency 2) is appropriate in this case? If not, what would be a more appropriate way of defining this deduction?

12. A normal CA 2006 rule is that gains on subsidiaries are not distributable until those are passed up to the parent via a dividend. This is complicated for insurers as they often have subsidiaries which are investment managers. Gains on those investment manager subsidiaries should be treated in the same way as for non-insurance subsidiaries and should be included within the definition of "qualifying undertakings".

13. The complication for insurers is that they might invest in funds managed by their in-house investment manager. Accounting rules mean that these underlying investment funds might themselves count as a subsidiary, even if there are external investors. This is why there is an "except for" exclusion from the definition of a qualifying undertaking. We support this exclusion.

14. However, the proposed s843A(8)(e) could be interpreted to exclude investment managers which are subsidiaries of insurers. The definition of qualifying undertaking should be broadened, and the exclusions narrowed, so that only the investments vehicles are excluded from the definition of qualifying undertakings, not investment managers.

Q4c: Should the cost price of the "undertaking" be adjusted for inflation when determining if/by how much shares at their current value exceed cost price?

15. We do not support such an adjustment. Neither the Solvency II nor the statutory accounts include such adjustments and they would only add to operational complexity.

Q5: Do you agree that the concept of a defined benefit pension scheme is sufficiently clear without further definition? If not, how would you propose it be changed?

16. The concept of a defined benefit scheme is sufficiently clear.

Q6: Can you provide a rationale for including, or not including, Solvency 2 transitional measures as part of the distributable profits figure?

17. We support the inclusion of transitional measures in the technical provisions as part of the distributable profits because their role in the calculation of technical provisions is an integral part of the Solvency II regime on which the CA 2006 approach is based. The PRA has made clear that transitional measures count as capital and, in order for firms to be allowed to apply these measures, they need to have a plan in place for how they will be utilised and the PRA needs to approve this.