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GIRO conference and exhibition 2010
Lis Gibson and Martin White

How Big is Too Big?

A review of the application of the new tax rules for GI reserves

12-15 October 2010

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Agenda

- Thanks
- Quick recap on the tax opinions
- Case Study 1
- Case Study 2
- Update on interpretation of the rules from HMRC
- Considerations in forming an opinion
- What would it take to be unable to sign?

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Thanks

- Working Party Members
  - David Hindley
  - Dix Roberts
  - Martin White
  - Lis Gibson
- Case Study companies
- Additional Support
  - Chris Marinan
  - Jayne Faulkner

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Quick Recap on Tax Opinions

- The Legislation
  - Schedule 11 to the Financial Services Act 2007 – Technical Provisions made by General Insurers
- The Regulations
  - The General Insurers' Technical Provisions (Appropriate Amount) (Tax) Regulations 2009 SI2009/1926
- New rules apply to accounts on or after 31/12/09
- Corresponding tax filing deadline is 31/12/10
- HMRC will respond with any issues by 31/12/11

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Quick Recap on Tax Opinions - continued

- Appropriate Amount

  = UPR + AURR + claims outstanding provision (OS+IBNR)

- Claims Outstanding Provision must satisfy the following:
  - A1: Insurer gives written confirmation “not excessive”
  - A2: Confirmation based on actuarial opinion or other skilled
  - B: Provision derived using prevailing circumstances
  - C: Provision made in accordance with BAS standards
- Otherwise appropriate amount limited to best estimate = mean

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Quick Recap on Tax Opinions - continued

- “Not Excessive”
  - not defined directly
  - “the estimate includes no more than a reasonable margin to take into account the nature or type of risks to which the liabilities relate and the uncertainty in measuring those risks”
- Discounting
  - Not mentioned
  - But fall-back best estimate is undiscounted
- Additional detail – see WP Report GIRO 2009 (10 Aug 2009)

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Case Study 1 – Large UK Insurance Group

- Level of opinion
  - Used FSA return level, which is the sum of a number of Group subsidiaries and which write UK direct business;
  - No existing actuarial reporting at this level, only at various subsets.
  - The Regulations do not foresee this situation
  - they assume discrete entities
  - however HMRC will conduct all their testing using FSA returns so seems a proportionate approach

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Case Study 1 – Large UK Insurance Group - continued

- Approach taken
  - consider scenarios
  - consider the impact of events that might happen but which are not allowed for in central estimates.
  - some scenarios use specific examples to illustrate potential magnitude; others are modelled scenarios.
  - scenarios consider ultimate impact, not just what might be recognised over 1 year
  - Adverse impact was compared with any held margin (at the aggregate company level, not class by class).

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Case Study 1 – Large UK Insurance Group - continued

- Opinion
  – based on the result of the scenario analysis.
  – asbestos risk meant opinion was not difficult.
- Reporting - was a little awkward.
  – TAS-R assumes decision makers need information before making a decision.
  – But opinion made some time after provisioning levels finalised. So nothing to decide!
  – TAS-I brings this report into scope fully but not clear if there is a good fit.

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Case Study 2 – UK companies part of Overseas Group

- Level of Opinion
  - Three legal entities: one large, one medium, one small
- Approach taken
  - consider overall reserve volatility in recent past
  - stress and scenario testing
  - utilise main reserving exercise and its work on uncertainty
  - consider unit risk sizes, especially for small legal entity
  - compare margin with ICA reserve risk capital amount

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Case Study 2 – UK companies part of Overseas Group – cont

- Opinion
  – based on scenarios, and unit risk size considerations
  – clash with ICA reserve risk on small legal entity
- Reporting
  – In tandem with main reserving exercise reporting
  – Report well ahead of tax provisioning timetable
  – Uncertain how much discussion of reasons for judgement was required; how much disclosure of stress calculations?

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Update on Interpretation of the rules from HMRC

- HMRC issued revised instruction in its “General Insurance Manual” published on 12 May 2010
- HMRC intends the appropriate amount to be a risk adjusted best estimate
- HMRC regards discounting as an element, but not necessarily a sufficient element of the appropriate risk margin
- A non-statutory approach is now allowed – one case this year
- Company can elect a tax provision below the reserves carried in the accounts but above a bare best estimate, if supported by an opinion – more details in the Appendix

Considerations in Forming an Opinion

- Reminder from the Legislation:
- “the estimate includes no more than a reasonable margin to take into account the nature or type of risks to which the liabilities relate and the uncertainty in measuring those risks”

Key Issues

- Reasonable
- Nature or type of risks
- Uncertainty in measuring those risks

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Considerations in Forming an Opinion - continued

- Nature or type of risks – some examples
  - Class exposed to shocks 10 years after writing?
  - Class exposed to financial downturn
  - Class exposed to social trends changing
  - Class exposed to latent claims
  - Class exposed to liability inflation drivers
  - Bootstrap generally fails to pick up these key themes, so arguably not suitable for this purpose
  - Uncertainty in measuring those risks – maybe bootstrap?

Considerations in Forming an Opinion - continued

- Group Discussion
  - Who signed a tax opinion in 2010?
  - Who assisted with the work for a tax opinion in 2010?
  - Where any opinions provided without the same person carrying out a full reserve review?
  - If so, was there a full reserve review available from another party with access to them?
  - What considerations were made?
  - What was the level of reporting?

What would it take to be unable to sign?

- How big is too big?
- Group discussion

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- **GIM6620 - Technical provisions: appropriate amount Regulations: the alternative rule**
- In most cases it is expected that the conditions set out at GIM6610 will be satisfied. If they are not, the alternative rule is the relatively simple and straightforward one that the liabilities representing unpaid claims are to be computed as the undiscounted best estimate of the future cash flows in respect of the claims outstanding, and this is further clarified as referring to the mean of their distribution. This is a technical description of the best estimate, but in practice the manner in which it is arrived at will be accepted unless there is good reason to question it with the aid of the Government Actuary.

How Big is Too Big? APPENDIX - 2

A review of the application of the new tax rules for GI reserves

- As the best estimate is not discounted, it will reflect the implicit risk margin outlined at GIM6610. As explained there, some lines of business may justify an additional risk margin, but catering for that would be difficult. This method might therefore sometimes understate the provisions for the period of account. It is, however, unlikely that insurers will use this method creatively (as a kind of provisions disclaimer) because the accounts figure will stand unless an HMRC officer takes the initiative in applying FA07/SCH11, and financial accounting and regulatory reporting rules will ensure that sufficient margin is added to avoid under-provisioning.

- If the company gives notice of a proposed alternative provisions figure, smaller than that appearing in the accounts, and confirms that it is, in the opinion of a skilled person in the terms of GIM6610, a figure that is ‘not excessive’, it should be accepted (without confirming the actual methodology) unless applying the risk factors outlined at GIM6650 there appear to be good grounds for enquiry. The approach should be not to challenge the opinion of a skilled person unless there are sound reasons to do so.

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A review of the application of the new tax rules for GI reserves

- The aim of this approach is to deliver a fair figure for the amount deductible - a risk adjusted best estimate - where confirmation in the terms of GIM6610 cannot be given. It follows that the company should be asked for its assurance that
- confirmation in the terms of SI2009/1926 regulation 5(2) condition A could not have been given
- the figure proposed is both sufficient (regulation 8(7)(b)), and not excessive.
- If these confirmations are not forthcoming the statutory basis will be applied and the HMRC officer will consider whether the accounts figure should in fact stand (FA07/SCH11/PARA1 (2)).