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A FABLE

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CHAPTER 1

"You canNOT be serious!"

NOT so long ago—just before lunch. Just outside Boston.

"Chuck, I'm sorry to throw this at you, but Bill Spendsir wants to see you this afternoon." The words sounded like a death knell in Charles Wiseman's ears.

"Boy that's short notice—if it's about what I think it's about."

"Hey don't worry. Just tell it to him like it is. Remember, we're all on the same side. Besides, your revenues support your operation."

"Alright. Thanks Bud. Oh, what time's the meeting?"

"Straight after lunch. I'd go down around 1.00 p.m."

So that was Wiseman's lunch hour ruined. Not that he need be worried. Concerned yes; worried no. Bill Spendsir had only been on board a month and he'd got everybody jumping. As Executive Vice President and Chief Financial Officer of U.S. Reinsurance Company he'd taken it upon himself to tidy up the whole company. Some thought a sale of the company was in the offing. Some thought increased profitability was the name of the game and that jobs were now at risk. New brooms and all that!

Chuck, however, was far from new, having been with the company since leaving college in '64—just before all the fun started! He'd been head of special risks reinsurance for 7 years and his job was as safe as any. With a team of only 8 he had an annual revenue of over $10 million, and most of that was straight profit. This made Chuck very happy—he was after all on a productivity bonus.

"Maybe he thinks I'm paid too much", thought Chuck. "Couldn't be, he's an American!"

Chuck thought a great deal more for the next hour, worked on some figures, and trudged off to meet his new Executive Vice President. In trying to get away from the 'us and them' syndrome, the executive offices of the U.S. Re were on the 10th floor, the rest of the company being spread over the other 16 floors.

"Hi Mary Beth, is Mr Spendsir in?"

"Oh hi Chuck, yes sure go on in."

"Mr Spendsir, I'm Chuck Wiseman . . ."

"Yes Chuck come on in. Nice to meet you."

Chuck was pleasantly surprised to meet such a genial host. He was also pleased to get his hand shaking arm back in one piece. The aggressive pumping action was noteworthy as was the fact that his hand on return had the same number of fingers as he'd originally held out. Well you never know with CFO's!

"Take your jacket off Chuck. You may as well make yourself comfortable, we could be here a long time. As you'll gather from my accent, I was born in Britain."

"Oh then I am paid too much", thought Chuck.

"I was raised in Britain but I became an American citizen over 20 years ago."

"There's a chance!" thought Chuck.

"I was interested to hear that you have some U.K. business on the books. And for reasons I'll explain later I'd like to learn more about what you've been doing there. I should say that I already know from Bud that you've been trying for over 3 years to break into the market and you've done only 5 deals."

"But they've netted us over $1,750,000. And it's in the bank", said Chuck. "It's better than a smack in the belly with a big wet fish!!"

"And the last deal was over 12 months ago!" replied Spendsir, looking quizzical. Chuck knew Bill Spendsir had done his homework.

"Look Chuck", said Bill, "I have no complaint with the $1¾ million, it's the 'only 5 deals' that interests me. I have some contacts over there and maybe I can help. Maybe I can't, I don't know. Maybe we should give up with that market and put our resources elsewhere. Maybe we should consider a joint venture with a domestic U.K. company—if you already haven't!"

Chuck was confused. He didn't know whether his operations were contracting or expanding. He did know that the new CFO had virtually no papers, files or notes on his desk. In the short time he'd been with the company Bill Spendsir had developed a reputation as a motivator of others. He was an ideas man, not a number cruncher, not a memo writer. He'd certainly got Chuck Wiseman on his toes. Not that that should bother Chuck, he was used to thinking on his feet. As a marketing man he was used to speaking in public and he would apply the same confidence now to his audience of one.

"Alright", said Chuck, "where should I start and how much detail can you take?"

"Tell me the full story. But hey, I'm no actuary, so to some extent keep it simple and I'll pull you up if you lose me. And listen Chuck, I'm going to play devil's advocate a little, but don't let that put you off. I just want to make sure I understand everything."

"Well it started about 4 years ago when I decided to investigate whether there were any surplus relief opportunities in Europe."

"Oh you're into those actuarial terms already", interrupted Spendsir. "I think you should know, if you don't already, that I've come to U.S. Re after several years with the parent corporation and my knowledge of reinsurance is pretty thin. Mind you, some might argue that shouldn't prevent me from doing a ton of business, but nevertheless . . .".

"OK let me take a step backwards", Chuck continued. "If I can recall it correctly, in 1985 at an industry meeting over here, an actuary from a consulting company explained the difference between 'traditional reinsurance' and 'financial reinsurance'. It goes something like:

'traditional reinsurance'—where the nature of the risk is that of a reinsurer making a profit; and he rarely will!
'financial reinsurance'—where the nature of the risk is that of some government body attempting to disallow the effect of the reinsurance; and they most surely will!!

"Whilst not agreeing entirely with the second definition I do feel that in today's market environment it is practically impossible on traditional business to offer competitive rates and a full service and still meet our profit objectives. Some direct writing companies have got so sharp in playing one reinsurer against another that reinsurers might be better off investing in long term bonds rather than long term insurance! Anyway, as you will know, Bill, I have nothing to do with so called traditional reinsurance. My area of involvement is solely in the use of reinsurance as a financial tool."

"You want to explain that a little more?"

"Alright, let's start off with the reinsurance of one small life policy for nothing more than the desire to spread or offload mortality risk. The risk assumption process translates into a financial effect. The payment of a reinsurance premium is a cash flow item; we receive an asset; the asset has to be invested; we earn investment income; we set up a liability; we pay a claim and have reverse cash flow etc. etc. Whatever its original intent, reinsurance definitely brings about changes in accounts, both statutory and tax. Reinsurance affects profits and we're taxed on profits so reinsurance affects taxes. Prior to 1982 we were taxed on investment income and reinsurance impacted on that as well so it affected our tax bill then. Well, we turn the whole thing around and ask 'if reinsurance causes something to happen in our accounts, statutory or tax, then why not use reinsurance to cause the accounts effects we want?' And of course we don't keep it to ourselves we try and help our clients and potential clients with their perceived accounts problems."

"So you're in the accounts studying business now?" asked Bill.

"Not exactly, it's not too hard to find out who has new business strain or who is going to be faced with a big tax bill. There's a pretty active market here in the States so we spend most of our time coming up with new approaches or competing on renewal terms."

"OK", said Bill, "now having gotten ourself a name in this financial planning market, which aspect of it gives us the most revenue, the statutory or the tax side?"

"Well, prior to '82", said Chuck, "we were doing really well on the tax planning. The so called 'Mod Co 820' deals. But we had a change in law that put a stop to all that and so we moved our energies into the surplus relief market."

"Oh we're back there again", said Bill with some dismay. "You're going to have to explain this more fully."

"Actually it's quite simple, at least in concept", continued Chuck. "In any event it brings us back to our discussion about the U.K. so why don't I explain it by reference to some material I prepared for U.K. offices?"

"Sounds good", said Mr Spendsir.

"Stated simply", said Chuck "surplus relief is the relieving of new business strain, often in a short term programme, in a way that does not necessarily require the transfer of assets. The traditional way of relieving strain had been by the direct writing office receiving large upfront commissions from a reinsurer with excess surplus. The business reinsured continues in the books of the reinsurer until natural expiry, and so it is truly in the nature of a long term investment made by the reinsurer. He assumes all risks and therefore makes all the profits—or losses as the case may be."

Bill Spendsir was finding it hard to hold back. He knew Chuck was speaking in general terms but he still wanted to add or argue. He decided to do neither. Holding his tongue was something he wasn't good at but he knew he had lots to learn. He would wait and see if things got clearer.

"I can see something's bothering you", said Chuck, "but please, allow me some leeway. I'm sure you don't want a full discussion on the pros and cons at this stage. As you'll see with regard to the U.K. this discussion is of academic interest only."

"Go ahead", said Bill, "I can see you read minds as well as sell reinsurance!"

"Alright. Again in general terms there must be something wrong with this traditional method of relieving strain. Excuse me, I don't mean it like that. Let's say, it's not necessarily the most financially efficient way to relieve strain. For example, strain may be looked upon as being caused by an excess of liabilities rather than a shortage of assets. Why solve a liability problem with a commission payment—i.e. a cash flow solution? New business strain may be a problem that lasts only say 5 years or so. Why solve the problem with a 30, 40 year reassurance programme? Why should a direct writer be in business to write long term covers and give long term profits to a reinsurer? If the direct writer believes in the long term profitability of his own product surely he only requires assistance in the short term and thereafter should be happy to receive his expected stream of profits. In other words, you don't just buy a new car because your old one has a flat tyre! Sure it gets you over the original problem but not in the way that makes the most sense!

"So to get over these types of objections we've seen a growth in the last 10 years or so of short term surplus relief programmes in which the reinsurer, rather than paying over cash commissions in year 1, absorbs some form of liability—be that the policy reserves or amounts owed but not paid. In renewal years, income streams from the policies reinsured that would normally be paid over to the reinsurer are instead used to reduce the reinsurer's liability. In this way cash flows are kept to a minimum.

"This is bulk reinsurance with say quarterly, half yearly or annual accounting. At the point when the reinsurer's liability falls to zero the need for reinsurance disappears and the reinsurance agreement terminates. The reassurance programme should mirror quite closely the original new business strain pattern and so the agreement ends as the projected strain period ends."

"It can't be as simple as that?" interrupted Bill Spendsir.

"Well the reinsurance arrangements may look complicated", said Chuck, "but actually both in concept and in practical operation the transactions are pretty straightforward. Last year we solved over $200 million of strain problems. We even had one deal for $40 million of relief which came to us on 30th December and which was signed and sealed by 31st."

"You know, Chuck, you're making me nervous now. I do want to understand this more fully but I think for today let's just keep with the concepts. In particular what were we doing with this business in the U.K.?"

"Well, quite simply", continued Chuck, "we wanted to know if there was a surplus relief market overseas."

"You mean them getting to relieve U.S. strain or us relieving their strain?" asked Mr Spendsir.

"Both", replied Chuck, "though our main interest was their ability to relieve U.S. strain. There's an interesting idea that as each country has its own bases of accounting and establishing reserves then the policy liabilities would have different values in different countries even for the same block of business. So for example, if actuaries in the U.K. could use a higher rate of interest in their valuation than we could, then by ceding business to a U.K. company we could possibly turn $10 million of US strain into say $8 million of U.K. strain."

"Sounds like a great idea", said Bill. "How did it go down?"

"Like a lead balloon!" was Chuck's quick reply.

"How come?"

"Oh many reasons. I think surplus relief as we—I mean American reinsurers—know it, is pretty much an American concept relying heavily on our accounting practices. It was a new idea to U.K. offices. They may never have heard of it before; it involved millions of dollars of accounts items, premiums, reserves, etc. So, overall, I doubt if they could get much comfort over these large scale transactions. Then there were some hefty financial considerations. There's a form of tax in the U.K. called stamp duty which could be levied on imported business. There's the question of letters of credit from the U.K. company to cover U.S. reserve liabilities."

The CFO interrupted, "So presumably the financial benefit to the U.K. office wasn't sufficient to either offset the cost items or enthuse them enough to try to allay their fear of the unknown? What was the financial benefit to them anyway?"

"Well let's just keep with the statutory or cash position for the moment. The U.K. company would get an annual fee, a straight percentage of the U.S. strain assumed. Just as you pay for a cash loan with a percentage interest charge, so too for a 'loan' of the U.K. office's surplus it gets a percentage fee."

"What sort of fee?"

"About 2 to 3% of the amount of surplus hit, per annum. Of course if the U.K.

office uses a more liberal valuation basis then the fee as a percentage of the U.K. strain is higher. But even so, this may well not be sufficient to offset the stamp tax."

"Which is?" enquired Spendsir.

"It's 50 cents for each $1,000 of face amount" replied Chuck. "Except they call face amount sum assured."

"Oh I'm sure there's a different name for it. There is for just about everything else", said Bill.

Chuck continued "So depending upon the nature of the block of business to be reinsured, the method of reinsurance and the relationship between the face amount and the strain levels, it may well not pay a U.K. office to accept this business—although one office suggested we might want to place some business with its off-shore subsidiary but that brought us into questions about U.S. Federal Excise Tax, so switching one cost item for another. Mind you, we did hear of one U.K. office doing a $40 million surplus relief deal, but if they did, they didn't advertise the fact."

"So taking this business to the U.K. is pretty much dead in the water?" asked Bill. "Well what about them sending their strain to us?"

"Oh they'd do that if we came up with attractive cash financing, but we don't even do that here", said Chuck. "On top of that, cash financing would involve us in currency risks. We just don't need it. The other point is that some American surplus relief arrangements have minimal passage of risk and I think the actuary of a U.K. ceding office could little relieve his strain if he felt that sufficient risk wasn't passed away."

Chuck Wiseman went on. "But let's go back to this taking of U.S. Business to the U.K. What we've discussed so far has really been cash flows and statutory accounting and there's an extremely important item which we've got to include."

"TAXES!" interrupted the CFO.

"TAXES!" agreed Wiseman. "Did you know that some English people think that taxes is an American state to the north of Mexico?"

"No", mused Bill Spendsir, "it's their name for yellow cabs!" For once the two executives laughed.

"Alright, enough of this seriousness", said Chuck, "this brings us back to where we came in. While trying to investigate surplus relief in the U.K. I met one pretty sharp guy who saw that he may be able to use surplus relief to help him with his tax problem. Well no that's not quite right. He saw from the surplus relief material which I provided for him that our reinsurance techniques could be extended to create an opportunity in the U.K."

"What did you give him?"

"Oh like we gave most companies, a ton of information! But the thing that caught his eye was this; I think I have it here with me." Chuck quickly brought from the back of his file a couple of typed notes headed 'Surplus Relief'. He put them down in front of his CFO. (Tables 1 and 2.)

Table 1.

SURPLUS RELIEF (IGNORE TAXATION)

DIRECT WRITER—WITHOUT REASSURANCE

$Vo=$	0	$V_1=$	100
$P=$	100	$E=$	10
Loss $=$	10		
	110		110

Strain of 10 to be relieved by reassurance on basis:
90% reserve deposit.
10% reassurance commission.

Cash position:

To Reassurer:	Premium		100
To Direct Writer:	Reserve Deposit	90	
	Commission	10	
			100
	Net cash flow		0

DIRECT WRITER AND REASSURER—WITH REASSURANCE

Direct Writer				Reassurer			
$Vo=$	0	$V_1=$	0	$Vo=$	0	$V_1=$	100
$P=$	100	$RP=$	100	$RP=$	100	$C=$	10
$C=$	10	$E=$	10	Loss $=$	10		
Loss $=$	0						
	110		110		110		110

Strain of 10 has been transferred to reassurer with zero cash flow.

Table 2.

SURPLUS RELIEF

SIMPLIFIED MECHANICS

Ceding Company Without Reinsurance

Revenue Account				*Balance Sheet*			
Premium (P)	100	Expenses (E)	10	Cash	90	Pol. Res.	100
'Loss'	10	Reserve (V)	100	'Loss'	10		
	110		110		100		100

Business Reinsured on Basis:

Ceding company pays reinsurer:	Reinsurance Premium (RP) $=$	P	$= 100$
Reinsurer pays ceding company:	Reserve Deposit (V)	$= 100$	$= 110$
	plus Commission (C)	$= 10$	
Net cash flow to ceding company			10

However, cash flows must be kept to a minimum. The commission item (C) is, therefore, ***not*** paid over in cash but is established as an 'amount owed' by the reinsurer. The ceding company similarly takes credit for an 'amount due' from reinsurer.

Net cash flow now ***nil.***

Table 2 (*continued*)

Accounts Position After Reinsurance

(a) *U.S.A. Practice*

Revenue Accounts

Ceding Company				*Reinsurer*			
Premium	100	Reins. Prem.	100	Reins. Prem.	100	Commission	10
Commission	10	Expenses	10	'Loss'	10	Reserve Dep.	100
Reserve Dep.	100	Pol. Reserve	100			Pol. Res.	0
'Loss'	0						
	210		210		110		110

Balance Sheets

Ceding Company				*Reinsurer*			
Cash	90	Pol. Reserve	100	Cash	0	Pol. Res.	0
Amount Due from Rein.	10			'Loss'	10	Amount Owed to Ced. Co.	10
'Loss'	0						
	100		100		10		10

(b) *Alternative Accounting Practice*

Revenue Accounts

Ceding Company				*Reinsurer*			
Premium	100	Reins. Prem.	100	Reins. Prem.	100	Commission	10
Commission	10	Expenses	10	'Loss'	10	Pol. Res.	100
'Loss'	0	Pol. Reserve	0				
	110		110		110		110

Balance Sheets

Ceding Company				*Reinsurer*			
Cash	90	Pol. Reserve	0	Cash	0	Pol. Reserve	100
Amount Due from Reins.	10	Deposit held on behalf of Reins.	100	Deposit with Ced. Co.	100	Amount Owed to Ced. Co.	10
'Loss'	0			'Loss'	10		
	100		100		110		110

Despite the differences in accounting practices, the strain is passed to the reinsurer without the need to pass cash.

Renewal years

In renewal years, profits made by the reinsurer, which would otherwise be refunded to the ceding company by say the use of an experience refund formula, are instead used to reduce the 'amount owed to the ceding company'. When the 'amount owed' reduces to zero the strain disappears as does the need for reinsurance. The reinsurance agreement can then be terminated.

'Fees'

The reinsurer is generally paid a 'fee', however termed, which is a small percentage of the strain. Each year as the strain reduces then so does the 'fee'. This is somewhat analogous to an interest charge for a cash loan. Here the 'loan' is of the reinsurer's surplus account. It is not of course a loan in the banking sense, repayment being conditional on the emergence of profits under the reinsurance arrangement.

"Table 2 is only a variation on Table 1. It is just simple math to show what happens in the first year. Look at the first example, where the commission is paid rather than owed. The direct writer's strain of 10 is not really caused by a shortage of cash as it still holds a net 90. So it enters into a reinsurance surplus relief programme designed to keep cash flows to a minimum. As you can see, strain passes to the reinsurer whose account now looks like that of the ceding office prior to reinsurance. Well, what this English guy did was to focus on the middle section, the cash position. He noted that the only item that enters into his tax account was his payment of commission, which is a deduction to him. So he could have a tax deduction created without cash flow."

"Wait a minute!" Bill Spendsir needed some enlightenment. "The premium is not taxable income, but the commission is a tax deduction? Then why don't we just ship billions of dollars of reinsurance premiums and get them to pay us smaller billions of dollars in commissions and then the whole industry need pay no taxes? Ever! It can't be that simple, surely?"

"Actually, I think it is. At least from a mechanical point of view it is."

"So how come we've only done 5 deals and made $1\frac{3}{4}$ million?" said Bill with increasing interest.

"Let's get in to that a little later because this isn't the full picture. The answer to your question is even harder to find when you know of the other opportunities there", said Chuck.

"You mean they have other ways of saving taxes? On this sort of scale?" asked Bill.

Chuck could see his CFO beginning to get excited. How he wished he'd been able to produce the same effect with the U.K. offices he had visited.

"Oh yeah", Chuck continued, "but again let's talk about that later. Let me explain where we've got to first, and then get into why we haven't been more successful and what we can do in the future."

"Alright it's your show."

Chuck went on. "So we went to the U.K. to solve a U.S. statutory problem and came back with a U.K. tax opportunity. We found a suitable block of business, entered into discussions, underwriting, risk passage, administration, all the usual reinsurance things—and within 4 days we'd signed a deal and made half a million."

Bill Spendsir just couldn't hold back, "Now wait a minute. Is it simple or isn't it?"

"Bill, with all due respect let me come to that in a minute. It is a pretty big issue. Let's just first of all get things down in the right order."

Bill Spendsir nodded.

"There isn't much more now anyway", said Chuck. "The first deal was with a direct writer. We did a second deal, similar to the first, about 4 months later, this time with a reinsurance company. And that was it till about 18 months ago when we started investigating the opportunity for taking taxable income off U.K.

offices. After about 3 or 4 months we finally signed some deals that give us income over a 4 year period."

"And this income deal, that's a different type of transaction to the first two?" asked Bill.

"Yes it is", replied Chuck. "Let me go back a stage and explain. For purposes of our discussions, life offices in the U.K. can be considered to be taxed on investment income less management expenses."

"Management expenses? Not just investment expenses?" enquired the CFO.

"No, management expenses", said Chuck. "And as a matter of course, or tradition, this has been extended to include the cost of acquiring business, namely commissions. This basis of taxation is often referred to as '*I—E*'. And just to liven things up, it is possible to offset these expenses against chargeable gains."

"You can offset commissions and reinsurance commissions against chargeable gain?" asked Bill.

"I believe so", replied Chuck.

Bill Spendsir had the feeling that he was at one end of a rainbow with the other end dipping into a pot of gold somewhere between Edinburgh and Exeter! He ran his fingers through his hair—it didn't take long, the years had seen to that. He looked at his reinsurance man and said: "Let's get some coffee."

Walking to and from the coffee machine, they conversed about anything but business. Both of them had nothing else on their mind but this was supposed to be a break. No sooner had they got back when they started again.

"Chuck, just go back again and explain this other type of deal you did, the one where you take away their taxable income."

"Alright", said Mr Wiseman. By now he was amazed as to how quickly the Executive VP was catching on to the opportunities. True to form Spendsir wasn't taking notes but he wasn't getting lost either. "Some U.K. offices write short term products—3, 4, 5 years with high interest guarantees; they're called income bonds or growth bonds or something like that. They are single premium products sold pretty much to compete with bank or savings and loan deposits. To compete in the savings market the rates obviously need to be attractive and if a life office is taxed directly on its investment income it can't offer much to its policyholders. So it must have an excess of '*E*' over '*I*', or it must reinsure the bonds with a company that does."

"Or it can bring in expense deductions like the first 2 deals you did", Bill Spendsir interrupted.

Chuck Wiseman was now truly impressed. So much so that he couldn't help bursting forth: "That's right! But in the case in question the company wanted to rid itself of its investment income by reassuring its bonds. We managed to offer better terms than the local companies and got the deal."

"How come we can offer better terms?" asked Bill.

Chuck was ready for this: "We're basically taxed on our profits from the reassurance, so the U.K. deductions aren't worth a great deal to us. On top of that we can supply almost unlimited amounts of deductions. You've no doubt seen the size of our reinsurance portfolio?"

"OK", said Bill, "I think I understand where we create deductions. You want to explain how we take their income? Actually if we take their income we must give them something in return or else it wouldn't be worthwhile them doing the transaction would it?"

"Right again", said Chuck. "What we do is we convert their taxable investment income into non taxable underwriting income. And if you leave out our profit and expense charges we can do this swap pretty much dollar for dollar, taxable income for non taxable income. Here's how it works in principle. This is not specific to single premium bonds, this treatment works for regular premium business also."

Wiseman quickly produced another page from his marketing material. "This is something I left with offices who expressed interest", he said. "No pun intended!" Actually, the heading was altered—just in case!"

Table 3.

CONVERSION OF TAXABLE INVESTMENT INCOME INTO NON-TAXABLE UNDERWRITING INCOME

SIMPLIFIED MECHANICS

Introduction

The following serves to show on a mathematical basis how taxable investment income may be converted into non-taxable underwriting income. Full discussions on the economics of tax saving, business purpose, Treasury views, risk passage, benefit sharing, accounting etc., etc., are beyond the scope of this paper. It is meant only to highlight the basic mechanical principles involved.

Assumptions

Ceding company taxed on investment income (I).

Reinsurer taxed on profits.

Reinsurer will pay death claims (D), surrenders (S), reserve increases ($V_1 - Vo$), in return for reinsurance premiums (P) and investment/interest income (I). In addition, the reinsurer will refund all profits using an experience refund formula:

$$ER = P + I - D - S - (V_1 - Vo).$$

All reinsurance exchanges to occur at the end of the accounting period.

Asset transfers, cash flows to be kept to a minimum. Reinsurer will, therefore, deposit 'funds' with the ceding company to meet liabilities assumed. Interest income (I) must be paid to reinsurer in respect of such 'reserve deposits', and this income shall be calculated by multiplying the deposited fund amount by an appropriate interest rate.

Opening or Initial Transaction

Ceding company selects suitable block of business for reinsurance. Let statutory reserves on block be Vo.

Define Initial Reinsurance Premium = Statutory Reserves = Vo.

Then,

Ceding company pays to reinsurer:	Initial Reinsurance Premium =	Vo
Reinsurer pays to ceding company:	Initial Reserve Deposit =	Vo
Net cash flow:		0

Table 3 (*continued*)

Tax effect on both ceding company and reinsurer *nil.*

End of First Renewal Accounting Period

Ceding company pays to reinsurer: Premiums plus Interest Income $= P + I$

Reinsurer pays to ceding company: Claims plus Reserve Increase plus Experience Refund $= D + S + (V_1 - Vo) + ER$

$$\begin{aligned}\text{Net cash flow to reinsurer} &= P + I - (D + S + (V_1 - Vo) + ER) \\ &= P + I - D - S - V_1 + Vo - P - I + D + S + V_1 - Vo \\ &= \underline{\underline{0}}\end{aligned}$$

This is on a cash basis. Review exchange on a *tax* basis. If the only item of tax consequence is I then the above method provides a *deduction of* I *from the taxable income* of the ceding company. An amount equal to I returns through reinsurance but as non-taxable underwriting income. Tax effect on reinsurer *nil.*

In Practice

As the above renewal transaction algebraically always equals zero, there is no risk passage and therefore no reinsurance(?). The actual terms of reinsurance would allow risk passage, carry forward of reinsurance losses and, of course, the payment of a 'fee' to the reinsurer for assuming risk and for providing the effective mechanism outlined above.

There was then the largest period of silence since the two men met. Spendsir carefully studied the material; Wiseman sat back in confidence. He didn't wish to disturb Spendsir's train of thought but he still had lots to tell. Bill Spendsir looked up and asked: "This 'opening transaction', do you use inforce or new business?"

"Well", replied Wiseman, "at the date of the initial transaction the business is in force, so mathematically it doesn't matter whether it's the inforce from this year's new business or whether it's previous years' issues."

Silence again.

When Spendsir finally raised his head, Wiseman continued his teach-in: "The beauty of the U.K. high income bonds is that as there is virtually no mortality risk then there is no need for an experience refund formula. You simply pay back as a policy benefit an annual bonus or dividend. As it's underwriting income it isn't taxed so it passes straight through to the policyholder."

"What do you mean 'no mortality risk?'" asked Bill.

"Oh I mean from the policyholder's point of view. He pays 1,000 in premium and gets 1,000 of death benefit", replied Chuck.

"Is that a life policy then?"

"Some people over here might think not, but apparently it is over there", said Chuck. "If you want to hear something else that's crazy—they don't guarantee voluntary premature termination values! And they match their assets and liabilities!"

Spendsir's head shot up. "What? How can they lose?"

Chuck responded: "Well they have some brokerages and expenses so early deaths can hit them."

"But still", said Bill and just left it at that. He nodded to himself and then asked: "Where do we get our money in all this?"

"In both cases", explained Wiseman "for both '*I*' and '*E*' deals we charge a fee based upon what worth we bring to the transaction. As we are helping to reduce taxable income then we share in the tax savings of the U.K. office and we usually do this through the commission or premium levels." Changing course somewhat Chuck went on. "Going back to the income bond deal, the strange thing is that the reinsurer receives investment income and pays back a policy bonus, and both payments can be expressed as percentage amounts. So 10% interest say, paid to the reinsurer is tax deductible to the ceding company, but 7% bonus paid back is not taxable income. So the obvious extension is why not get them to cede a block of inforce regular premium business, pay us interest on deposited back assets and then we pay them a non-taxable bonus depending upon mortality experience. In this way, tax planning through reinsurance is open to all. We could even reinsure their participating business."

"Excuse me", enquired Bill, "but what's this about them paying us interest on deposited assets?"

Chuck replied: "Oh like I said before, reinsurance has to be efficient. There is no cash flow problem here so why take cash? Also the tax is on the income not the assets so why take assets? There are some arguments that taking the assets minimizes Revenue attacks on the income not being ours but we fund the policy liabilities out of renewal premiums and interest and so the interest must be ours if we are to pay policy benefits."

"So in a way", Bill interrupted, "it's like us making a loan to the ceding company of the assets it would normally pass us and then they must pay us an interest charge on that loan?"

"I suppose you can think of it like that."

"Very interesting", mused Mr Spendsir. He thought in silence some more. Still he took no notes. "Right, let's get down to the burning question. Why aren't we doing tons of this business?"

Before Wiseman could even attempt to answer Spendsir said: "If I understand what you've told me, and of course if you're right in what you've told me, U.K. life offices are taxed on this '*I–E*' basis plus gains, if I remember rightly."

Wiseman nodded. Spendsir continued.

"Through their reinsuring out we can take all the '*I*' they want to throw at us and give it them back as non taxable income. We can cede reinsurance to them to create millions of '*E*' commission deductions which they can use to offset '*I*' or gains. THEN WHY THE *!*! IS ANYBODY OVER THERE PAYING TAX!?"

Spendsir had raised his voice not because he thought "anybody over there" might hear him but because he was totally mystified. He wanted to ask the same question in many different ways but it still came out the same. He knew from his own experience that U.K. individuals liked personal tax benefits—mortgage interest deductions, private medical covers even company cars—a rarity in the U.S.—surely they must apply the same attitude at the corporate level. He went on: "Look there's got to be something wrong here. Is it our state of knowledge, our marketing techniques or their attitudes?" He was now shaking his head in amazement.

"Alright that's enough of my ranting, put me out of my misery Chuck."

"Oh I'm not sure that I can", said Chuck. "I'll gladly share with you what I picked up on my travels round but even that won't give the full answer I'm sure. But let's start off with the known and then move into the unknown.

"There's nothing wrong at all with the reinsurance techniques. We employed the income conversion method for several years here before 'Mod Co 820' was removed. We've done a handful of '*I*' and '*E*' deals in the U.K. so we know mechanically at least they work there too. Of course we don't profess to be tax experts or give tax advice and where possible we'll gladly work with local advisors."

"And what sort of reaction did you get there?" asked Bill.

"Well", said Chuck, "some consultants only want to advise, they don't want to sell these transactions. One consulting firm that had been involved in these types of transactions refused to have anything to do with us as they already had clients on both sides of the tax fence who they could put together. I even argued that we may be able to offer better terms for their clients but they didn't want to know."

"They wouldn't even allow you to quote terms?" enquired Spensir, more as a statement of disbelief than as a question.

"Oh you haven't heard the half of it yet", said Chuck. "Wait till we get on to the life offices themselves. But first let me explain how we've tried to market financial reinsurance. With my past contacts, attendance at industry meetings, and with the aid of a marketing consultant, we targeted around 100 direct companies for visits. We also maintained and developed contacts with consultants and reinsurers in the hope that we might explore any joint venture opportunities. You know about the consultants! The reinsurers were always courteous but I think they feel that the U.K. is their market and they don't want us to pinch their clients or foul up the market some way. Of the 100 offices, we managed to visit about 70. 20 wouldn't let us in the door, and the rest wouldn't even give us the courtesy of a reply!"

Bill Spendsir broke in: "You've got to be kidding!?"

"Would that I was."

"But why?"

"Seeing as they don't allow us to get into any dialogue with them it's hard to know."

"30% wouldn't even see you! Have we got a bad name over there?"

"No I don't think many of them knew we existed—even if we are larger than any of their own reinsurers", replied Chuck.

"That is amazing! Alright, what about the other 70?"

Table 4.

DIRECT WRITER—NO TAXATION

Year 1		Year 2	
$Vo=0$	$V_1=200$	$V_1=200$	$V_2=233$
$P=100$		$P=100$	Profit = 88
$I=10$		$I=21$	
Loss = 90			
200	200	321	321

Year End Cash $=100+10=110$	Year End Cash $=110+121=231$
$I=10\%\ (100)=10$	$I=10\%\ (110+100)=21$
	Overall Profit $=-90+88=-2$

DIRECT WRITER TAXED ON I AT 50%

Year 1		Year 2	
$Vo=0$	$V_1=200$	$V_1=200$	$V_2=233$
$P=100$	Tax = 5	$P=100$	Tax = 10·25
$I=10$		$I=20{\cdot}50$	Profit = 77·25
Loss = 95			
205	205	320·50	320·50

Year End Cash $=105$	Year End Cash $=215{\cdot}25$
	Overall Profit $=-95+77{\cdot}25=-17{\cdot}75$*

* The overall loss of 17·75 is made up of:

Basic product loss of	2
Taxes $=5+10{\cdot}25=$	15·25
Interest loss on year 1 tax (5) $=$	0·50
	17·75

WITH REASSURANCE TO REASSURER TAXED ON PROFITS AT 50%

(Product reassured on original terms with experience refund (ER) or profit share to return all profits, assets etc. to direct writer

Define $ER_1=Vo-V_1+RP+I-D-S-ER_0$

(where ER_0 is the absolute value of any negative experience refund in the prior years)

Year 1

Direct Writer		Reassurer	
$Vo=0$	$V_1=0$	$Vo=0$	$V_1=200$
$P=100$	$RP=100$	$RP=100$	
	Tax = 0	$I=10$	
	Profit = 0	Tax Benefit = 45	
		Loss = 45	
100	100	200	200

Year End Cash $=0$	$ER=0-200+100+10=-90$
	Tax $=50\%\ (100+10+0-200)=-45$
	Year End Cash $=155$

Table 4 (*continued*)

Year 2

Direct Writer		*Reassurer*	
$V_1 = 0$	$V_2 = 0$	$V_1 = 200$	$V_2 = 233$
$P = 100$	$RP = 100$	$RP = 100$	$ER = 2{\cdot}5$
$I = 0$	Tax = 0	$I = 25{\cdot}5$	Tax = 45
$ER = 2{\cdot}5$	Profit = 2·5		Profit = 45
102·5	102·5	325·5	325·5

$ER = 200 - 233 + 100 + 25{\cdot}5 - 90 = 2{\cdot}5$
Year End Cash = 233

REPEAT YEAR 2 WITH RECAPTURE AT YEAR END

Year 2

Direct Writer		*Reassurer*	
$V_1 = 0$	$V_2 = 233$	$V_1 = 200$	$V_2 = 0$
$P = 100$	$RP = 100$	$RP = 100$	$SV = 233$
$I = 0$	Tax = 0	$I = 25{\cdot}5$	$ER = 2{\cdot}5$
$SV = 233$	Profit = 2·5		Tax = 45
$ER = 2{\cdot}5$			Profit = 45
335·50	335·50	325·50	325·50

Year End Cash = 235·50 | Year End Cash = 0

Overall Profit = 0 + 2·5 = 2·5*

* Overall profit of 2·5 is made up of: Basic product loss of 2
10% interest on reassurer's year 1
tax benefit of 45 = 4·5

REVIEW OF 2 YEAR OPERATION

Reassurer

Overall cash position:	= 0
Overall tax position:	+45 − 45 = 0
Overall profits:	−45 + 45 = 0

Direct Writer

	(*a*) *Without Reassurance*	(*b*) *With Reassurance*
Overall cash position:	= 215·25	= 235·50
Overall tax position:	−5 − 10·25 = −15·25	= 0
Overall profit:	−95 + 77·25 = −17·75	= 2·5

With reassurance the overall cash and profit positions have increased by 20·25. This is made up of:

Taxes saved of 5 + 10·25	= 15·25
Interest saved on tax (5) not paid	= ·50
Interest on created tax benefit of 45	= 4·50
	20·25

Table 5.

INCOME BONDS

Direct writer sells 9½% 4 year single premium bond.
Market interest rate 12½%.
Direct writer taxed on investment income less expenses (I–E) at 35%.

Direct Writer — Year 1

$Vo=$	0	$V_1=$	97·35
$P=$	100	$E=$	2
$I=$	12·25	$B=$	9·50
Loss $=$	·20	Tax $=$	3·60
	112·45		112·45

$I=12\frac{1}{2}\%$ (100–2)
Tax $=35\%$ (12·25 – 2)
Year End Cash = 97·15

Direct Writer — Year 2

$V_1=$	97·35	$V_2=$	98·25
$I=$	12·15	$B=$	9·50
Loss $=$	2·50	Tax $=$	4·25
	112·00		112·00

$I=12\frac{1}{2}\%$ (97·15)
Tax $=35\%$ (12·15)
Year End Cash = 95·55

(Tax on interest makes product more and more unprofitable)

WITH REASSURANCE TO COMPANY TAXED ON PROFITS AT 50%
NET REASSURANCE PREMIUM (NRP) = 96·50

Direct Writer — Year 1

$Vo=$	0	$V_1=$	0
$P=$	100	$NRP=$	96·50
$I=$	·20	$E=$	2
$RB=$	9·50	$B=$	9·50
Tax Benefit $=$	·65	Profit $=$	2·35
	110·35		110·35

$I=12\frac{1}{2}\%$ (100 – 96·5 – 2)
Tax $=35\%$ (·20–2)
Year End Cash = 2·35

Reassurer — Year 1

$Vo=$	0	$V_1=$	97·35
$NRP=$	96·50	$RB=$	9·50
$I=$	12·05	Tax $=$	1·10
		Profit $=$	·60
	108·55		108·55

$I=12\frac{1}{2}\%$ (96·50)
Tax $=50\%$ (96·5 + 12·05 – 97·35 – 9·5)
Year End Cash = 97·95

Direct Writer — Year 2

$V_1=$	0	$V_2=$	0
$I=$	·30	$B=$	9·50
$RB=$	9·50	Tax $=$	·10
		Profit $=$	·20
	9·80		9·80

$I=12\frac{1}{2}\%$ (2·35)
Tax $=35\%$ (·30)
Year End Cash = 2·55

Reassurer — Year 2

$V_1=$	97·35	$V_2=$	98·25
$I=$	12·25	$RB=$	9·50
		Tax $=$	·90
		Profit $=$	·95
	109·60		109·60

$I=12\frac{1}{2}\%$ (97·95)
Tax $=50\%$ (97·35 + 12·25 – 98·25 – 9·5)
Year End Cash = 99·80

(Reasurance effectively allows profitable product for both direct writer and reassurer)

Chuck went on: "Well I made the same pitch with all of them. Explained who we were and what we were doing both in the U.S. and the rest of the world. Left some marketing material and a copy of our annual statement. We discussed the uses of reinsurance as a financial tool and I left them with a copy of these."

Chuck Wiseman then pulled out a series of papers which he neatly set down on the desk (Tables 4, 5, and 6).

Table 6.

COMPANIES TAXED ON SAME (PROFITS) BASIS AT DIFFERENT RATES

Company Taxed at 25%

Year 1

Vo = 0	V_1 = 200
P = 100	
I = 10	
Tax Benefit = 22·5	
Loss = 67·5	
200	200

Tax = 25% (100 + 10 − 200) = −22·5
Year End Cash = 132·5

Year 2

V_1 = 200	V_2 = 233
P = 100	Tax = 22·55
I = 23·25	Profit = 67·70
323·25	323·25

Year End Cash = 233·20
Overall profit = −67·5 + 67·70 = ·20
Overall gross profit = −90 + 90·25 = ·25*

Company Taxed at 50%

Year 1

Vo = 0	V_1 = 200
P = 100	
I = 10	
Tax Benefit = 45	
Loss = 45	
200	200

Tax = 50% (100 + 10 − 200) = −45
Year End Cash = 155

Year 2

V_1 = 200	V_2 = 233
P = 100	Tax = 46·25
I = 25·50	Profit = 46·25
325·50	325·50

Year End Cash = 234·25
Overall profit = −45 + 46·25 = 1·25
Overall gross profit = −90 + 92·5 = 2·50*

* The extra profit available (2·50 − ·25) = 2·25 is the interest earnings on the larger tax benefit = 10% (45 − 22·5) = 2·25.

"As you can see, they are only mathematical examples of how reinsurance may be applied. The surplus relief sheet I gave you earlier belongs with these. It's deliberately simple. We haven't, for example, taken into account timing differences, the funding of the strain etc. Most of the figures were just plucked out of the air. As I say, they are only meant to be taken as simple arithmetic illustrations."

Spendsir knew that there was no need to be picky. He found an extra sheet.

"And what's this?" he asked holding it out to Chuck (see Table 7).

"Well, one of the points of discussion was the fear of how large tax savings could be a red flag in their accounts. So I provided this table to show how life companies in the U.S. were not afraid to have their tax payments published. As you may remember, 1978 thru 81 was the period of greatest activity for the U.S. reinsurance tax deals. As Rock and Big City are both mutuals it also serves to

Table 7.

FEDERAL INCOME TAXES INCURRED

	Rock Life	Big City Life
1978	$361,000,000	$294,000,000
1979	$380,000,000	$343,000,000
1980	$120,000,000	$78,000,000
1981	$32,000,000	$129,000,000

show that tax saving is not just the domain of aggressive stock companies. At this point in the presentation I expand on our American experience, saying how we as an industry saved $2 billion in tax revenue over the period 1979–1981, and I ask how much they want to save."

"And what do they say?"

"Generally nothing!"

"You mean they say nothing or they want to save nothing?"

Chuck looked down. "As far as we are concerned it amounts to the same thing!"

"You do speak the same language, don't you?" asked Bill getting somewhat frustrated.

Chuck now felt on the defensive. "Alright", he said, "I don't think the British in general and British insurance executives in particular respond to a hard sell. They have a reputation for being conservative and unlike Americans don't seem willing to share their problems or opportunities with outsiders."

Bill interrupted "Not even if the outsiders are trying to help them?"

"Well maybe they don't quite see it like that", retorted Chuck.

"Are you sure you're seeing the right people in the companies you visit?" asked Spendsir.

"That's a good question," replied Chuck. "We try and go as high as we can and we nearly always end up with an actuary."

"Is that bad?"

"Overall I think it is!" Chuck went on. "Of what I can gather, actuaries over there think that if you ask a question it's an expression of ignorance and they don't want to appear ignorant either in their own office or in industry meetings. I heard tell that they formed a student society so that people could ask questions without fear of their questions being recorded for generations to come to see how ignorant they were!"

Bill Spendsir found this a little hard to take. "No, even actuaries must realize it's a rapidly changing world and they must want to keep abreast of all developments. Surely?"

Chuck didn't want to labour the point. "Well there's the other thing that maybe actuaries are not people with whom to discuss tax savings. We talked to one old guy who told us that just about the only tax education he got in his actuarial exams was to insert 't' or '$(1-t)$' into his premium formulae. He said that in covering the financial aspects of company operations there had been a statement about life insurance being long term and as such 'profit' was not really definable on an annual basis. This hampered the development of profit motivated actuaries, so he said."

Bill said there was only one solution—"don't deal with actuaries then!".

Chuck responded. "You may well be right, but fortunately or unfortunately, you can't avoid or ignore them. They're a pretty powerful bunch for all that. In any event, regardless of who we see we really have no idea as to what they do after our visit. They may bin our material for all we know."

Bill Spendsir didn't think his reinsurance expert was feeling very optimistic. "There must be some light at the end of this tunnel. Don't you ever get feedback?"

"Oh sure, but sometimes it isn't much help", said Chuck. "A couple of years ago I went to see one company, and before the meeting I saw in their revenue account a taxation item of about $15 million. In the meeting they told me they don't pay any tax! Several of the larger offices said that in theory they don't mind the idea of tax planning but that they are not going to be the first large office to do it in the way we discuss. Tell them of other companies and they may follow."

"Lemmings die that way don't they?"

"I'd rather say lemmings don't survive that way", replied Chuck. "Some offices complain about the problems of maintaining dividend levels, or as they call it reversionary bonuses, but won't save taxes to enable them to pay more to their policyholders."

Bill once again interrupted. "Now wait a minute. Who are these companies in business for, the revenue authorities or their policyholders? Do the executives have wider responsibilities to the public at large, do . . .".

It was Chuck's turn to interrupt. "All I can say Bill is that tax saving is a management decision and there seems to be some trade off between current tax levels, what happens if things get worse, what happens if they are penalized retroactively, how does that serve their present policyholders etc., etc. It seems that the fear of Inland Revenue action motivates inactivity, and the current review of insurance company taxation in Britain only puts the brakes on more."

Spendsir wouldn't let this go. "Sure and if I were the Revenue I'd be grateful! Don't the offices recognize that a decision to do nothing is still a management decision and that it could have negative impact in terms of opportunities lost?" He was obviously involved!

"Hey I've been fighting this for 4 years, you don't have to tell me." Chuck Wiseman was also somewhat agitated.

As they calmed down, the CFO wanted to understand the apparent level of inactivity more fully.

"OK. The insurance companies know the basis on which they are taxed."

Chuck agreed. Bill went on.

"Do they arrange their business to pay the most tax, the least tax or is it a number which drops out at the end of the year and they can't do anything about it?"

"I wish I could tell you", said Mr Wiseman. "I think there had been some Upper House decision from way back, I don't know 1910 or 16 or something saying that companies could arrange their affairs to minimize their tax bills. But in the last few years I believe there have been one or two cases: one called Furness *v.* Dawson, which is often thrown at us, appears to overrule the previous decision. But I didn't see much evidence to suggest the life offices were doing much in the way of obvious tax savings even prior to Furness *v.* Dawson, or to the Chancellor's review."

Wiseman didn't feel fine discussing legal matters and Spendsir sensed it. "Is the Furness case an insurance case?"

"No I don't believe it is."

"Are there any rulings or cases on reinsurance taxes?"

"No I don't think there are. In fact we were once asked if we would like to be party to a test case. We declined because if we had been successful the local reinsurers would have been able to use the test case to greater marketing advantage than we could."

Getting somewhat sidetracked Bill asked what the U.K. reinsurers were doing about tax planning.

Chuck answered that he believed the reinsurers dabbled in the market, particularly for single premium high income bonds but either for political or client/marketing reasons they didn't appear to have a high profile over tax schemes. While making these comments he also got a little sidetracked.

"You see I think one of the problems we encounter is that there doesn't appear to be either open forums or education on tax savings and the uses of financial reinsurance. I sometimes feel like one crying in the wilderness."

"And they see you as a lone wolf?" said Bill, not expecting a response.

But he got one!

"You know, all the companies I talked to over there seemed to take the news of a review of taxation as a signal to do even less. When we had changes in company taxation here in '82 and '84 and in personal taxation at the end of 1986 we had a virtual explosion of activity. With rates of tax going down we did what we could to accelerate deductions, defer income and the like. Suggest to the Brits that they may have a once in a lifetime opportunity and they react as if it's all a bad dream: 'wake me when it is over'."

Mr Spendsir seemed as if he were in his own dream for a moment. Then he asked if there was anyone doing the types of reinsurance under discussion.

"Oh indeed there are. Obviously we've done some, we know of other deals and we know of an active market in income bonds when interest levels allow. Talking of income bonds, whichever way you cut it their reinsurance is nothing more than the conversion of taxable income into non-taxable income. Say they're tax saving and the U.K. offices will say it's only tax planning. They claim that they are not saving taxes that would otherwise be paid but that they are providing a product service which without reinsurance wouldn't even be sold. Ask them to apply the same argument to the reinsurance of their other regular premium business and they don't want to know."

He brooded.

"I was once at an industry meeting, in Detroit I think, where a representative from a consulting firm openly spoke as to how his company had put over 25 deals together—and that was over 3 years ago! In a way it's funny; some U.K. offices don't entertain transactions because they think that their action will cause a change in the basis of taxation, while other offices not a million miles away are managing their affairs by doing some of the very same transactions."

They both smiled. Chuck went on: "I was working on this table before lunch. It's from the Reports and Accounts we'd got on some companies."

He extracted a hand written sheet full of figures (see Table 8).

Table 8.

LONG TERM REVENUE ACCOUNT ITEMS
ORDINARY BUSINESS (£ MILLION)

	Year End Fund	*1985 Tax*	*1986 Tax*	*1986 (I−E)**	*1986 Tax (I−E)*	*Tax Increase*	*Ranking by size of Life Fund*	*1986 Tax*
Armada Amicable	2248	11·2	10·6	18·0	59%	−5%	9	9
Bannockburn Assurance	2178	1·3	1·4	10·4	13%	8%	10	17
Bosworth Bountiful	2730	13·0	15·0	107·0	14%	15%	8	8
Crecy Conservers Ins.	4445	12·5	17·5	125·1	14%	40%	5	5
Culloden Life	7864	26·0	43·2	408·4	11%	66%	2	2
Floddenfield Fellowship	1711	5·9	7·0	86·2	8%	19%	13	12
Galipoli Growth	6002	12·0	3·5	331·7	1%	−71%	3	16
Hastings Health & Life	1248	9·1	9·8	104·1	9%	8%	15	10
Heights of Abraham Ass.	1789	8·8	6·4	66·9	10%	−37%	12	13jt
Malplaquet Mutual	12425	68·6	72·4	537·5	14%	6%	1	1
Mons Mutual	459	3·2	6·4	19·2	33%	200%	18	13jt
Preston Pans Provident	870	3·6	16·6	16·4	101%	361%	17	7
Ramilles Regent Life	4057	9·0	8·8	163·7	5%	−2%	6	11
Sicily Savings	1933	0·7	4·6	68·2	7%	557%	11	15
Trafalgar Assurance	1058	1·1	0·7	29·1	2%	−36%	16	18
Waterloo Wealth Group	1459	14·6	17·9	82·2	2%	23%	14	3
Yorktown Yearly Ins.	5245	19·3	17·7	275·8	6%	−8%	4	4
Ypres & Heaps Mutual	3675	4·5	16·8	177·3	10%	273%	7	6

* Investment Income minus (Commissions and Management Expenses)

"I don't quite follow what this table shows," said Spendsir.

"Not much! The figures are all over the place and they're not directly comparable. Maybe if we had what they call their DTI returns we might have been able to figure something out."

"And what exactly were you trying to figure out?" enquired Bill.

"Well, first of all whether there is any noticeable unified trend as with the Rock and Big City figures. . . .

The CFO interrupted: "You're not going to find that with only 2 years' tax payments."

"No I appreciate that but they all might have been going down. . .".

"Not from what you've told me so far!"

"No, but more importantly I was trying to work out some size-related tax schedule to see how these companies determine that they are happy with their own tax levels compared to other offices, if not compared to zero. I also wanted to see if it was obvious who was saving tax and who needed tax planning assistance. And I think we can take it for granted that not one company uses this or any other table to look round the market before feeling happy about its tax payment. With common year ends this would be pretty nigh impossible. Besides, should they compare tax payments on a size or profitability basis? Should you include in the comparison other types of financial companies? All types of companies?"

Bill Spendsir was not given the chance to respond.

"No, it remains one of the great unsolved mysteries of our time! A U.K. life office that is shown a perfectly legitimate way to cut its tax bill from X to $75\%X$ refuses on the grounds that X and not $75\%X$ is the absolutely correct amount they feel they MUST pay!"

Wiseman was waving his finger as a teacher might if reprimanding a child.

"If we define $Y = \cdot 75X$, then why the heck pay X? Why not Y?"

Again the CFO was unable to break in. Chuck Wiseman was in full flight.

"I'll tell you something else which is difficult to follow. The contingent capital gains tax liability for 15 of the companies in the table is nearly £3 billion. And yet the specific contingency reserve established by the 15 in respect of this liability is zero! Zip! Zilch!!"

Bill finally managed to get back into the conversation. "Well I'm sure if they're not doing it right their Authorities will be down on them soon. But let me ask you someting completely different. I don't think I have heard you mention risk yet?"

"O.K. This is all based on the use of reinsurance so of course we must have risk assessment and risk passage. The more the merrier! We talk about pricing the business taking into consideration the bases of taxation—which is what an actuary would do anyway. It's funny but many offices may actually be involved in reinsurance programmes where they get tax benefits without any mortality risk involvement and yet they do not always recognize it."

"How's that?" asked Spendsir.

"Well when an individual case is reinsured for pure risk purposes only, say on a YRT or risk premium basis, the expenses of putting that case on the books of the direct office are still deductible to the direct writer even though the mortality risk resides 100% with the reinsurer. No, this question of risk is long and interesting but I'm not even sure if the tax bases over there make any reference to risk when assessing what is income and what are deductions. Participating endowment expenses are deductible at the same rate as non-par whole life expenses even though the amount at risk will obviously vary."

Mr Spendsir nodded. Mr Wiseman had the feeling that time-out was about to be called. He still did not know where this left his U.K. operations. He felt the need to relay one more incident, just in case.

"Bill let me tell you about one company that I visited in 1982 and early '83. After about 3 meetings our original offer to help save the company $6 million was finally rejected. That was July of '83 when British life insurance premiums were, under certain circumstances, part tax deductible for the policy holder. This obviously gave an edge to the insurers over the other financial institutions. Anyway, the actuary of this particular company gave as the reason for not saving $6 million through reinsurance the fact that his action might lead to the loss of premium deductability for the whole industry. Very noble? Well 9 months later the Government removed the deduction anyway. So as it turned out he lost deductability through no fault of his own, but he also lost his company $6 million through what I feel was a bad management decision.

But it doesn't end there, for in 1984/5/6 he still had not availed himself of the opportunity. So, all in all, you could argue that he has lost his company $24 million! Now other than by bad investment, how could he lose this sort of money?"

It reminded Bill of a joke; something about the best way for an actuary to make a small fortune is by starting with a large one!

Chuck continued. "Alright, it's a matter of looking forward or backward, but even so for as long as tax changes are not made retroactive and penalties aren't imposed, every year that passes represents lost revenues, lost profits—for us as well as them!"

The CFO seemed to have had all he could take. "I'm sorry to say Chuck that you haven't helped me much."

Not knowing whether this comment was directed at him personally or at the information he conveyed he got ready to defend himself when Bill continued.

"I said earlier that I had reasons for asking you about the U.K. and I'll now tell you what they are; well what it is really. We've been asked if we are interested in purchasing an English reinsurance company. Like you, I'm not too 'gung ho' on the traditional market, but I wanted to get a feel for financial reinsurance opportunities there. Now I am totally convinced of the opportunities. I just do not like what you say about the market."

Chuck quickly stepped in. "Oh you know it's a different kettle of fish when you have a domestic operation."

"What's this with you and fish?"

"It's an old Laurel and Hardy expression", said Chuck. "Anyway, I think if you are going to consider acquiring then we would have a different perspective on the market. Not much mind you, but it could help. Particularly if the target has some size and a decent client base."

"Oh I appreciate that. Are you free for dinner?"

Chuck stuttered: "W-well yes, I guess."

"Good", said Bill, "why don't we continue this over dinner? As far as those interest deals are concerned, time is certainly money, so why don't we try and wrap this up tonight?"

Chuck Wiseman put on his jacket and he and Bill agreed to meet around 6.00 p.m.

The afternoon had shot by. Now Chuck was starting to think as to how a U.K. office might change his life, his profit centre, his role. He would be glad when this day was over.

CHAPTER 2

"We've Herod It All Before!"

"Yes?" It certainly was a rude awakening. Chuck had called out in response to the mention of his name, only to find a sea of faces turned towards him. He had dozed off during the service and thereby missed the minister's opening comments on the Gospel reading from Matthew 2: 1–12.

"The word 'magi' has several meanings from 'magician' to 'wiseman'." It was just at this point that our hero came back to life! He tried to disappear inside his great coat to hide his embarrassment. He decided that it was high time he paid some attention to what the priest was saying.

"The gospel readings do not specifically mention 3 wisemen. There have been assumed to be 3 as there were 3 gifts, but we do not know for certain that the 3 gifts were brought by 3 visitors. Anyway, regardless of their number, I want to talk to you this evening about another aspect of this gospel which often gets lost as we tend to concentrate on the images of the carol and the gift giving.

"St Matthew continues: 'Herod called together all the chief priests and the scribes of the people and enquired of them where the Christ was to be born'. 'At Bethlehem in Judaea', they told him, for this is what the prophet wrote:

" 'And you, Bethlehem, in the land of Judah you are by no means least among the leaders of Judah, for out of you will come a leader who will shepherd my people Israel.' "

"You see", continued the priest, "the people in Jerusalem, who firmly believed in prophecies, had it handed down for centuries that a saviour would come and that he would be born in Bethlehem. But none of the local people heeded their own teachings. They could not be bothered to go and seek out the truth. Even when foreigners arrived with a wondrous, mystical tale, no one paid them any attention. Why even Herod, rather than go himself, simply sent the wisemen on to Bethlehem, to seek out the Child and to report back to him of their findings. Herod, who in modern terms had a vested interest in what the wisemen had to say, could not be bothered to search and find out for himself.

"Now I ask you brethren, how many of you shun people, ideas, teachings, and perhaps sadly the truth simply because those people and what they have to say does not originate from within your own community? How many of you, be being wrapped up in your everyday chores fail to pay adequate attention to those matters which are crying out for your consideration?

"Will you be like the people of Jerusalem and miss the opportunity because your hearts and minds are closed? Will you be like Herod and fail in your responsibilities because you could not be bothered?"

Chuck Wiseman, with his mind still full of the afternoon's discussion, wanted to jump up and shout "Alelluia", but felt that he had already done enough to attract the attention of the congregation.

When they all stood at the end of the service to sing "We Three Kings" no-one sang louder than Chuck. The song was now his personal theme tune! Suitably uplifted, he left the church and made his way back to the office. Bill Spendsir was waiting in the foyer.

As they walked down Kennedy Boulevard in silence, Chuck's thoughts returned to the evening's service, the priest's homily, the gospel reading. Suddenly he laughed out loud.

Bill Spendsir, wondering whether the moon was full asked: "Something funny?"

"Sort of", replied Chuck, "did you know that St Matthew was a tax collector? And who said it was better to give than to receive?"

"The British obviously", thought Bill.

"Chuck, there was something I forgot to mention to you earlier. I have a friend in Philadelphia who was originally from England; an actuary called Tony Gillett. Have you thought of using him to help market these reinsurance arrangements?"

"Oh boy, not likely! Tony wouldn't agree with a single thing I've said!"