

REPACKAGING THE LIFE OFFICE

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"To make plans and project designs brings with it many good sensations; and whoever had the strength to be nothing but a forger of plans his whole life long would be a very happy man: but he would occasionally have to take a rest from this activity by carrying out a plan—and then comes the vexation and the sobering up."

F. Nietzsche

1. INTRODUCTION

1.1 TRADITIONALLY the interest of actuaries and many other life assurance specialists in the 'corporate structure' of life offices has largely been limited to questions surrounding the distinctions between mutual and proprietary companies. More recently, attention has also been paid to composite insurance companies—principally to protect the interests of the long term business policyholders.

1.2 Developments over the past ten years or so have led many life offices to reappraise their corporate structure. A number of companies have decided to set up a (non-insurance) group holding company, the principal subsidiary of which would be the established life assurance company. This paper will consider some of the pressures which have resulted in these reorganizations, in particular:

- (a) the impact of Section 16 of the Insurance Companies Act 1982 which restricts insurance companies to only conducting activities in connection with insurance;
- (b) the various provisions in the Insurance Companies Regulations 1981 which limit the admissibility of particular assets and specify minimum accounting standards which must be adopted when writing down certain fixed assets;
- (c) the additional flexibility with regard to marketing and the financing of marketing costs which a revised structure will allow;
- (d) the purchase of companies for sums substantially in excess of their net asset value which may give rise to difficulties in accounting for the 'goodwill element' in the purchase price;
- (e) the potential tax advantages (and, in some cases, disadvantages) which may result from the creation of a non-insurance holding company.

1.3 Many of the points raised in the paper will have particular relevance to those life offices for whom the efficient use of a limited supply of capital is especially important.

1.4 Major life offices currently owned by a non-insurance holding company

include Abbey Life Assurance Co Limited (Abbey Life Group plc), Allied Dunbar Assurance plc and Eagle Star Insurance Co Limited (BAT Industries plc), Guardian Assurance plc (Guardian Royal Exchange plc), Hill Samuel Life Assurance Limited, TSB Life Ltd and Target Life Assurance Co Ltd (TSB Group plc), Legal & General Assurance Society Limited (Legal & General Group plc), Pearl Assurance plc (Pearl Group plc), Prudential Assurance Co Limited (Prudential Corporation plc) and most recently the Royal Life companies (Royal Insurance Holdings plc).

1.5 Many of the above holding companies are long established, others reflect corporate acquisitions, but some, including Prudential Corporation plc, Pearl Group plc and Royal Insurance Holdings plc appear to have been formed in response to a perceived business need. Perhaps the clearest intent expressed in published accounts is that to be found at page 1 of the Pearl Group Corporate Review 1986:

"Pearl Group plc was formed, with Pearl Assurance as its subsidiary, to enable the group to provide more widely-based services for its customers. Existing legislation limits the activities of insurance companies to insurance or related business. Pearl Group plc, as a holding company, is not subject to these restrictions and is therefore a more suitable medium through which to launch a wide range of financial services. This move is important in helping Pearl to meet what it sees as its priorities."

1.6 The sound actuarial management of a life office requires that the actuary has regard to all factors which may have a fundamental impact on the position of the business. Structural considerations cannot be divorced from the essential management of the office and therefore should not be regarded as a specialist province which is inhabited by accountants or merchant bankers. Many proprietary life offices have altered, or at least considered changing, their corporate structure and the actuary needs to be aware of the impact any such movement might have on fundamental areas like:

- (a) the overall financial position of the group;
- (b) premium rating;
- (c) reserving; and
- (d) capital requirements, perhaps due to new business strain.

1.7 This paper is only intended to provide an introduction to some of the issues which have resulted in many life offices being 'repackaged' into the holding company form. For this reason the various arguments raised are put in general terms only. Any office wishing to establish a holding company structure will need to consider carefully its individual position and requirements.

2. SECTIONS 16 AND 6 OF THE INSURANCE COMPANIES ACT 1982

2.1 *Section 16*

2.1.1 Section 16 of the Insurance Companies Act 1982 ('ICA 82') states that:

"(1) An insurance company to which this Part of this Act applies shall not carry on any activities, in

the United Kingdom or elsewhere, otherwise than in connection with or for the purpose of its insurance business.”

The definition of insurance business is given in Section 95 of the Act. Section 16 (2) treats the management of a company's own pension fund, excluded from the definition of insurance business in Section 95, as an activity carried on in connection with its insurance business.

2.1.2 The implications in practice of this restriction remain unclear as, to the authors' knowledge, Section 16 has not been tested in a court of law. Certainly the Department of Trade and Industry ('DTI') originally appeared to have adopted a relatively permissive attitude with regard to life offices which operate what may be deemed to be activities 'unconnected' with insurance which were established prior to the enactment of the ICA 82. For example some offices have engaged in unit trust activity (by setting up separate unit trust companies whose staff, however, may not be clearly identified from the employees of the life office) and may also provide computer services to associated and subsidiary companies.

2.1.3 Following Article 8(1)(b) of the E.E.C. Insurance Directive the attitude of the DTI towards life offices now seeking to establish similar organizations (or wishing to move into other service industries such as estate agencies) cannot be so liberal. Indeed we are aware that the DTI have questioned the ability of insurance companies to: legally carry on trustee business, issue certain types of investment orientated contracts which might be construed as non-insurance business (for example, single premium bonds) and the provision of services by insurance company staff to outside bodies. The adoption of a more stringent attitude by the DTI will of course have implications for life offices, not least with regard to their competitive position within the wider market providing financial services and their utilization of available resources. It does not appear unreasonable to assume that it is the Directive which inhibits the DTI from more widely exercising its powers under Section 68 ICA 82 to disapply or modify the application of Section 16 to particular life offices. The establishment of a non-insurance holding company allows the group to set up and operate a variety of subsidiary companies without the possibility of falling foul of the Section 16 restriction. For example, computer services to the group may be provided by staff employed by the holding company. Computing services may then be sold to the life subsidiary and other users in return for a fee. To avoid potential difficulties with the Inland Revenue and the DTI it is important that such agreements are framed on an 'arms length' commercial basis.

2.1.4 It is interesting to note that for the purposes of Friends' Provident operational merger with United Kingdom Provident Institution, the Secretary of State issued an Order under Section 68 of the ICA 82 that Section 16(1) "... shall not apply to anything done by Friends' Provident Life Office which is done in connection with or for or which is conducive to facilitating the proposed association . . ." between the two offices (note 5 to the 1986 Friends' Provident returns). Presumably the Section 68 order has been issued to avoid any

contravention of the ICA 82 which might result from the provision of services from one company to another in connection with the operational merger.

2.1.5 It is also of interest to note that there is no territorial limitation to Section 16 ICA 82. Where an overseas company establishes a life branch in the U.K., it is the company which is authorized to carry on insurance business in the U.K. It is a moot point whether non-insurance activities carried on outside the U.K., say at head office, could result in a breach of the Act. The same point may apply where a U.K. authorized life office has an overseas branch.

2.2 Section 16—ABI circular 42/88 and other recent developments

2.2.1 On 18 May 1988 the ABI issued to members Circular 42/88 on Section 16 ICA 82. The purpose of the circular was to report on the current position following discussions with the DTI. The circular did not seek to advise on what activities carried on by a life office could be regarded as in breach of Section 16. Instead, it pointed out that contracts entered into as a result of such activities might be illegal, void and therefore unenforceable and only the Courts could give an authoritative ruling on the interpretation of the section. The circular advised that there would be less concern if any non-insurance business carried on was compatible with, and small in relation to, a company's main insurance business but there would be concern if the activity reduced the effectiveness of the supervisory returns or posed a threat to the company's solvency margin. These concerns could be present even where the activity was carried out by a subsidiary if the insurance holding company had a legal or practical responsibility for it. These situations would be less likely to arise where a non-insurance holding company had been established above the insurance company and the subsidiary carrying on this non-insurance activity was owned directly by the holding company.

2.2.2 Since the authorization of insurers by the DTI also confers authorization under the Financial Services Act ('FSA 1986', see Section 22), a breach of Section 16 ICA 82 might prejudice the authorization to carry on investment business under the Act. The Royal Magazine, referred to below, notes that the European Commission has expressed concern about the growth of financial conglomerates and the Commission has considered the introduction of a directive on groups of companies. The feeling within the Commission is reported as being that the 'top' company in an insurance group should be a non-insurance company and this is likely to be reflected in any proposals which the Commission puts forward on the subject.

2.2.3 The Royal Magazine of summer 1988 sets out some of the reasons why The Royal decided to set up a non-insurance holding company. Reference is made to the discussions with the DTI, referred to above, and lists particular commercial concerns:

- (a) Royal was advised that Section 16 could inhibit acquisitions as an interested party, such as a shareholder, could suggest that the acquisition

did not relate to Royal's insurance business. The introduction of such an objection would involve delay, extensive legal consultations and the possibility of an uncertain court hearing;

- (b) financial guarantees to a subsidiary company could be inhibited unless provided in the form of performance bond insurance policies which, of course, is short term business;
- (c) the DTI has questioned whether it is in order for staff to be employed centrally by a parent insurance company whilst in practice working all or part of the time for non-insurance subsidiaries.

2.3 *Section 6*

2.3.1 Section 6 of the ICA 82 prevents the creation of new composite insurance companies. This could prove to be a barrier to existing life or general insurance companies who are seeking to increase their range of products, perhaps in the area of 'personal lines' type business. A non-insurance holding company can be used to create a financial services group, which is capable of providing a full range of insurance products to its clients with life and non-life business being underwritten by separate subsidiary companies. In this way the intentions of the legislators (protection of the long-term policyholders) can be upheld, whilst allowing the group to exploit a particular marketing strategy.

2.3.2 It may be argued that this strategy does not reduce risk to the group via the limited liability accorded to the general insurance operation (which is assumed to be more risky than life business). Given that insurers are in the business of covering risk, it is anticipated that any group which is perceived by the public of being willing to walk away from an insolvent subsidiary would suffer from a lack of confidence.

3. ASSETS, CAPITAL AND INSURANCE COMPANY LEGISLATION

3.1 Other than specifying what assets are permitted links for unitized funds (Regulation 72 and Schedule 13—as amended), the Insurance Companies Regulations 1981 SI 1918 No. 1654 ('ICR 81') do not directly place limits on the investment powers of insurance companies. Instead rules are laid out specifying how investments may be valued and the extent to which they may be taken into account for the purposes of the annual DTI returns. These returns are intended to demonstrate the solvency of the insurer to the DTI (the supervisory authority) and the wider public/insurance community. In addition, the ICA 82 and ICR 81 place limitations on the ability of insurance companies to raise various types of capital.

3.2 A non-insurance holding company is not, of course, subject to the asset valuation and admissibility regulations and capital restrictions laid down by

insurance company legislation. This can be used to the group's advantage and five particular areas spring to mind:

- (a) the asset admissibility regulations;
- (b) the write-down charge on certain fixed assets;
- (c) commissions which have been paid but not earned;
- (d) the raising of debt capital; and
- (e) partly-paid capital.

3.3 *Asset admissibility*

3.3.1 The asset admissibility limits are outlined in Part V and Schedule 8 of the ICR 81. Any assets held in excess of these limits are deemed to be 'inadmissible assets' and, unless permission is obtained from the DTI, may not be counted when demonstrating the solvency of the assurer in the DTI returns. A more efficient use of the group's assets would involve the holding company owning assets which may potentially fall foul of the valuation limits. An example might arise where a small unit linked company wishes to own its head office as a property investment, whose admissibility is limited to 5% of the long term business amount. In addition, certain assets must be left out of account and thus are totally inadmissible for DTI purposes. For example, no value can be placed on advance commission or unearned commission because of Regulation 41(3) and, similarly, no value can be placed on assets which are not mentioned in Regulations 37–48 such as commodities and some financial instruments (such as units in an unauthorized unit trust). The potential use of the holding company in the case of unearned commission is discussed in Sections 3.5 and 3.6 below.

3.4 *Fixed assets*

3.4.1 The minimum rates at which specified fixed assets must be written down are laid down in Regulation 43 of the ICR 81. These rates are arbitrary, reflecting neither the estimated useful life of the asset nor its residual value and so do not comply with Statement of Standard Accounting Practice ('SSAP') 12, 'Accounting for depreciation'. They are, in many cases, more stringent than is found in typical non-insurance companies statutory reporting. A good example is computer software. Arguably, even when purchased with computer hardware, computer software must be immediately written off under the ICR 81 whereas it is normally depreciated over a number of years in the financial accounts. Hence a more efficient use of group assets may be arrived at if fixed assets are owned by a non insurance company within the group and used to provide services to the insurance subsidiary or leased out to the insurance subsidiary. As the rate of depreciation in the holding company's books is likely to be lower than the minimum allowed by the ICR 81, the effective assets of the group are thereby 'increased'. This practice may be used to help minimize the capital requirements of a new and expanding life office. It should be noted that to obtain this benefit

any lease to the insurance subsidiary may have to take the form of an operating rather than a 'finance lease', as defined in SSAP 21 ('Accounting for leases and hire purchase contracts'). This is because the lessee of a finance lease must record the lease as an asset in its balance sheet and the obligation to pay future rentals as a liability. The leased asset is inadmissible for valuation purposes.

3.5 Commissions paid but not earned

3.5.1 Paid but not earned commissions ('unearned commissions') and advance commissions are a particular case of inadmissible assets under the ICR 81, as both assets are wholly disallowed by the DTI. (Unearned commissions, paid in respect of business already sold, and subject to a clawback if the policy lapses within a defined period, should be distinguished from advances to be recovered from future commissions which will be payable in respect of business yet to be sold.) Traditionally, for reasons of prudence, life offices have written-off all commission advances against revenue on a payments basis in their report and accounts too.

3.5.2 Advance commissions are debts and it is possible that, in law, unearned commission constitutes an interest free loan from the life company to the intermediary, which is repaid as the policy remains in force and the commission is earned. The actual wording of the agreement between the life office and the intermediary will be important, however the definition of a loan given in Chitty⁽⁴⁾ helps to illustrate the point at issue:

"A contract of loan of money is a contract whereby one person lends or agrees to lend a sum of money to another, in consideration of a promise express or implied to repay the loan with or without interest."

3.5.3 Due to the underlying nature of unearned commission and advances to intermediaries which are recoverable against future new business it is possible to account for commission on an earned basis and hold as an asset a debtors (or a prepayment) item in respect of the unearned and advance commission payments made to intermediaries. A holding company structure may be used to the advantage of the group by using the holding company to make commission advances to the intermediary. Another group company may be used instead of the holding company but it must not be a dependent of the life subsidiary. As commissions are earned, the life subsidiary repays the parent from the commission loading contained in the premiums collected from the policyholder. In this manner the group may make full use of its unearned commission asset which is held as a debtors item in the parent's balance sheet. The practical impact on the life company is to reduce the new business strain as it no longer has to finance the immediate writing-off of unearned commission advances.

3.5.4 The practical considerations involved in framing such an arrangement include:

- (a) the holding company must bear the cost of irrecoverable advances to avoid

the creation of a contingent liability in the life subsidiary which would need to be taken account of for DTI purposes;

- (b) the unearned commission asset would be subject to provision for bad or doubtful debts;
- (c) such agreements must be made on an 'arm's length' basis which will include making allowance for the interest costs incurred by the holding company as a result of financing the commission advances. If the agreement is not framed in a commercial manner, the life company's directors will be unable to give a clean certificate due to paragraph 6(b) of Schedule 6 of the Insurance Companies (Accounts and Statements) Regulations 1983;
- (d) under the LAUTRO rules, the period over which initial commissions are earned may extend to four years for some contracts. This would appear to make the option of using the holding company to make commission advances more attractive for companies which use the LAUTRO earning period, although the discounting of indemnity commission payments will reduce the initial capital outlay;
- (e) where the actuary calculates modified reserves in order to reduce the impact of new business strain, consideration needs to be given to whether the valuation basis requires adjustment in order to recognize the front end costs now being met by the holding company;
- (f) in the case of a life company with participating policyholders, the use of a holding company to finance new business strain will impose an additional cost to shareholders in that front-end costs will no longer be met by the estate.

3.5.5 The financial impact of a holding company acting as a marketing agent for its life office subsidiary may be illustrated as follows:

- * Assume indemnity commission of £1m, due in two equal instalments; the first on receipt of the first year's premium, the second on receipt of the second year's premium but paid in full to the intermediary when the sale is initially made.
- * Allowance for credit risk 7%. The credit risk must take account of lapses and the consequent failure to recover the commission due from the broker/salesman because of insolvency or other reasons.
- * Interest costs 13%.

3.5.6 The commission charged by the holding company to the life subsidiary might be £550,000 in each of the first and second years, so that its financial accounts may be illustrated as in the table on p. 125.

3.5.7 Although the life subsidiary will have paid away more commission than it would otherwise have done, it is relieved of all financing costs, including credit risk and has relieved its new business strain. Instead, the financing costs are transferred to the non-insurance holding company which, it has been assumed in

Profit and loss account

	<i>Year 1</i>	<i>Year 2</i>
	£'000	£'000
Commission income	550	550
Interest income	—	1
	<u>550</u>	<u>551</u>
Commission expense	(500)	(500)
Interest expense	(59)	—
Provision for bad debts	(35)	—
Profit (loss) for the year	<u>(44)</u>	<u>51</u>

Balance sheet

	<i>Year 1</i>	<i>Year 2</i>
	£'000	£'000
Debtors	465	—
Cash	—	7
	<u>465</u>	<u>7</u>
Financed by:		
Profit and loss account	(44)	7
Loan	509	—
	<u>465</u>	<u>7</u>

the example above, has borrowed to finance that cost. It would appear that there is nothing to inhibit the holding company from factoring its unearned commission or advance commission debtors. If this is done the holding company is more likely to charge intermediaries a commercial rate of interest when they receive indemnity commission. The taxation implications of this strategy are considered in paragraphs 5.4.5 to 5.4.6 below.

3.5.8 It has been suggested that where a life group seeks a public listing of its shares it may be easier to do so where the financing arrangements of the group are explicitly shown in its accounts, as set out above, as compared to the more traditional method of reinsurance financing treaties.

3.6 Recovery of unearned commission balances

3.6.1 Section 3.5 dealt with the situation where the holding company is used to finance unearned commissions. It may be desirable to extend the financing operation to deal with existing unearned commission debtors. For existing life operations this would result in a temporary capital advantage by effectively 'recovering' any unearned commission already paid but written-off by the life company in respect of in force business still within the initial commission period. The holding company may make a lump sum payment to its life subsidiary in

order to purchase the future stream of payments made by the life company as the commission is earned on this block of business. Broadly, the life subsidiary has factored its debtors. The lump sum constitutes a capital injection into the life operation (thereby improving its solvency on a DTI basis) and can be 'balanced' in the holding company by the creation of a debtors item. Some capital strain may arise within the holding company due to the provision which must be made for bad or doubtful debts. Also, the holding company will make a payment which reflects the time value of money as some commission on current LAUTRO scales might not be earned for nearly four years, however the payment of a discounted sum may give rise to tax problems (see paragraph 5.4.3).

3.6.2 Points to note about the 'recovery' of unearned commission balances on business already written include:

- (a) because current and future new business commission advances are assumed to be made by the holding company, the capital advantage to the group is only temporary and will be effectively amortized over the remaining initial commission period of the policies covered by the agreement between the two companies;
- (b) the lump sum payment will be credited to the revenue account of the life company and will contribute to the actuarial surplus (or reduce the actuarial deficiency) arising in the following valuation. For companies with participating business complications may arise due to Section 30 of the ICA 82 where the proportion of surplus distributed to policyholders cannot normally be reduced by more than $\frac{1}{2}\%$ as compared to the proportion of surplus distributed to policyholders at the previous valuation;
- (c) the tax impact on the two companies. For the life office, the lump sum received will be treated as a negative expense. Whether this has a positive or negative impact on the company depends on its particular tax position. For companies with an excess of management expenses, the point at which these expenses can be fully set off against their investment income will be brought forward (see paragraph 5.4.3 below);
- (d) as debtors, intermediaries will need to be notified of the assignment of outstanding balances from the life company to the holding company.

3.7 Holding companies and life office solvency

3.7.1 In Sections 3.3 to 3.6 we have seen how a non-insurance holding company can be used to reduce the capital requirements for writing life insurance business. It has been suggested that this strategy breaches the spirit (rather than the letter) of U.K. legislation and that the cautious approach adopted by the ICR 81 with regard to valuing assets is intended to ensure that life offices are run on prudent lines. Whilst the use of a holding company in this way reduces the implicit margins available to the Appointed Actuary, the life subsidiary still has to formally demonstrate its solvency in the usual way.

3.7.2 It would seem that one of the implications of this strategy for life office actuaries is the need to be aware of what accounting practices are being adopted at the holding company level (for example, in relation to the provision for bad debts when calculating the value of the unearned commission asset).

3.8 *Debt capital*

3.8.1 The ICR 81 can make the raising of debt capital particularly unattractive to authorized insurance companies. Debt must be shown as a liability in the company's accounts and, in the case where the debt finance is used to purchase assets which are wholly or partially inadmissible to the DTI, the solvency of the company, as revealed in the DTI returns will be reduced. Examples of such purchases include: using the finance to write what is essentially profitable business which generates new business strain, fixed assets which have to be depreciated over a considerably shorter period than their useful working life and the goodwill element which may arise on the acquisition of a life or other operation.

3.8.2 Again a group corporate structure headed by a non-insurance holding company increases the flexibility open to the group. The holding company, if it so desires, may tap the debt capital market for funds without hindrance from the regulations and inject a portion of this as a capital contribution or equity into its life subsidiary. Normal business considerations must, of course, apply with regard to servicing and repaying the debt. It has been suggested to the authors that the raising of debt through a non-insurance holding company may be commercially attractive as some bankers appear to take the view that the Insurance Companies (Winding-Up) Rules 1985 (SI 1985 No. 95) result in some uncertainty as to the security that can be offered by a life office to creditors. This may mean that a non-insurance holding company can obtain finance at better terms than its life subsidiary.

3.8.3 The holding company then has the following options:

- (a) if the solvency of the life subsidiary in the DTI returns is not an issue, the holding company may on-lend the borrowings to the life subsidiary. It may be possible for the holding company to make a small 'turn' on the loan on the grounds that the life subsidiary could not have itself obtained loan finance at such advantageous terms;
- (b) the holding company may use the debt to subscribe for equity capital in the life subsidiary. The holding company will have to be aware that the ability of the life company to pay dividends will be limited by the nature of its business and the provisions of the ICA 82. It follows that a developing life office may be unable to provide a dividend stream to service the debt obligations incurred by its parent.

3.8.4 Many of the life offices which have become heavily involved in mortgage

lending over the past couple of years have chosen to raise funds for these transactions by borrowing funds using companies in the group other than the life company. It appears that using the life office to raise debt which is then invested in the asset of mortgage loans may have a number of disadvantages:

- (a) liabilities of the life fund need to be matched by appropriate investments, whilst, subject to this constraint, the office seeks to maximize its investment return. The creation of what is essentially a large portfolio of short to medium term floating rate investments may well result in restrictions being applied to other aspects of investment strategy to avoid an unacceptable level of mismatching;
- (b) where the life office distributes dividends to shareholders which are related to the cost of the bonus (say 10%), the returns to shareholders will be 'geared-down' by this mechanism. This may be contrasted with the position of banks where advances can be a multiple of shareholders' funds and the interest margin received by the bank is effectively 'geared-up' for stockholders.

3.8.5 Where a group wishes to borrow for mortgage lending outside the life office whilst offering lenders the financial security of the whole group, it is easier for a non-insurance holding company to guarantee the borrowings than the life office (paragraph 2.2.1 above).

3.9 Partly paid share capital

3.9.1 As a result of Section 7(2) of the ICA 82 it is not acceptable for authorized insurance companies to issue unpaid or partly paid share capital. Where partly paid capital has inadvertently been issued it is understood that the DTI have insisted that the partly paid shares must be ignored for the purposes of the DTI returns and the solvency calculation (even though cash has been received for the paid up portion of the shares).

3.9.2 As in the case of debt capital, the use of a holding company allows the group to adopt a more flexible approach with regard to its capital requirements. Partly paid capital may be raised by the holding company and injected into the life subsidiary as a capital contribution or fully paid equity.

3.9.3 Regarding rights issues, the DTI have indicated that action is unlikely to be taken against an issue which provides for payments by instalments on fixed dates over a short period.

4. ACQUISITIONS AND ACCOUNTING

4.1 Accounting and DTI practice

4.1.1 Recent purchases of life insurance companies have given rise to the

creation of significant 'goodwill' figures (i.e. the purchase price exceeds the fair value of the assets bought).

4.1.2 In accounting terms 'purchased goodwill' (i.e. the goodwill created when a business is purchased) is defined in SSAP 22 ('Accounting for goodwill') to be the difference between the fair value of the consideration given and the aggregate of the fair values of assets acquired. On acquisition the goodwill so generated may be:

- (a) written off immediately to reserves (at once affecting the balance sheet position of the purchaser); or
- (b) held in the balance sheet of the purchaser and written-off over the period of the useful economic life of the asset by making an annual charge to the profit and loss account.

4.1.3 The accounting treatment for goodwill above contrasts with the position outlined in the ICR 81. U.K. insurance regulations require the assets of a life insurance company to be valued on a break-up basis. The bases to be used to value dependants are set-out in Regulations 39 and 40 and Schedule 7 of the ICR 81. The precise bases to be adopted are complicated, however a 'look through' approach must be adopted to determine the net asset value which could be distributable to shareholders in the event of the dependant company winding up. On such a valuation basis, any goodwill held in respect of an acquired dependant company could not be brought into the solvency calculations.

4.2 Implications for predatory insurance companies

4.2.1 It will be seen that an acquisition by an insurance company could have an adverse impact on its solvency as established by the DTI returns. The insurance company will face the twin problem of the immediate write-off of the goodwill element in the purchase and limitations concerning its ability to raise debt capital to finance the deal (see Section 3.8 above).

4.2.2 To avoid problems created in the life insurance company by large goodwill balances, a holding company can be used to make the purchases. Goodwill will then arise only in the holding company and can be amortized in consolidated accounts against the stream of profits flowing from the life assurance company or any other group operations.

4.2.3 There could be structural problems where a group acquires more than one life insurance subsidiary although in practice these will probably be resolved in the short term by a merger of operations (having gained permission of the courts under Section 49 ICA 82) or by reinsuring the liabilities of one company into the other.

4.2.4 The method of accounting for the goodwill arising on the purchase of a life insurance company raises the question of what is goodwill arising on such a purchase. In their paper on life office appraisal values, Burrows and Whitehead⁽¹⁾ summarized the issues of appraisal value accounting. Following the require-

ments of SSAP 14 ('Group Accounts'), a fair value should be attributed to the assets acquired from which the purchase consideration should be deducted to determine goodwill. Adapting the methodology of Burrows and Whitehead's paper the 'embedded' value of the purchased business in force could be recognized in the balance sheet of the holding company, separate and distinct from goodwill (i.e. reducing the excess of the consideration over the asset value which is then attributed to goodwill). The holding company could then write off the goodwill directly to reserves but amortize the embedded value on consolidation against the future stream of earnings emerging from the purchased business. The embedded value should increase as further profitable business is put on the books and this increase can be credited to profit. This method recognizes in the consolidated balance sheet that part of the premium over book asset value paid for a life assurance company is for the profits 'locked up' in the business in force whilst part of the premium is for the more conventional types of goodwill, the ability to generate future profits.

4.2.5 The approach outlined in paragraph 4.2.4 could be applied to other financial services businesses acquired which have medium to long term contracts in force (e.g. for asset or fund management). The attraction of using this approach is that it leaves the balance sheet of the life insurance company free of the complications of goodwill and the strains of debt financing of acquisitions.

4.2.6 The use of a non-insurance holding company will certainly increase the options available to a group wishing to expand. However, there will be longer term implications for the life office, for example, increased competition for resources within the group. These pressures will exist any way but the creation of a formal group structure may serve to highlight them.

4.2.7 For the holding company, any purchase must be justified by commercial logic. In particular, if goodwill is to be held in the balance sheet, careful consideration has to be given to what period should be used for the write off and the likely future impact on the profit and loss account of the group.

4.3 Holding companies and defensive measures

4.3.1 On the other side of the coin, a number of insurance groups have placed some form of appraisal value (and a corresponding non-distributable reserve) in the balance sheet of the holding company in an attempt to give shareholders some indication of the true worth of the life operation. This defence tactic has been most noticeable in the composite sector and probably dates from the takeover of Eagle Star by BAT Industries.

4.3.2 It is difficult to gauge how successful the efforts of the composites have been in trying to communicate the value of their life operations to shareholders and potential investors. Given the constant takeover speculation that exists in this sector (and regarding other quoted life companies) it appears that the use of a holding company to carry an intangible asset in its balance sheet is a tactic well worth pursuing. This approach may of course be adopted by unquoted

companies and used when determining the value of the operation to a potential purchaser or business partner.

4.3.3 The topic of life office accounting is currently the subject of a working party. It is not appropriate to pre-empt its results, however it is apparent that placing embedded values in the balance sheet representing the value of future profits of the in force business is an approach which may, at times, substantially underestimate the market value of the operation. This market value may be estimated by a full appraisal value which attempts to place a value on the potential of the operation to generate profitable business. A full appraisal value can be very subjective (especially at a time of fundamental change in the life market) and in any case cannot be included in the Companies Act accounts since SSAP 22 prohibits any value being placed on non purchased goodwill.

4.3.4 It is expected that the use of embedded values will necessitate some formal actuarial opinion to be given to the company's directors. This opinion could come from in-house actuaries and/or external consultants and is used to support the valuation of future profits from in force business.

5. TAXATION

5.1 The saving of tax is not the main purpose of a non-insurance holding company which is primarily intended to allocate resources more effectively (without impairing policyholder security). The non-insurance holding company does not automatically result in tax advantages but may do so. There are many circumstances in which such a company may be tax inefficient. It is usually possible to form a non-insurance holding company without giving rise to significant tax liabilities. These points are discussed below by reference to current tax law. It should be noted that in June 1988 the Inland Revenue published a consultative document on the reform of life taxation. If any of the three non exclusive options referred to in that document are enacted there will have to be a fundamental reappraisal of the taxation position of all life offices.

5.2 Formation of a non-insurance holding company

5.2.1 A non-insurance holding company can be formed without significant tax costs. Where it is proposed to introduce a new holding company above a life company, the shareholders may exchange their shares in the life company for shares in the holding company without incurring a liability for capital gains tax purposes. The shareholders are treated as acquiring their shares in the holding company at the same time and for the same price as their shares in the life company (Sections 85 and 78 CGTA 1979). This statement must be qualified in that it applies to U.K. resident shareholders. Non resident shareholders are not usually subject to U.K. capital gains tax (Sections 2 and 12 CGTA 1979) and must consider the tax laws of the territories in which they are resident to ascertain if they qualify for a tax free roll-over on the share exchange.

5.2.2 The cost base of the shares in the life company to the holding company will be their market value at the date of acquisition (Section 29A CGTA 1979).

5.2.3 Capital duty has been abolished. There should be no stamp duty charge on the share exchange (Section 77 Finance Act 1986).

5.3 *Post formation transfers*

5.3.1 Once a holding company has acquired an existing life company it may be desirable to transfer certain fixed assets or commission advances from the life company to its new parent to obtain some of the advantages referred to in Sections 3.1 to 3.6 above.

5.3.2 Any assets held by the long-term business fund can only be transferred at fair market value (Section 29 ICA 82) and the consideration given by the holding company must be paid for and not left 'outstanding as a debt' (Section 31 ICA 1982). The fair market value of fixed assets may exceed the amount at which they are carried in the statutory books of the company especially if the carrying value is equal to the admissible amount at which they are carried in the DTI return. In the case of advance commission debtors and prepayments of unearned commission this will certainly be the case because such debtors have a nil value for DTI purposes and this practice normally is adopted as an accounting policy in drawing up the statutory accounts.

5.3.3 Where the fair market value paid by the holding company for the acquisition of fixed assets regarded as 'plant' for tax purposes exceeds the balance of unallowed expenditure for tax purposes, there may be a recapture or clawback of capital allowances (the term used to describe tax depreciation) in the life company. The holding company will obtain allowances on the fair market value paid for the plant.

5.3.4 Should other chargeable assets, such as land and buildings be transferred to the holding company, no capital gains will arise because the sale will be intra-group (Section 273 Taxes Act 1970). However, where a life company carries on annuity business, and the profits on the realization of assets are taxed as income, there are no provisions which permit a tax free transfer. There may not be a problem where the actuarial liability reflects the appreciation in the value of the assets over original cost to the life company, as will be the case with linked business, but there may be an acceleration of tax where the transfer results in the realization of what otherwise would be unrealized appreciation. The Revenue is contending that unrealized appreciation in respect of both linked and unlinked assets should be brought into account in annuity computations. The industry is resisting this contention and, it is submitted, that at least unrealized appreciation on unlinked investments should not be brought into account until it is realized.

5.3.5 Where (as in Section 3.6) advance commission debtors are sold to the holding company and such debtors have been written off and claimed as an expense of management, the receipt from the parent will be treated as 'negative commission' in the hands of the life company. Where the character of the

advance commissions as a debtor has been recognized for tax purposes the transfer should be tax free (Section 134 CGTA 1979). It would appear advisable to transfer such debtors at their face value rather than at a discount, because it is unclear whether the life company would obtain a deduction for the factoring costs.

5.4 The impact of a non-insurance holding company on the tax position of the group

5.4.1 Where a holding company owns fixed assets let to an insurance subsidiary or acts as an intermediary for its subsidiary it will carry on a trade for tax purposes. Where its activities are more restricted say, for example, the business is confined to holding shares in its subsidiary or letting land and buildings to the life office, it may be regarded as 'an investment company' (Section 130 ICTA 1988). The holding company will then be taxed on the profits of its business and the subsidiary should obtain a deduction for rental and commission payments to the holding company. Where the holding company is regarded as an investment company the same consequences should follow, i.e. the parent will be taxed on its income and the subsidiary will obtain a deduction for the payments made. The most critical issue dependent upon whether the holding company is a trading company or an investment company is likely to be relief for interest paid (see paragraph 5.4.6 below).

5.4.2 Normally, the Revenue will not seek to adjust for tax purposes the consideration agreed for the provision of services and other facilities between two U.K. resident trading companies even where the arrangements are between connected parties. In strictness, excessive payments can always be disallowed (Sections 74 and 75 ICTA 1988), and because a life office is normally taxed as an investment company rather than as a trading company, the Revenue has power to impute income to the holding company where services are provided at less than an arm's length price (Section 770 ICTA 1988). As referred to in paragraph 3.5.4 above, the ICA 82 prohibits a holding company providing services at an excessive price and, indeed, the regulatory pressures are such that a holding company may provide services to the life subsidiary at less than an arm's length price. Nevertheless, provided that the consideration agreed under the trading arrangements between the two companies are commercially driven it should be acceptable for tax purposes.

5.4.3 Where a non-insurance holding company is used to relieve the financing costs of a life office, for example by acting as a marketing agent, the situation commonly encountered in an office with material new business strain of an excess of management expenses over taxable income will be mitigated. This should mean that the life office will more rapidly approach a tax paying position than would otherwise be the case, and should surplus emerge before the office achieves an excess of investment income over management expenses, may result in a notional Case I profit requiring the restriction of expense relief.

5.4.4 It is not possible however to express an unqualified view because the

Revenue are challenging certain of the practices that have given rise to excess management expenses. In the past it has been common to claim a deduction for all expenses of management (including commissions) when 'disbursed' or paid. The Revenue points out that the words of the section confer a right to deduct in computing the total profits for an accounting period "any sums disbursed as expenses of management . . . for that period" (Section 75 ICTA 1988). The Revenue contends that the true legal nature of advance commission is that of a debtor therefore a deduction should not be given until the commission is due and becomes earned. Recently this contention has been extended to include unearned commissions where the correct answer is less clear because much depends on the proper construction of the commission agreement which varies from case to case. It would appear that a deduction should be given for commissions paid when they become due, albeit that the life office may have a right to recover part of the commissions paid in the event of policy lapses. However, if the agreement was worded in such a way that instead of the commissions being subject to 'clawback' in the event of certain contingencies a debt was created until the commission was earned, the deductibility of the prepaid commissions would be less certain. In these circumstances, the deferral of expense, represented by the advance commission debtor in the holding company referred to in the table on page 125 does not necessarily result in a tax disadvantage, although it is fair to say that the period in which the life office is in an excess expense position should be reduced. This may be advantageous in the pricing of some products and in the actuarial valuation because tax relief for expenses will be given earlier rather than later.

5.4.5 The acceleration of surplus should advance the point at which a notional Case I profit emerges, especially with the harsher Revenue approach towards what are acceptable reservations of profit, particularly in a life office without participating policyholders. This acceleration of surplus for tax purposes may be mitigated by reduced depreciation and amortization charges. Whether the acceleration of surplus is material for tax purposes largely depends upon whether significant surplus emerges before the life office has an excess of taxable income over expenses of management. If surplus emerges before that time there may be a restriction of expense relief by reference to the notional Case I profits test resulting in a carry forward of the restricted expenses.

5.4.6 In Section 3.8 it was noted that a holding company may serve as a useful vehicle for raising debt finance. Commercially, many life groups have found it advantageous to raise mortgage finance outside the life office and, indeed, debt is notably absent from the accounts of life companies generally. There may be a useful tax advantage in raising debt in a holding company where the life office has excess expenses and there are other profits within the group available to relieve interest charges. This is because the excess management expenses of a life assurance company can only be relieved against the profits of that business (Section 432 ICTA 1988). In addition, it is not possible to surrender excess expenses of management to other companies within the same group for tax purposes (Section 403(6) ICTA 1988). Whilst there is no similar restriction on the

surrender of life 'charges on income', any notional Case I restriction of expenses will lock these charges into the life company because relief for charges on income is given after all other reliefs (Section 338 and 76(2) ICTA 198). These restrictions do not apply to the trading losses or excess expenses of management of a non-insurance holding company. However, where there are insufficient profits within the group to relieve interest costs, they can only be carried forward in a holding company which is a trading company if incurred for its own trade (Section 393(9) ICTA 1988), whereas excess interest expenses will be carried forward as excess management expenses in a holding company which is an investment company.

5.4.7 The greater flexibility of a non-insurance holding company in obtaining relief for finance charges may be particularly important if the Revenue's examination of certain reinsurance arrangements, an important source of finance to many offices, especially the smaller life offices, results in them becoming ineffective for tax purposes.

5.5 Inland Revenue consultative document

5.5.1 The Inland Revenue consultative document on the reform of life taxation⁽⁵⁾ issued in 1988 contains a number of proposals which, if implemented, may significantly increase the advantages of a non-insurance holding company. It is not the purpose of this paper to extensively analyse the proposals but it should be noted that:

- (a) both options B and C suggest that a life office should be taxed on the basis of its gross results, before reinsurance. Option A does not specifically deal with the point, but notes that problems would arise if the policy holders investment roll-up were to arise in the hands of a non-U.K. office (paragraphs 9.11, 10.11, 10.16 and 12.8 of the consultative document). This may result in financing reassurances becoming less attractive and could encourage external debt raised by a non-insurance holding company;
- (b) option B would introduce a Schedule X charge on the policy holders' investment returns computed by reference to the increase in the mathematical reserves as adjusted together with a Case I charge on shareholders' profits (Chapter 9 of the consultative document). This may result in a reassessment of how new business strain is best carried within a life group;
- (c) a fundamental criticism of the present regime of life taxation is that relief for initial expenses should be eliminated or restricted in some way so that the policy holders' investment build up may be taxed as it arises. Such proposals may encourage life offices to take new business strain outside the life office, into, for example, a non-insurance holding company.

6. MARKETING CONSIDERATIONS

6.1 The advantages of using a holding company structure can extend to the sphere of marketing. In addition to allowing the group to offer a wider range of financial services without running into Section 16 difficulties, the holding company allows management various possibilities with regard to marketing these products. Two basic approaches appear to be possible:

- (a) for individual operating companies to be responsible for the marketing of products subject to various corporate requirements which may be set by the holding company. It is highly likely that all the companies in a Companies Act group will constitute a 'marketing group' for the purposes of the FSA 1986 and will therefore have to ensure that any company representatives offer 'best advice' to customers across the range of the groups investment products. It is anticipated that many such groups will *organize their marketing around distribution channels (for example, direct sales and intermediary)* rather than conform to the traditional distinctions of product type (life assurance, unit trust, mortgage lending etc.) although the rules of the self-regulating organizations restrict price or service differentials between different sales forces;
- (b) the holding company itself can act as a marketing agent for its subsidiary companies. The potential for co-ordinating the marketing activities of the group in this manner would appear to offer a degree of commercial logic with the parent company acting almost as a financial supermarket.

6.2 *Diversified approach*

6.2.1 The more diversified approach outlined above would appear to be suitable for larger operations for whom over centralization can become a problem. Operating companies may then be given an amount of independence, subject to certain internal management controls from the parent company. This may take the form of corporate goals such as a return on shareholders equity (say for a life company and measured by some type of appraisal value), a minimum dividend target (perhaps for estate agencies) or a desired level of market share (this could be appropriate for the investment management of segregated pension funds). The individual operating companies can then be given freedom to pursue their desired marketing and business strategies, with rewards to key management being partly related to the performance of their operating company against the goals set by the central management.

6.2.2 The level of control which the holding company management seeks to exert on their operating companies will clearly vary. A diversified approach presupposes that the management of operating companies will be given the opportunity to exploit the additional freedom which should be available to them. The holding company will be responsible for setting operating guidelines. It will

also retain other important functions such as determining overall corporate strategy, in the allocation of limited resources between operating units and, perhaps, in determining the underlying marketing philosophy which is to be adopted by the group.

6.2.3 Subject to possible Section 16 difficulties this type of system can, of course, be operated through a single company structure by setting up appropriate sets of internal departments and management accounting systems. The holding company form, however, may be thought of as having a number of potential advantages. The existence of externally audited accounts for subsidiary companies does help to promote greater responsibility and accountability, a more detailed allocation of expenses (although precise apportionment may still be difficult in many cases), the feeling of independence for their management and adds to the 'impartiality' of the results which are reported each year. Subsidiary companies also offer the possibility of rewarding management and staff with share option schemes which can be used to promote the corporate interests of the group. In addition, the attraction (in terms of motivation and recruitment) of being able to offer former middle management and certain marketing staff director status in a subsidiary company should not be overlooked. The possible uses of share option and Profit Related Pay Schemes are briefly discussed in Section 6.4 below.

6.2.4 It should be clear that it is essential for corporate controls on independent operating companies to reflect the aims of central management. For instance, if the parent company is looking to one of its subsidiaries (say a life company) to produce a flow of dividends, then it would be inappropriate for a management incentive package to be related to the return on shareholders equity as measured by an appraisal value. In the area of marketing, central management may well wish to ensure that the marketing activities of its operating companies conforms to an overall 'image' which it is seeking to project.

6.2.5 A diversified marketing approach can be employed when a company wishes to enter a new field, for example if a broker office wishes to establish a direct sales force. In this way the establishment of a new marketing subsidiary allows the group to create a separate identity which it feels might be desirable to exploit a niche market. Another example could arise if the operation wished to set up a company to engage in mass marketing activities or promote a product which is new to the group (perhaps mortgages). This strategy has been apparent in recent years as a number of traditional companies have acquired a unit-linked company.

6.2.6 The recent decision of the Life Assurance and Unit Trust Regulatory Organisation ('LAUTRO') to allow 'marketing groups' to operate a limited policy of differential pricing (i.e. an identical product can be priced differently according to its distribution outlet) appears to have reduced one potential difficulty from the pursuance of a diversified marketing strategy. LAUTRO's Rules require that a marketing group offer a product at the same price to all its company's representatives. LAUTRO do, however, allow a marketing group to

offer the same product at a better price to independent intermediaries and for direct mail operations. Notification of this position must generally be included in the cancellation notice given by company representatives to policyholders. Thus a group may attempt, to a limited extent, to recognize differences in distribution costs in the pricing of its products. It may even attempt to go further and try to obtain different levels of profitability through different distribution channels, with higher margins being taken in the marketing arm whose products are assumed to be less price sensitive.

6.3 Co-ordinated marketing approach

6.3.1 The adoption of a co-ordinated marketing approach, by using the holding company as a marketing agent for the whole range of the group's financial services products appears to offer some attractions, especially to smaller operations. In the first place, if marketing staff are employees of the life company, Section 16 considerations might well arise. By acting as a marketing agent, the holding company would, in terms of the FSA 86, be an appointed representative of its subsidiary operating companies. In some cases it may be deemed necessary for the holding company itself to seek authorization itself from LAUTRO.

6.3.2 The main advantage of this approach would appear to be that it allows any direct sales force to offer a much wider range of financial services products. Similarly, the holding company itself may seek to market a range of financial services to independent intermediaries, or even attempt a high street retail project (perhaps by attempting to exploit the opportunities presented by any estate agencies it owns). It is envisaged that subsidiary companies will act as providers of products and services to the holding company and they will be subject to the type of corporate controls outlined in paragraph 6.2.1 above.

6.3.3 The points made about remuneration and enhanced status in the section on a diversified marketing approach may be applied in this context too. Subsidiary company management and staff may have a portion of their remuneration dependent on the performance of their particular unit, with the possibility of a further scheme based on the success of the top company. Under this type of structure, incentives for marketing staff would be linked to the performance of the holding company.

6.4 Profit Related Pay Schemes and share options

6.4.1 In the Finance Act 1987 the Government introduced the concept of tax beneficial Profit Related Pay ('PRP') schemes. Within the parameters of these schemes it is generally possible for a company to relate part of the pay of a group of employees to the profits of the sector of the business in which they are involved.

6.4.2 In the case of a life insurance company there is a technical difficulty with the PRP legislation, which requires accounts to show a true and fair view of the

profit centre to be drawn up and reported upon by the company's auditors, in support of the profit on which the PRP payments are based (paragraph 19 Schedule 8 TA 1988). The accounts drawn up by a life insurance company for statutory purposes typically do not show a true and fair view and the company's auditors might well have difficulty reporting satisfactorily on these accounts under the PRP legislation. The Revenue have now agreed that the accounts of a life office, including a mutual office, which comply with Schedule 9 of the Companies Act 1985 will be regarded as complying with the PRP legislation (ABI circular 26/88). In addition, it may be possible to use a non-insurance holding company or, say, a group management services company to offer a PRP scheme to some of the employees of the group.

6.4.3 It would be usual for any approved share option scheme to be offered by a holding company rather than a subsidiary. But if the parent company is listed on a recognized stock exchange, shares of a subsidiary can be used for an approved share option scheme for employees of the subsidiary to reinforce their identification with their immediate employer (paragraph 11 Schedule 9 ICTA 1988). However, before such schemes are made available consideration must be given to the dilution of the parent's interest in the subsidiary and whether an appropriate exit route is available to make the shares attractive to the employees. The ABI has laid down detailed guidelines to insurance offices as investors in companies which operate share option and profit sharing schemes in circular 56/87. These guidelines recommend that to best achieve a clear community of interest between employees' and shareholders' options should normally only be granted over the equity of the parent (rather than subsidiary) company. Life offices will no doubt consider the guidelines in determining what are appropriate arrangements for their own share option and profit sharing incentive schemes.

6.5 *Marketing relaunch*

6.5.1 The restructuring of any operation allows the group to use these changes to provide a platform from which the company is 'relaunched into the new era'. This is particularly true of quoted companies where a corporate restructuring will inevitably attract a certain amount of trade and media attention. By using the restructuring as a vehicle for a marketing relaunch (perhaps in terms of a new corporate identity, or in order to provide additional impetus to the existing marketing effort) the company may seek to capitalize more fully on the attention it will attract. Typical strategies adopted in this context include the promotion of a new image to customers and the industry, presentations and videos given to staff, the redefining of corporate goals and the design of fresh marketing materials and logos.

6.6 *The financial services market*

6.6.1 For some years pundits have predicted the consolidation of the various financial services markets (such as life assurance, banking, house purchase and

unit trusts) as the traditional distinctions between the various institutions become increasingly blurred. One scenario envisages the creation of a number of financial services conglomerates operating in the 'retail' market. Other operators would then be reduced to providing a specialist service to a particular market niche. Given the power of the leading banks and building societies, such developments would appear to have serious implications for the life assurance industry which is currently dependent on the attraction of monies for investment and pensions (as opposed to protection) purposes.

6.6.2 The ideal of 'level playing fields' for all providers of financial services is unlikely to be achieved as varying industries, for example banks and building societies, are subject to different levels and type of regulation. Due to its very nature, the insurance industry is likely to be heavily regulated in an understandable effort to try to ensure that insurers have sufficient financial strength to underwrite the risks they accept from the public. In what promises to be a more competitive world, the restrictions imposed by U.K. insurance regulation may well cause some companies difficulty. The creation of a non-insurance holding company would appear to increase the flexibility of the group, allowing it to use its available capital and marketing strategy with more efficiency.

6.6.3 The recent joint initiatives by Guardian Royal Exchange and Commercial Union in setting up insurance companies with third parties are particularly interesting. In both cases the third parties appear to be providing the distribution arm, as tied agents of the new companies, whilst the insurer contributes its technical and administrative expertise. It is apparent that these ventures require the participants to establish an independent company in order that the returns from the operation can be assessed and apportioned between the participants. The precise basis for this split will of course be a matter for commercial negotiation.

7 MUTUAL INSURANCE COMPANIES

7.1 The repackaging of a mutual life office involves complex legal considerations. The precise legal constitution of mutual offices may vary but many mutual offices have been formed by private Acts of Parliament. Where, for example, such a mutual office wished to become the subsidiary of a new Companies Act holding company (which could form additional subsidiaries to carry on non-insurance business) it would require an Act of Parliament to provide that membership of the office was limited to the holding company. If the members of the mutual office were to become members of the new holding company with similar rights which they currently enjoyed this would need to be covered by the Act or, it might be that the opportunity would be taken to demutualize. The topic of demutualization has been dealt with recently by Franklin and Lee⁽²⁾ in their paper presented to the Staple Inn Actuarial Society and will not be considered in detail here. A mutual, however, can adopt other strategies to obtain additional capital without resorting to a demutualization or losing its independence via a merger with another mutual office.

7.2 One strategy involves the creation of an investment company whose assets consist of certain investments which were formerly in the life fund. Shares in the subsidiary may then be sold to investors outside of the mutual. In this way additional capital may be brought into the mutual if the shares can be sold for an amount in excess of the net value of the assets disposed of. The creation of a subsidiary investment company may then allow the subsidiary access to debt capital markets with less constraint on asset admissibility.

7.3 As a variation on this theme, a mutual company which has a unit linked or a unit trust subsidiary, for example, may be able to raise capital by selling part of its shareholding. Such subsidiaries would be valued for solvency purposes on a 'look through' net asset value basis whereas the sale price, reflecting 'goodwill', should be substantially higher. A significant contribution to surplus would thus be generated, albeit at the expense of a loss of future surplus and, possibly, management control. Nevertheless, it may be worth considering, particularly perhaps if the sale is to an organization where other benefits could arise: for example, new distribution channels.

7.4 An alternative method which a mutual might employ to raise additional capital would involve it purchasing a proprietary life company. Initially, due to the goodwill which is likely to be involved in the deal, the purchase will reduce the solvency of the purchaser. To raise additional capital effectively, the mutual must transfer its long term business into the long term business fund of its subsidiary. This transfer will be governed by Sections 49 and 50 of the ICA 82. Shares in the proprietary company may be floated by the mutual to raise the capital it requires. This exercise may be thought of as being effectively a demutualization by the 'backdoor' and for this reason it may well not be favoured by some. Also, it may be difficult to find the right proprietary company at the right price. Alternatively, a mutual could itself form a proprietary life company, transfer its long term business fund to that company and offer shares to outsiders. This would raise the intriguing question of the ownership of the mutual. Presumably, provision would have to be made for membership of the mutual to subsequently depend on the holding of policies with the new proprietary insurance company.

7.5 It is clear that the arguments in favour of demutualization, especially for smaller companies, might be formidable. The advantages of creating a holding company, as discussed above, mainly derive from the increased flexibility and capital efficiency which can be promoted. ABI circular 42/88 (paragraph 2.2.1 above) specifically referred to the potential problems presented to a mutual office in complying with Section 16 ICA 82. For a mutual company the most persuasive argument in favour of a full blown demutualization is likely to arise from a shortage of capital. A recurring theme of this paper has been the changing nature of the life assurance and other financial services markets. This may all add up to increased pressure on some mutual operations due to:

- (a) increased competition for new business from both the insurance and non-insurance sectors;

- (b) the need to contain overheads and offer an improved service to the policyholders;
- (c) increased expenditure on fixed assets such as on the computer hardware and software required for 'flexible' unit linked products;
- (d) the need to offer a wider range of financial services.

The, at best, limited ability of a mutual to raise the additional capital which may be required to respond to these challenges could well result in the demutualization of a number of offices or joint ventures through subsidiaries. A significant disadvantage to management arising out of a demutualization, or joint venture, is likely to be the new level of accountability resulting from the creation of a body of shareholders.

8. POSSIBLE DISADVANTAGES OF A HOLDING COMPANY STRUCTURE

8.1 This paper has extolled the virtues of life offices adopting a corporate structure headed by a non-insurance holding company given the current state of the financial services market and insurance regulation in the U.K. To balance the picture somewhat, we will now examine some of the disadvantages which may arise if this prescription is adopted.

8.2 *Increased complexity*

8.2.1 Even if the newly created holding company is a non trading 'shell' company, it adds to the complexity of the organization. It is unlikely to lead to a reduction in the number of management and executive posts, rather it is almost certain that additional positions will be created. If this occurs, salary roll and associated costs will be increased.

8.2.2 The creation of the holding company structure itself will result in many one-off costs. The fees levied by professional advisors (legal, accountancy and management consultancy for example) will be explicit costs, whilst the expenditure of management and other staff time will require an effort, the costs of which will be less easy to quantify.

8.3 *Corporate control*

8.3.1 This is perhaps the most difficult area and concerns problems which are certainly not unique to a holding company structure. Nevertheless, a diversified group trading through a series of relatively autonomous subsidiary companies faces many difficult choices about exactly how to control operations. If too tight a rein is kept by the top company, business opportunities may be missed and the management of subsidiary companies will probably become disenchanted as a result of their lack of influence. Conversely a lack of control from the centre may also cause problems, for example:

- (a) trading companies may pull in conflicting directions. In the instance where

one company is selling (pensions) products to corporate clients, whilst another subsidiary is engaged in marketing individual (and therefore personal pension) contracts, they could conceivably compete with each other;

- (b) a duplication of certain efforts due to a lack of co-ordination between operating companies or as a result of an 'empire building' mentality which may arise within subsidiaries;
- (c) expense overruns, perhaps resulting from the failure to introduce the comprehensive set of reporting procedures which are required to successfully operate this type of structure;
- (d) a lack of overall strategic direction for the group as a whole, which may result in business opportunities being missed.

Whilst the conventional single life office is by no means immune to these problems, a holding company structure is likely to present management with additional difficulties in this area. On the other hand, such problems should be identified more rapidly when they arise in subsidiaries and this may be a significant advantage of the holding company form for traditional '90/10 life offices' where management are, to some extent, insulated from the effects of their actions by the with profit fund.

8.3.2 The successful resolution of the organizational and control difficulties associated with the adoption of a revised corporate structure will, no doubt, require the adoption of solutions which are unique to each company. Attention will have to be paid to such intangible features as office culture and the personalities of key individuals.

8.4 Technical difficulties

8.4.1 The adoption of a holding company structure can introduce various 'technical difficulties' which an office has not previously encountered. Typically these problems will be legislative or tax related. Examples might be:

- (a) with the introduction of non-insurance companies, the group could find itself open to the payment of value added tax on certain intra-group transactions unless a VAT group registration was adopted;
- (b) service agreements between companies need to be framed so as to operate on an 'arms length' commercial basis to minimize potential difficulties with both the DTI and the Inland Revenue;
- (c) a capital restructuring may, if carelessly designed, result in a sizeable tax bill.

8.4.2 Many of these problems can be solved by in-house experts or with the help of consultancy advice. They do, however, illustrate the need to adopt a careful approach when undertaking a significant restructuring, with an appropriate amount of attention being paid to detail.

9. CONCLUSIONS

9.1 The theme underlying this paper has been the need for life offices to carefully examine their corporate structure in the light of the restrictions and opportunities provided by the new legislation and the financial services market. The treatment of most life assurance contracts as investment business has been formalized by the FSA 86 and an efficient and flexible corporate structure will be an important factor in determining who wins and loses in the new environment.

9.2 If the actuary wishes to be seriously involved in the strategic management of a life office, he needs to be aware of the options which are available in the field of corporate structure. The factors underlying the choice of office structure may also have an impact on traditional actuarial spheres of operation (for example, the use of a holding company to reduce new business strain should affect the pricing of an office's contracts) or, equally, they may serve to focus attention on the new markets and products which may exist for the company.

9.3 The development of the life office within the framework of a wider financial services market has already begun. Given the current state of insurance company legislation in the U.K., it is our contention that the use of a non-insurance holding company is an important first step in promoting the flexibility which will be necessary in the new market.

10. ACKNOWLEDGEMENTS

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