UK Tax Legislation for General Insurance Technical Provisions

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1. BACKGROUND AND AIMS OF THE PAPER

Introduction

1.1 This paper relates to the tax rules governing technical provisions for general insurance companies. The relevant tax legislation is Schedule 11 to the Finance Act 2007 - Technical Provisions made by General Insurers ("the Legislation") and associated regulations - The General Insurers' Technical Provisions (Appropriate Amount) (Tax) Regulations 2009 SI2009/1926 ("the Regulations"). The Legislation and Regulations are summarised in Section 2, with the original material being shown in Appendix 1, along with a pre-final draft of HMRC's relevant guidance in Appendix 3. The Legislation replaces the previously applicable S107 of Finance Act 2000 which was repealed by the Finance Act 2007. The Regulations come into force on 1 September 2009, to apply to periods of account ending on or after 31 December 2009.

1.2 This paper aims to provide relevant material for actuaries and other reserving specialists who are involved in applying the Regulations. However, it does not represent formal or informal guidance from either the UK Actuarial Profession or the Board for Actuarial Standards. Rather, it provides a summary of the Regulations, as the authors understand them, gained through discussions that they have had with HMRC during the evolution of the Regulations over the last few years. We also raise a number of discussion points around the interpretation of the Regulations. Inevitably, actuaries (and others who are affected by the rules) will need to interpret the Regulations themselves in each particular context, and use their professional judgment to decide how they should be implemented in practice.

1.3 It is intended that this paper will be discussed in a workshop at the annual general insurance actuarial convention ("GIRO") in October 2009. The paper is intended to provide the basis for that discussion. We hope to receive feedback on the paper at the GIRO workshop, and perhaps also through other channels (e.g. from tax specialists within insurance companies and professional firms).

1.4 Depending on feedback that we receive on this paper, it is possible that we may be asked by the UK Actuarial Profession to use some of the material contained here to produce a more formal "Information and Assistance Note" ("IAN").

1.5 At the time of writing, the Regulations are not yet in force, and hence it has not been necessary for any firm to apply them in practice. It is likely that further issues around their practical application will emerge in due course. If so, the authors may issue an update to this paper.

1.6 The authors are not tax specialists, and so this paper should not be taken to represent any kind of authority on the detailed application of the Legislation or Regulations in practice.

Brief summary of the Legislation and Regulations

1.7 The Legislation and Regulations are designed to place a limit on the tax deduction for general insurance technical provisions, so as to ensure that insurers do not reserve too prudently for tax purposes. They will apply to general insurance companies and UK branches of non-UK general insurance companies, Lloyd's syndicates and their members, controlled foreign companies ("CFC's) and UK companies that have an interest in CFC's.

1.8 Under the Regulations, the technical provisions in the accounts should be allowable for tax purposes, provided the claims reserves elements of those provisions (effectively the case reserves plus IBNR/IBNER) are based on an opinion that those provisions are not excessive. In most cases, this opinion would be expected to be provided by an actuary (although that is not a requirement) and in any case needs to comply with relevant actuarial standards. There is no provision in the Legislation for a general insurer to self-assess for tax purposes any figure other than the accounts provision, although HMRC's guidance authorises its officers to accept figures alternative to those appearing in the accounts provided they are accompanied by a suitable actuarial opinion.

1.9 The insurer's tax return may be challenged if HMRC considers that the technical provisions stated in the accounts exceed an "Appropriate Amount". In the event of a challenge, if an insurer does not provide a suitable opinion, then the default basis for the claims reserves that will be allowable for tax purposes will be the undiscounted best estimate, defined as the mean of the distribution of potential outcomes.

1.10 HMRC will apply certain tests to relevant data in order to identify "outliers" who they consider might, in the company's accounts, be using technical provisions that are excessive for tax purposes. If, following application of these tests and other procedures, HMRC chooses to enquire into the tax deduction for the technical provisions for a particular insurer, then this could ultimately result in the tax deduction being limited to an amount lower than that used by the insurer in its accounts and therefore in its tax return. If this is the case, then the closing technical provisions for tax purposes will be set to the lower allowable amount. The effect would be a deferral of the tax deduction, as this closing value would then become the opening value in the subsequent year's tax computation.

1.11 The above is only a very high-level summary of the Legislation and Regulations. A more detailed description is contained in Section 2 of this paper.

1.12 Section 3 considers the issue of determining whether the reserves are excessive or not. Section 4 provides some commentary on the actuarial guidance that is relevant to this issue and finally section 5 considers a range of other issues that the authors have identified in relation to the Regulations.

1.13 We have also include appendices showing the Legislation and Regulations themselves, an extract from the relevant accounting regulations related to certain elements of the technical provisions, a pre-final draft copy of

HMRC's guidance on this subject and finally an example actuarial opinion wording.

Acknowledgements

1.14 Simon Claydon, David Clissitt and Chris Marinan provided comments on drafts of the paper. A draft of the paper has been reviewed by HMRC, and the Board for Actuarial Standards has reviewed a draft of Section 4. We thank all of these parties for their input, but the authors take full responsibility, however, for any errors, omissions or other deficiencies within the paper. The views represented in this paper are the authors alone and not necessarily those of their firms or employers, or of the Faculty and Institute of Actuaries.

2. OUTLINE AND INTERPRETATION OF THE NEW LEGISLATION AND REGULATIONS

Introduction

2.1 This section summarises the Legislation and Regulations, as given in Appendix 1. This is simply the authors' own interpretation and does not represent any formal interpretation from HMRC, the UK Actuarial Profession or any of the authors' employers. We cannot give any assurance as to the accuracy of this interpretation – the actual Legislation and Regulations should always be regarded as the definitive source, and individual companies will need to make their own interpretation of the Legislation and Regulations when applying them in practice.

2.2 There are several issues that might arise when interpreting the Regulations in particular. The issues identified by the authors are given below after the definition of the Appropriate Amount.

Appropriate Amount

2.3 The technical provision in the accounts that is used for the purpose of the Regulations (defined as the "Appropriate Amount") is defined as the sum of:

a) the UPR;

b) the additional amount for unexpired risk (ie the URR); and

c) the claims outstanding provision (i.e. case reserves plus any IBNER and IBNR)

all on a net of reinsurance basis, and may include provisions for claims handling expenses.

2.4 Item c) - i.e. the case reserves and IBNR/IBNER - within the Appropriate Amount can only be included in the Appropriate Amount if the following three conditions are satisfied:

A **i)** The general insurer must give written confirmation with the tax return that the claims outstanding provision is not excessive, and

ii) that confirmation must be founded on or supported by the written opinion of an actuary or other suitably skilled person (see below), which is

B derived using the circumstances prevailing at the time at which the technical provisions are adopted by the general insurer; and

C is made in accordance with standards set by the Board for Actuarial Standards (or an equivalent standard for non-UK general insurers).

2.5 If any of these conditions are not met, the appropriate amount of the claims outstanding provision is limited to the undiscounted best estimate. The reference to "best estimate" in the Regulations is stated as intending to be

a reference to the mean of the distribution of the potential outcomes of the claims to which the estimate relates (at paragraph 7 (3) (a)).

2.6 In the remainder of this paper, we refer to the confirmation in A i) above as "The Confirmation" and to the opinion in A ii) above as "The Actuarial Opinion" (for convenience, but noting that the opinion does not necessarily need to be given by an actuary).

Compliance and Interpretation

2.7 There are a number of issues for a company to consider as a result of these Regulations. These are discussed further below.

Suitably skilled person

2.8 The "suitably skilled person" in condition Aii) is not further defined within the Regulations, but it will presumably need to be someone able to interpret and follow actuarial guidance. It appears therefore that the Actuarial Opinion must therefore be an actuarial one, even if the person giving it does not need to be a Fellow of the Faculty or Institute of Actuaries (or other professional actuarial body). It is understood that the broad term is used by HMRC to cater for exceptional cases where the requisite skill may be that of a lawyer or engineer.

2.9 The person giving the Actuarial Opinion can either be employed by the company (including a Director) or be external to the company.

2.10 If the opinion is given by an employee or Director of the company (as opposed to a person who is external to the company), then the Regulations require that the Confirmation must include a statement confirming the status of the person giving the opinion. By "status", HMRC have confirmed that the Regulations (in paragraph 6 (2) of Part 2) simply mean that it must be made clear whether the person is a Director or otherwise of the company.

Elements requiring Confirmation and Actuarial Opinion

2.11 Whilst the conditions in relation to the Appropriate Amount require a Confirmation and Actuarial Opinion in relation to the case reserves and IBNR/IBNER, no Confirmation or opinion is required in relation to the UPR and URR. These amounts must of course in any case be computed in accordance with the relevant accounts regulations (which are shown in Appendix 2 to this paper for ease of reference). The derivation of the UPR is effectively usually a relatively mechanical process with limited judgment required in most cases. However, if a loss is anticipated on the unearned premiums and a URR is deemed appropriate, there will clearly be judgment involved in establishing that amount, which is not itself subject to the Confirmation or supporting Actuarial Opinion.

2.12 The Regulations state that the claims handling expenses that are allowable for tax purposes include both allocated and unallocated claims handling expenses. The Regulations do not, though, state whether the Appropriate Amount can include an allowance for reinsurance bad debt, but we feel that

if an insurer has included an allowance for reinsurance bad debts in their accounts in relation to the relevant components of the Appropriate Amount, then it is reasonable for this to be taken into account by the actuary when giving their Actuarial Opinion.

Format of Confirmation and Actuarial Opinion

2.13 HMRC does not give any specific guidance on the format of either the Confirmation or the Actuarial Opinion; they appear to be leaving that to each insurer's discretion. We give an example Actuarial Opinion wording in Appendix 4. Clearly, each insurer and person providing the Confirmation and / or Actuarial Opinion will need to determine their own wording, possibly in consultation with HMRC, if required, and hence this example wording is not intended to be appropriate for any specific situation. It does not represent any form of "approved" wording from HMRC, the UK Actuarial Profession or the Board for Actuarial Standards.

2.14 The example in Appendix 4 is intended to provide wording for an opinion that relates solely to whether or not the claims reserves are excessive. If an actuarial opinion is prepared for other purposes by or for the company (e.g. at Lloyd's for solvency purposes) then it might be possible to amend that opinion to include an additional statement that the reserves are not excessive (as opposed to producing an entirely separate opinion for tax purposes alone). In this case, clearly the signatory to the opinion would need to ensure that the opinion satisfies all relevant purposes without any conflicts, and also that the relevant reserve amounts and governing regulations are appropriately referred to in the opinion.

Actuarial Standards

2.15 Consideration needs to be given to whether the calculations and analysis carried out in order to reach the Actuarial Opinion, if there is one, were undertaken in accordance with actuarial standards. The Regulations make it clear that the actuarial standards that must be complied with are all generic and relevant specific technical actuarial standards published by the Board for Actuarial Standards in relation to the performance of actuarial functions. The issue of what guidance applies is considered in more detail in Section 4.

Definition of "excessive"

2.16 The Regulations deem the liabilities to be an excessive estimate unless "the estimate includes no more than a reasonable margin to take into account the nature or type of risks to which the liabilities relate and the uncertainty in measuring those risks". This seems to suggest that an amount that is equal to a best estimate plus a risk margin, may be acceptable, as long as that risk margin is "reasonable", taking into account the portfolio being considered.

2.17 This issue is at the heart of the actuarial considerations involved in providing the Actuarial Opinion, and we therefore consider this in more detail in Section 3.

2.18 Despite the inevitable and possibly difficult judgmental aspect to the interpretation of "excessive", and the fact that most actuaries are more

accustomed to providing a "sufficiency" opinion rather than the opposite "not excessive" opinion, the authors consider that in most cases, it should be reasonably straightforward for an actuary (or other suitably skilled person) to demonstrate that the relevant reserves are not set at a level that can be described as excessive. However, since this is a new area for actuaries and other reserving specialists, it remains to be seen whether this is actually the case in practice, and there may of course be some companies where the actuary concludes that the proposed reserves are excessive (in which case a lower figure might be used by the company for tax purposes, as discussed further in paragraph 2.22 below).

Discounting

2.19 No mention of discounting is made in the Regulations in relation to the Actuarial Opinion, although the fallback best estimate position is clearly stated as being on an undiscounted basis. HMRC appear to be leaving it to the company to consider whether discounting is appropriate for some or all of the reserves.

2.20 One possible interpretation is that in determining whether or not the reserves are excessive, HMRC may consider that it would be appropriate to take into account what potential there is for investment income to accrue on those reserves, as well as of course the underlying uncertainty associated with the potential future claims outgo. Furthermore, where an insurer already discounts some or all of their reserves in their financial statements, then we assume that HMRC would expect this basis would be used for the purpose of the Actuarial Opinion.

2.21 Individual actuaries and insurers will need to consider their own position in relation to discounting, and decide whether or not they wish to clarify any related uncertainties with HMRC. Of course, since the fallback position can only be on an undiscounted basis, the need to consider whether the reserves should be discounted, in whole or part, does not apply if the fallback position is used.

Use of an amount lower than that in the Accounts

2.22 HMRC have confirmed that the aim of the legislation is to ensure that a suitably skilled opinion based on the parameters specified by the Regulations is reflected in the figures that feed through into the tax calculation, and have instructed their officers to accept, subject to normal risk assessment procedures, an alternative reserve figure put forward by the company with a suitable actuarial opinion if the accounts figure is recognised by the company to be excessive so the normal Actuarial Opinion cannot be given. Only if there were a dispute that went to litigation would the fallback undiscounted best estimate be enforced.

Timing – of Regulations and provision of Confirmation/Opinion

2.23 The Regulations come into force on 1 September 2009 and apply to accounting periods ending on or after 31 December 2009. For Lloyd's, the Regulations will first apply to syndicate returns in respect of profits or

losses declared in 2010 - that is to the 2007 Year Of Account returns and run-off of earlier Years Of Account as at 31 December 2009.

2.24 In relation to the timing of the submission of the Confirmation and the preparation of the Actuarial Opinion, as long as the Actuarial Opinion reflects the circumstances prevailing at the time at which the technical provisions are adopted by the general insurer, then this will be acceptable to HMRC. In other words, as long as the "as-at" date used in any actuarial calculations/analysis to determine whether or not the reserves are excessive is the same as the as-at date for the relevant financial statements, then the opinion does not have to be provided at the time at which the accounts are produced.

2.25 It should be noted that the Regulations make it clear that the Confirmation must be provided to HMRC along with the tax return, but the Actuarial Opinion does not necessarily need to be provided to HMRC (unless called for if, exceptionally, an enquiry is opened). The Confirmation must be founded on or supported by the Actuarial Opinion given to the insurer, which means it must therefore be signed on or before the date of the Confirmation. The insurer can of course choose to provide the Actuarial Opinion to HMRC if it wishes, which HMRC guidance suggests may beneficially affect the risk assessment.

2.26 We understand that the filing deadline for the tax return is one year after the accounting date for a general insurer and six months after the accounting date (for the syndicates) in a Lloyd's context. Companies and Lloyd's entities may of course wish to file sooner than these deadlines, which would affect the timing of the Actuarial Opinion being required, since that opinion would need to be available at or before the date of the Confirmation, which should accompany the tax return.

2.27 We assume that in establishing the reserves to be used in the financial statements, the directors of the company (and possibly the auditors) would want to know whether these reserves are likely to be suitable for tax purposes. Hence, at the time the accounts are finalised, we would expect that most companies would at least want a degree of certainty around whether a "not excessive" opinion is likely to be forthcoming from the person providing the Actuarial Opinion, even if the formal opinion (and associated report) is not available at that time. An alternative compromise that might satisfy this requirement would be to follow the approach used in the Lloyd's Statement of Actuarial Opinion solvency regime whereby the formal (and usually brief) actuarial opinion is provided at the time the associated solvency return is finalised, and the supporting report is provided within, say, approximately two months of the date of the opinion. With this approach, the formal Actuarial Opinion for tax purposes would be signed (but not necessarily provided to HMRC) around the time when the accounts are finalised, and then the supporting actuarial report would be produced before the tax return is submitted, at which time the Confirmation (and possibly the Actuarial Opinion as well) would be supplied to HMRC. Each insurer will need to decide whether they wish to submit the Actuarial Opinion and the supporting actuarial report to HMRC (which may be beneficial bearing in mind the comments in Section 2.25).

HMRC identification of insurers for investigation

2.28 We believe that HMRC intend the new rules to cause specific tax-driven actions in relation to the level of reserves that are allowable for tax purposes only in cases where the reserving strength is clearly excessive, and that they expect such instances to be rare, if not very rare. Their "risk assessment" approach to determining which insurers to investigate further seems to be twofold. First, they plan to use a quantitative test, or series of tests, to identify possible "outliers" compared to industry norms. These tests will be outlined in HMRC's General Insurance Manual (GIM) at paragraph 6660 (a pre-final draft of which is contained in Appendix 3 to this paper). Second, HMRC will determine certain "risk factors" which might warrant further investigation. These two aspects of the risk assessment approach are discussed in more detail below.

2.29 At the time of writing (early August 2009) we understand that HMRC are in the process of designing the quantitative tests based on using FSA return data to identify possible outliers compared to the overall market. This clearly only applies to the company market; HMRC have indicated that they will develop parallel tests for non-UK captive insurance companies and for Lloyd's syndicates, although we anticipate that this is likely to be more difficult than for the company market, due to the lack of suitable publicly available market data (although perhaps HMRC will be able to gather data from other sources). It will also be a challenge in relation to UK branches of other EEA insurers. We expect HMRC to publish details of the tests in due course and hence, in theory at least, it might then be possible for individual insurers to apply the tests themselves for earlier balance sheet dates to get some idea of whether they might be an outlier (if they have the relevant FSA or other data).

2.30 The second element of HMRC's risk assessment approach relates to the identification of what they might regard as possible "risk" factors, which might warrant further investigation. The risk factors that we believe HMRC might consider include the following:

- Use of the undiscounted best estimate, rather than the opinion route;
- If the opinion route has been used, who the opinion was given by and whether that person was either a) an employee b) a director or c) a consultant (i.e external to the company);
- If the opinion route has been used, how much information was supplied to HMRC to support the opinion (e.g. report or summary);
- Any other general information known to HMRC regarding the insurers' reserving history or other relevant matters, which HMRC might regard as possibly indicative of being a risk factor (e.g. a history of discussion with HMRC over appropriate reserving levels); and
- What level of tax is "at risk" (e.g. if there are substantial tax losses then HMRC may not consider an investigation to be justified).

2.31 HMRC's guidance at GIM6650 gives further details of the step by step approach that HMRC will apply (as per Appendix 3). This suggests that enquiries are only likely to be contemplated, save in exceptional

circumstances, where the quantitative tests have shown the insurer to be an outlier. Hence, in theory therefore, even if some or all of the above risk factors are present, HMRC are unlikely to open an enquiry if the insurer is not flagged as an outlier by the quantitative tests, but clearly this cannot be ruled out.

2.32 In any enquiry, for HMRC to be "successful" (ie demonstrate that the reserves were actually excessive, despite the possible existence of an opinion to the contrary) then they would have to demonstrate this based only on the information available as at the relevant valuation date (e.g 31 December), without making any use of the benefit of hindsight. This is consistent with HMRC's guidance at GIM6630. HMRC have confirmed that there is no room for hindsight.

2.33 In addition to the normal information powers in relation to tax enquiries, HMRC have the power to require a general insurer to obtain an independent report as to whether the provisions in the accounts exceed the Appropriate Amount, and if so by how much. Although we understand that such a report would not be routinely required in tax enquiries, the costs associated with fulfilling such a requirement may be significant. This underlines the need for all general insurers to ensure they are able to demonstrate clearly that they have complied with the Regulations. So, where the opinion route is used, this means being able to demonstrate that the opinion has met all the relevant conditions. Where there is no opinion, the Appropriate Amount becomes the undiscounted best estimate, and presumably in that case the insurer would need to be able to demonstrate that that figure is a "reasonable" undiscounted best estimate. This in turn may lead to the need to demonstrate that the undiscounted best estimate was a mean of potential outcomes (as noted in paragraph 2.5 above).

3. DETERMINING WHETHER THE RESERVES ARE EXCESSIVE

3.1 The Regulations require the insurer to give confirmation to HMRC with its tax return that the "amount of the liabilities stated in the accounts is not an excessive estimate of the amount of liabilities" if the insurer wishes to rely upon that figure in the event of an HMRC challenge (as opposed to defaulting to another figure). The Regulations state that an estimate is excessive unless it includes "no more than a reasonable margin to take into account the nature or type of risk to which the liabilities relate and the uncertainty associated with those risks". This seems to suggest that HMRC might accept that larger margins (relative to the best estimate) might be acceptable for more volatile classes of business. However, the term "reasonable" is not further defined or clarified by HMRC and hence this exercise becomes highly judgemental, particularly since the Regulations do not include any quantitative definition of what they regard as excessive.

3.2 We understand that any disputes between the insurer and HMRC relating to whether or not the reserves are excessive or not would be subject to the normal tax appeal processes – i.e. reference to an independent tax tribunal, and so the judgment on excessiveness is ultimately for the new Tax Tribunals, and ultimately the Courts, not HMRC.

3.3 In effect, by requiring an Actuarial Opinion to support the reserves that are allowable for tax purposes, but without giving a precise (or even imprecise!) definition of "excessive" or "reasonable margin", the Regulations have placed the interpretation of these terms firmly in the hands of the individual actuary (or other person) providing the opinion, subject to review within the legal system (i.e. via tribunals including likely use of expert witnesses). Such interpretation therefore lies at the heart of the application of these Regulations.

3.4 Numerous methods could be suggested for determining whether the provisions are excessive. As noted earlier, in order for it to be able to rely upon the technical provisions in the accounts for tax purposes, the Regulations require that the "general insurer" (which presumably effectively means the person who signs the tax return) gives written confirmation that this is the case, "founded on or supported by an opinion…….by an actuary or other suitably skilled person". Therefore it is vital that the method(s) chosen to support the confirmation can be readily communicated to the person giving the Confirmation, since they have ultimate responsibility (perhaps including some form of internal review by the Board as well) for providing the confirmation that the reserves are not excessive.

3.5 The method(s) chosen should also be proportionate. In some cases, the provision carried by the insurer may be only slightly above (or perhaps equal or below in some cases) the actuary's best estimate. If so, little additional work is likely to be required in order to provide a "not excessive" opinion. Where the carried provision is greater than the actuary's best estimate by more than a clearly "small" amount, then more work will likely be required. Judgment will of course be required in deciding what is "slightly above" or what is "more than a small amount".

3.6 Factors that the actuary could consider in determining whether a "not excessive" opinion can be given might include:

- The quality of the data available to conduct the provisioning exercise;

- The extent to which adverse scenarios have or have not already been factored into the actuary's best estimate. For example, an assumption of no change to the legislative background might be made in determining the actuary's best estimate. In reality, this possibility always exists with potentially material impact, and hence this should be taken into account in determining whether the booked claims reserves are excessive (by either allowing for this issue within the best estimate itself, or factoring it into the consideration of whether the booked claims reserves are excessive);

- The potential for latent claims within the insurer's portfolio;

- The extent to which high inflation assumptions have been factored into the actuary's estimates;

- The general statistical uncertainty underlying the estimation process; and

- The historical record of the actuary's estimate against the ultimate outcome (though this presupposes a reasonably long "track record" for the estimates).

The actuary will also need to consider what allowance, if any, should be made for discounting when considering whether the reserves are excessive, as discussed in Section 2.

3.7 One way to demonstrate that a margin above a best estimate is reasonable would be to calculate the impact of changing key assumptions to reflect adverse scenarios. Such scenarios should not be too extreme but reflect plausible alternative outcomes, perhaps based on events that have happened in the past. Assuming this is the case and the sum (across all scenarios) of these adverse movements is considerably greater than any margin carried in the provisions then a "not excessive" provision should normally be able to be given.

3.8 Another approach, already used by some insurers to assess the level of prudence in their technical provisions, might be to estimate the distribution of the future claims, and then determine the percentile on that distribution of the carried provision. This could include a "VAR" approach or a "TVAR" approach. In either case, a judgment then needs to be made as to whether this is a "reasonable" percentile, taking into account the specific circumstances. This approach could perhaps be used in conjunction with the "scenario" based approach described above.

3.9 In some cases (e.g. for very small companies or captives) a relatively simple approach may be appropriate. This could be based, for example, on an examination of historical individual claims (to show what is reasonable potential downside in the future outgo) or on an examination of the historical volatility in loss ratios or movement in ultimate claims estimates. Such approaches may also be helpful in more complex situations as additional supporting evidence for the conclusion that the claims reserves are not excessive.

3.10 Most UK insurance companies will already be assessing reserve uncertainty for the purpose of their ICAS work. They may well be able to make use of that work to determine where the booked claims reserves are in the spectrum of potential future outcomes, and hence determine whether the proposed booked claims reserves contain a reasonable allowance for risk (and hence whether they are excessive or not).

3.11 It is important that any consideration of whether or not the booked claims reserves are excessive takes into account the fact that some methods used to determine reserve uncertainty can under-estimate the tail of the distribution, and hence the results may need adjusting to ensure that appropriate allowance is made for all causes of adverse outcomes. The recent financial crisis has certainly focused everyone's mind on the subject of uncertainty. In determining whether reserves are excessive or not, it seems reasonable to ask ourselves some difficult questions regarding whether the data we have available (both at a company and market level) really does capture all the risks that need to be captured.

3.12 Any individual actuary considering the approach to use to determine whether the booked claims reserves are excessive will need to select an approach that they consider to be appropriate in the particular circumstances. In doing so they may be able to make use of the considerable volume of actuarial literature produced in the UK and elsewhere on the subject of reserve uncertainty, which may be relevant to this issue.

3.13 What is clear is that, in the same way as there is for determining best estimates of claims reserves, there will inevitably be a considerable degree of judgment involved in determining whether a particular booked claims reserve figure is excessive or not.

3.14 We have intentionally not quoted any specific "figures" (e.g. percentiles) that we would regard as being not excessive, but propose to take some soundings at GIRO and elsewhere to determine if any form of consensus emerges.

4 RELEVANT UK ACTUARIAL PROFESSION AND BAS GUIDANCE

4.1 Currently there is no specific guidance from either the Board for Actuarial Standards ("BAS") or the UK Actuarial Profession on this issue. However, we expect that any report supporting a "not excessive" opinion would need to comply with GN12.

4.2 At the time of writing, the BAS is in the process of issuing Technical Actuarial Standards. Exposure Drafts for generic Standards on Reporting, Modelling, and Data have been issued. We understand from BAS that these are likely to be issued as Standards in 2009 and will come into full force in 2010 (though earlier adoption is encouraged by BAS). We also understand that an Insurance specific Standard is in development and will be exposed in late 2009.

4.3 The authors' understanding is that the Insurance specific Standard will bring the work connected with providing an opinion for tax purposes into scope. Therefore the generic Standards will apply to this work. It is likely that reserving work in general will also be in scope so compliance with Standards for tax purposes may take little incremental effort.

4.4 Some of the potential issues around meeting the BAS Standards can be considered using the example of the Reporting Standard, where the impact is likely to be largest. Perhaps the purest process runs as follows: the actuary calculates an estimate of required reserves, Management then determines the amount to be carried in the Accounts, and finally the actuary opines on the reasonableness of any (positive) difference between the carried and required amounts.

4.5 Modelling and Data issues are most likely to be dealt with in the work carried out to provide the estimation of required reserves and so are outside the scope of this note (though model error and poor data may be issues which the actuary considers in forming the tax opinion).

4.6 The Reporting Standard requires actuarial information to be given before a decision is taken. In this case, the decision is on the amount to be carried in the accounts. So management may want to know ahead of their final decision about what level would be reasonable. This causes the process described above to become more iterative.

4.7 We understand that the terms "reasonable" or "not excessive" will need to be defined by the actuary as part of the work. This will clearly be highly judgemental. The interpretation of the definition will also need to be monitored over time and, in particular, any changes in definition should be clearly signalled and rationalised.

4.8 In moving from the required reserves to the carried reserves there may be a number of adjustments made which may not normally be part of the actuary's accountabilities. Example might include:

- Reinsurance bad or doubtful debt provisions
- Timing adjustments between the "as at" date of the actuary's work and the balance sheet date

- Unallocated Loss Adjustment Expenses
- Currency adjustments
- Estimates for large or catastrophic losses close to the balance sheet date.

4.9 The actuary responsible for the tax opinion should consider these adjustments when forming his or her opinion. A full reconciliation between the required reserves and the carried reserves is likely to be necessary. These considerations should be included in the report.

4.10 It is possible that the actuary responsible for the work to determine the required reserves is not the same person as the one providing the tax opinion. Reasons may include:

- The tax opinion is at UK insurance entity level which may not match the scope of work of any one actuary
- The entity may participate in Pools where the entity relies on opinions from the Pool actuary
- An entity may carry internal reinsurances which are ignored for management reporting purposes.

4.11 In forming the tax opinion, the relevant actuary may be relying on the work of others. In forming the opinion, the actuary may therefore need to discuss the relevant issues with other actuaries involved and set out what reliance has been placed on the work of others in the opinion and report.

5. OTHER ISSUES

5.1 This section considers a range of other issues that the authors have considered during the evolution of the Regulations over the last few years (that are not already dealt with elsewhere in the paper). The issues considered are as follows:

a) Impact of IFRS and Solvency 2

b) Application in a Lloyd's context

c) Application to captive insurance companies

d) Application to insurance groups

e) Application to UK branches of non-UK insurers.

a) IFRS and Solvency II

5.2 The Regulations relate to the accounts of the general insurer. For EU listed companies the accounts must be prepared under IFRS. However, a particular general insurer that operates within a listed Group may not itself be listed and its accounts may be prepared under UK GAAP. Often, there will be little or no difference in the outstanding claims provisions under the two accounting standards. The main exception so far as insurance provisions are concerned relates to claims equalisation reserves which may be a feature under UK GAAP but are omitted under IFRS. HMRC have confirmed that claims equalisation reserves are in any event outside the scope of the Regulations and so the actuary's opinion should not consider any such reserves.

5.3 It is too early to say how IFRS 4 Phase 2 will impact in this area. However, we understand that if this results in a change in the way in which general insurers establish their technical provisions in their financial statements, then it is likely that HMRC will consider whether it is appropriate to amend the Regulations so that the relevant basis for tax purposes is aligned with that under IFRS 4 Phase 2.

5.4 From end 2012, UK general insurers (above some minimum size) will be calculating technical provisions for prudential supervision purposes using the principles specified under Solvency II. Current indications are that such provisions will be discounted and be equal to a best estimate plus a risk margin. These provisions may not be the same as those calculated for inclusion in the financial statements (and therefore may be different to those that will be used for tax purposes). However, we would not be surprised if HMRC regarded the anticipated Solvency II basis for reserves as a reasonable basis for tax purposes. Therefore, and subject to progress on IFRS 4 Phase 2, it is possible that HMRC will consider whether the Solvency II technical provisions should be adopted for tax purposes from 2012. This will need further clarification in due course, and is not considered further in this paper.

b) Application in a Lloyd's context

5.5 Part 3 of the Regulations specifies how they will apply to members of Lloyd's. The rules operate by reference to the tax return made for a syndicate Year of Account by its managing agent. We understand that a further short set of regulations will be made shortly to adapt the existing Lloyd's administrative regulations as necessary. Any tax enquiries and potential adjustment for tax purposes are made at the level of the syndicate.

5.6 If an HMRC enquiry related to the reserves in a syndicate's tax return were to lead to a tax adjustment, then the Legislation gives power for HMRC to make additional regulations to modify any such disallowance in certain circumstances. We understand that this power could be used to adjust such an amount if the member had member-level reinsurance in relation to some or all of the amount in question. These regulations have not however been drafted yet and need not therefore be considered further in this paper.

5.7 In summary, in a Lloyd's context, the reserves to which the Regulations apply will be the lesser of:

(i) the Reinsurance To Close ("RITC") for the relevant syndicates**1** – i.e. just those reserves relating to the year of account that is closing at a particular year-end; and

(ii) the Appropriate Amount as defined in the Regulations (i.e the UPR, the URR and the claims outstanding).

In effect, the Regulations apply in a Lloyd's context to the RITC in the same way as they apply to the relevant reserves in a company context (with the proviso that if the RITC is greater than the reserve items included in the Appropriate Amount definition, then the latter is used). Part 3 of the Regulations effectively describes how the core company part of the Regulations (i.e. Part 2) is modified to apply in a Lloyd's context. In particular:

i) the Confirmation and Actuarial Opinion only relate to the outstanding and IBNR/IBNER part of the RITC (effectively the earned part of the reserves).

ii) there is no scope for non-UK actuarial standards to apply in a Lloyd's context [i.e Regulation 8 3) b) does not apply].

iii) the fallback approach of using an "undiscounted best estimate" in a company context translates to being the managing agent's best estimate of the reserves (undiscounted, we assume).

iv) there are various provisions catering for the fact that the Regulations apply at the Lloyd's member level.

5.8 Although in substance, the rules are the same in a Lloyd's context as in a company context, the fact that actuarial opinions for solvency purposes already exist at Lloyd's needs to be considered.

5.9 The solvency opinions address whether the reserves are sufficient, with no consideration required as to whether they excessive or not. The sufficiency

1 Except for syndicates in run-off where the reserves as at 36 months (and 48m etc.) are used.

consideration is often addressed by the actuary through comparing his/her independent best estimate of the reserves with the booked reserves that have been determined by the managing agent. If the booked reserves are at least as large as the actuary's independent best estimate, then this would normally allow him/her to sign the solvency opinion. In such a situation, the expansion of this work to cover that required for the tax opinion would require the actuary to consider whether the difference between the booked reserve and the actuary's best estimate is "reasonable", taking into account the nature of the business to which the reserves relate.

5.10 In considering the work required for tax purposes, as a supplement to the work required for solvency purposes, consideration also needs to be given to the fact that the tax opinion relates only to the case reserves and IBNR on earned business, whereas the solvency opinion relates to the total reserves (including UPR) for the relevant underwriting years (although the difference would usually be relatively small for underwriting years that make up the RITC).

5.11 Further work will be needed, possibly in conjunction with the Corporation of Lloyd's, to determine whether the existing solvency opinion framework can or should be amended so that the opinions cover both the new tax-driven "not excessive" purpose as well as the original solvency-driven sufficiency purpose.

5.12 There is a further area where actuarial input can be required into the level of prudence in the reserves for Lloyd's syndicates. This relates to the "gap" between the best estimate of reserves and the booked reserves. In some circumstances, we understand that a proportion of this gap may be allowable by Lloyd's to contribute towards assets to support capital requirements. In this situation, actuarial input might be required to ensure that this gap is not overstated – by effectively giving input to the reasonableness or otherwise of the best estimate (since if the best estimate were understated, this could effectively overstate the gap, and hence overstate the potential "capital credit"). The interaction between this area and the other two areas of the sufficiency opinion for solvency purposes and the "not excessive" opinion for tax purposes may need to be considered by actuaries working in the Lloyd's market.

c) Application to captive insurers

5.13 UK based captives will need to follow the Regulations. Captives with UK domiciled parents, but based in non UK jurisdictions are likely to be Controlled Foreign Companies and hence their parent companies will be liable to UK tax on their profits. Such captives and their parent companies are likely to need to comply with the Regulations for that purpose.

5.14 It is not clear how HMRC will determine whether a particular captive's claims reserves are excessive or not, as there will not be the industry data available to apply their overall "outlier tests", as discussed in Section 2. In the first instance, we assume they will rely on the Actuarial Opinion or the fallback position of the undiscounted best estimate. We understand that HMRC are likely to place greater emphasis on the amount of supporting information and explanations given when undertaking the risk assessment for captives.

5.15 For smaller captives, with limited claims experience, forming the Actuarial Opinion may not be possible using standard actuarial techniques. Rather, those providing the relevant opinions will perhaps need to rely upon a combination of wider benchmark experience, data used to set the premiums payable to the captive, and other simplified techniques such as those referred to in paragraph 3.9.

5.16 For small captives in particular, the relevant captive managers will often be the insurance experts who are closest to the captive's reserving position. We understand that HMRC will have no objection to a captive manager providing the relevant Actuarial Opinion, as long as they can demonstrate that they are suitably skilled persons and can comply with the relevant actuarial guidance. The Confirmation will need to be provided by the UK parent of the company, with their tax return.

d) Application to insurance groups

5.17 HRMC's guidance at GIM6670 (as per Appendix 3) describes how HMRC will approach application of the Regulations for insurance groups. In summary:

- Strictly speaking, as the primary legislation (i.e. Finance Act 2007/Schedule 11) applies to individual companies rather than groups, the Regulations also apply to individual companies rather than groups.

- However, since some groups submit consolidated regulatory returns for the relevant parts of their business, HMRC would expect to focus any enquiries and risk assessment on the group figures, rather than individual companies.

- If HMRC has to subsequently use its formal powers, then it will be necessary to deconstruct the consolidated group figures and apply the powers at company level.

Presumably, this means that the Confirmation and Opinion can also apply to the relevant group reserves, although since subsequent application of the formal powers could require consideration of the company-level figures, we assume that insurers would at least want to consider whether their work at a group level to demonstrate that the reserves are "not excessive" will carry over to an individual company level. An alternative would be to perhaps

provide HMRC with individual confirmation documents for each relevant underlying company with their tax returns, but for all of those confirmations to rely upon a single group-level Actuarial Opinion. Individual insurers will obviously need to assess how they approach this issue in practice.

e) Application to UK branches of non-UK insurers

5.18 The same Legislation and Regulations will apply to these branches, but there may be a number of difficulties for insurers applying them in practice. For example it will be necessary to determine whether UK or overseas actuarial standards apply and whether the different standards would have any different impact on the approach used. In addition, for some groups, the level of detail in relation to the reserving analysis that is already done at the branch level may not be sufficient for UK tax purposes, so additional work may be required beyond that already carried out for parent company/group purposes.

APPENDIX 1 – COPY OF RELEVANT LEGISLATION AND REGULATIONS

This Appendix contains a copy of the primary legislation (Schedule 11 to the Finance Act 2007) followed by the accompanying Regulations (and the accompanying explanatory note to the Regulations). The latter explain the "Appropriate Amount" referred to in the primary legislation.

FINANCE ACT 2007 - SCHEDULE 11 TECHNICAL PROVISIONS MADE BY GENERAL INSURERS

Restriction on amount of technical provisions made by general insurers

1 (1) This paragraph applies if a general insurer makes any technical provisions for a period of account.

(2) The amount of the technical provisions stated in the accounts for that period is to be taken into account in the calculation for tax purposes of the profits of the general insurer's trade for that period unless an officer of Revenue and Customs considers that that amount exceeds the appropriate amount.

(3) In that case—

(a) the excess is not to be taken into account in that calculation, and

(b) the profits of the general insurer's trade for the next period of account are to be adjusted accordingly for tax purposes.

(4) "The appropriate amount" means such amount as is determined in accordance with regulations made by the Commissioners for Her Majesty's Revenue and Customs to be the appropriate amount to be taken into account in that calculation.

(5) Any such determination must be made by reference to the time at which the technical provisions are made.

Enforcement

2 (1) This paragraph applies if an officer of Revenue and Customs gives a notice of enquiry under paragraph 24(1) of Schedule 18 to FA 1998 to a general insurer.

(2) The officer may by notice require the general insurer (at the general insurer's own expense) to provide the officer with a report as to whether (and, if so, the extent to which) the amount of any technical provisions stated in the accounts for any period covered by the company tax return into which the enquiry is made exceeds the appropriate amount.

(3) The report must cover such matters, and be in such form, as the officer may reasonably require for the purposes of the enquiry.

(4) The report must be made by a person who is appointed by the general insurer unless the officer requires the report to be made instead by another person.

(5) As soon as the general insurer appoints a person to make the report, the general insurer must give a notice to the officer specifying that person.

(6) A notice under sub-paragraph (2) must specify the time (which must not be less than 30 days) within which the general insurer is to comply with it.

(7) The following provisions of Schedule 18 to FA 1998—

(a) paragraph 28 (appeal against requirements imposed by notice under paragraph 27), and

(b) paragraph 29 (penalty for failure to comply with such a notice),

apply in relation to any notice under sub-paragraph (2) as they apply in relation to a notice under paragraph 27 of that Schedule.

(8) But the references in paragraph 28 of that Schedule to the provision of information are to be construed as references to the provision of a report under this paragraph.

Supplementary

3 (1) In paragraph 1 "general insurer" means—

(a) a company within the charge to corporation tax which carries on general business,

(b) a controlled foreign company (within the meaning of Chapter 4 of Part 17 of ICTA) which carries on general business, or

(c) members of a Lloyd's syndicate who carry on general business.

(2) In paragraph 2 "general insurer" means—

(a) a company within the charge to corporation tax which carries on general business, or

(b) a company which for the purposes of Chapter 4 of Part 17 of ICTA has an interest in a controlled foreign company (within the meaning of that Chapter) which carries on general business.

(3) For the purposes of sub-paragraphs (1) and (2) “general business” means business which consists of the effecting or carrying out of contracts that fall within Part 1 of Schedule 1 to the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (S.I. 2001/544).

(4) In the case of members of a Lloyd’s syndicate, references in paragraph 1 to any accounts for a period are to the return of the syndicate’s profits or loss for that period under regulation 4 of the Lloyd’s Underwriters (Tax) Regulations 2005 (S.I. 2005/3338).

(5) In paragraph 1 “period of account”—

(a) except in the case of members of a Lloyd’s syndicate, means a period of account for which an account is made up, and

(b) in the case of members of a Lloyd’s syndicate, means an underwriting year in which profits or losses are declared for an earlier underwriting year.

(6) In paragraphs 1 and 2 “technical provisions”, except in the case of members of a Lloyd’s syndicate, means any of the following—

(a) provisions for claims outstanding,

(b) provisions for unearned premiums, and

(c) provisions for unexpired risks.

(7) In paragraphs 1 and 2 “technical provisions”, in the case of members of a Lloyd’s syndicate (“the syndicate”), means—

(a) so much of the reinsurance to close amounts of the members, and

(b) so much of the provisions made by an open Lloyd’s syndicate of which any member of the syndicate is a member for claims outstanding, unearned premiums and unexpired risks,

as may be determined by or under regulations made by the Commissioners for Her Majesty’s Revenue and Customs.

(8) For this purpose—

(a) the reference to reinsurance to close amounts of any member of a Lloyd’s syndicate is to any consideration which, in accordance with the rules or practice of Lloyd's, is given (or any amount which, in accordance with those rules or practice, is treated as consideration given) by the member in respect of the liabilities arising from the member’s underwriting business in an underwriting year for the purpose of closing the accounts of the business for that year, and

(b) a Lloyd’s syndicate is an “open” Lloyd’s syndicate at any time after the end of its closing year if, at that time, the accounts of its business for the underwriting year for which it was formed have not been closed,

and in paragraph (b) “closing year” has the same meaning as in Chapter 3 of Part 2 of FA 1993 or Chapter 5 of Part 4 of FA 1994.

(9) In this paragraph—

“Lloyd’s syndicate” means a syndicate of underwriting members of Lloyd’s formed for an underwriting year, and

“underwriting year” means the calendar year.

(10) In this paragraph references to provisions for claims outstanding, unearned premiums and unexpired risks have the same meaning as in Schedule 9A to the Companies Act 1985 (c. 6).

(11) The Commissioners for Her Majesty’s Revenue and Customs may by regulations—

(a) provide in prescribed circumstances for paragraph 1 not to apply in relation to any member of a Lloyd’s syndicate, or

(b) provide in prescribed circumstances for a reduction in relation to any member of a Lloyd’s syndicate of the amount which (as a result of that paragraph) is not to be taken into account in the calculation mentioned in sub-paragraph (2) of that paragraph.

(12) The Treasury may by regulations amend sub-paragraphs (1) to (3) (definition of “general insurer”).

(13) In the event of any changes in the rules or practice of Lloyd's, the Commissioners for Her Majesty’s Revenue and Customs may by regulations make such amendments of paragraph 1 and this paragraph as appear to the Commissioners to be expedient having regard to those changes.

(14) Regulations under section 182(1)(a) of FA 1993 or section 229(1)(a) of FA 1994 (assessment and collection of tax charged in case of Lloyd’s underwriters) may, in particular, include provision applying paragraph 2 with modifications in the case of members of a Lloyd’s syndicate.

(15) Regulations under paragraph 1 or this paragraph may—

(a) make different provision for different purposes, and

(b) make supplementary, incidental, consequential and transitional provision.

Repeal of section 107 of FA 2000

4 In FA 2000, omit section 107 (general insurance reserves).

Commencement

5 (1) Paragraphs 1 to 3 have effect in relation to periods of account ending on or after the day on which this Act is passed.

(2) The repeal of section 107 of FA 2000 made by paragraph 4 has effect as follows.

(3) The repeal of—

(a) subsections (1) to (3) of that section (technical provisions made by a general insurer proving to be excessive or insufficient),

(b) subsections (5) to (8) and (10) of that section so far as relating to those subsections, and

(c) subsections (9) and (12)(a) of that section (which relate to those subsections),

has effect in relation to any amount that would otherwise have been treated as a receipt or an expense of a trade in computing for tax purposes the profits of the trade for any period of account ending on or after the day on which this Act is passed.

(4) The repeal of—

(a) subsection (4) of that section (election for any part of technical provisions not to be taken into account in a period of account),

(b) subsections (5) to (8) and (10) of that section so far as relating to that subsection, and

(c) subsection (12)(b) of that section (which relates to that subsection),

has effect so that no election may be made under that subsection in respect of technical provisions made by a general insurer for any period of account which begins on or after that day.

(5) There is a restriction in relation to any election made by a general insurer under that subsection in respect of technical provisions made by the general insurer for the final election period.

(6) The restriction is that the amount of the part of those provisions which the general insurer elects not to be taken into account in computing for tax purposes the profits of the general insurer’s trade for that period must not exceed 10% of the total amount of those provisions.

(7) In sub-paragraph (5) “the final election period”, in relation to any general insurer, means the general insurer’s first period of account ending on or after the day on which this Act is passed.

General Insurers' Technical Provisions (Appropriate Amount) (Tax) Regulations 2009

PART 1 INTRODUCTORY PROVISIONS

Citation, commencement and effect

1.—(1) These Regulations may be cited as the General Insurers' Technical Provisions (Appropriate Amount) (Tax) Regulations 2009 and come into force on 1st September 2009.

(2) In relation to a general insurer, other than a member of a Lloyd's syndicate, these Regulations shall have effect in relation to periods of account ending on or after 31st December 2009.

(3) In relation to a member of a Lloyd's syndicate, these Regulations shall have effect in relation to a syndicate return made in respect of profits or losses declared after 31st December 2009.

Interpretation

2.—(1) In these Regulations a reference to Schedule 11 is a reference to Schedule 11 to the Finance Act 2007.

(2) In these Regulations—

"Schedule 3 to the Accounts and Reports Regulations" means Schedule 3 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008(**2**); and

"syndicate return" means a return of a syndicate's profit or loss for an underwriting year made under regulation 4 of the Lloyd's Underwriters (Tax) Regulations 2005(**3**).

PART 2 GENERAL INSURERS (OTHER THAN MEMBERS OF LLOYD'S SYNDICATES)

Appropriate amount of technical provisions: general insurers (other than a member of a Lloyd's syndicate)

3. This Part applies to a general insurer other than a member of a Lloyd's syndicate.

4. For a period of account, the appropriate amount of the technical provisions for the purposes of paragraph 1 of Schedule 11 is the aggregate of—

(a) the amount of the provision for unearned premiums determined in accordance with paragraph 50 of Schedule 3 to the Accounts and Reports Regulations;

(b) the amount of the provision for unexpired risks determined in accordance with paragraph 51 of that Schedule; and

(c) the estimated amount of the liabilities in respect of claims outstanding arising from the general insurer's general business determined in accordance with regulations 5 to 8.

Estimated amount of claims outstanding: confirmation by general insurer

5.—(1) For the purposes of regulation 4, the amount of the liabilities in respect of claims outstanding arising from the general insurer's general business is the amount of those liabilities stated in the general insurer's accounts for the period if conditions A to C are satisfied.

(2) Condition A is—

(a) that the general insurer gives confirmation in writing that the amount of the liabilities stated in the accounts is not an excessive estimate of the amount of the liabilities, and

(b) the confirmation is founded on or supported by an opinion in writing given to the general insurer by an actuary or other suitably skilled person (which may include a director or employee of the general insurer) stating that the amount is not an excessive estimate of the amount of the liabilities.

Regulation 6 contains provisions supplementing condition A.

(3) Condition B is that the opinion referred to in condition A must reflect the circumstances prevailing at the time at which the technical provisions are adopted by the general insurer.

(4) Condition C is that the amount of the liabilities stated in the accounts is determined in accordance with regulation 8 (provisions supplementing regulations 5 and 7).

Provisions supplementing condition A

6.—(1) In the case of a controlled foreign company which is a general insurer within the meaning of paragraph 3(1)(b) of Schedule 11—

(a) references to "general insurer" in regulation 5(2)(a) and in this regulation (other than in sub-paragraph (b) of this paragraph) are to be construed as references to the company referred to in paragraph 3(2)(b) of Schedule 11, and

(b) the reference to "general insurer" in regulation 5(2)(b) is to be construed as a reference to the controlled foreign company.

(2) For the purposes of condition A in regulation 5, an estimate of the amount of the liabilities is an excessive estimate unless the estimate includes no more than a reasonable margin to take into account the nature or type of risks to which the liabilities relate and the uncertainty associated with those risks.

(3) If the opinion referred to in condition A is given to the general insurer by a director, or by an employee who is not a director of the general insurer, the confirmation must include a statement identifying the status of the person who gave the opinion to the general insurer.

(4) Subject to paragraph (5), the confirmation referred to in condition A must accompany the general insurer's company tax return which relates to the period of account (and if more than one company tax return relates to the period of account the confirmation need only be given with the return which relates to the earliest period in the period of account).

(5) If, at the time the company tax return is made, the general insurer has a reasonable excuse for not providing the confirmation with the company tax return, the confirmation may be provided to an officer of Revenue and Customs separately from the return but must be provided as soon as reasonably possible after the return is made.

(6) In this regulation "company tax return" means a return under paragraph 3 of Schedule 18 to the Finance Act 1998(**4**).

Estimated amount of claims outstanding where conditions in regulation 5 are not satisfied

7.—(1) This regulation applies in a case where any of conditions A to C in regulation 5 is not satisfied.

(2) For the purposes of regulation 4, the amount of the liabilities in respect of claims outstanding arising from the general insurer's general business is the general insurer's undiscounted best estimate of the future cash flows in respect of claims outstanding.

(3) For the purposes of paragraph (2)—

(a) the reference to "best estimate" shall be construed as a reference to the mean of the distribution of the potential outcomes of the claims to which the estimate relates, and

(b) the best estimate of the future cash flows must be the best estimate available at the time at which the technical provisions are adopted by the general insurer.

Provisions supplementing regulations 5 and 7

8.—(1) This regulation supplements regulations 5 and 7.

(2) Any calculation, computation or estimate required to determine the amount of the liabilities in respect of claims outstanding must be made in accordance the standards specified in paragraph (3) in force at the time at which the technical provisions are adopted by the general insurer.

(3) The specified standards are—

(a) all generic technical actuarial standards and relevant specific technical actuarial standards published by the Board for Actuarial Standards in relation to the performance of actuarial functions, or

(b) where the general insurer is not resident in the United Kingdom, such other standards or provisions of the law of the territory in which the general insurer is domiciled as may reasonably be regarded as equivalent in effect to the standards referred to in sub-paragraph (a).

In this paragraph, "the Board for Actuarial Standards" means the operating body of that name of the Financial Reporting Council(**5**).

(4) Any calculation, computation or estimate required to determine the amount of the liabilities in respect of claims outstanding must take into account—

(a) the nature or type of risks to which the liabilities in respect of claims outstanding relate, and

(b) the volatility and uncertainty associated with those risks.

(5) Without prejudice to the generality of paragraph (4), the reference in that paragraph to taking into account includes, in particular, taking into account liabilities—

(a) on the basis of general insurance business reporting categories described in Annex 11.3 to Chapter 11 of Volume 1 of IPRU(INS), or

(b) on the basis of grouping of risks in accordance with the descriptions of accounting classes for general insurance business set out in Appendix 9.16 to Volume 2 of IPRU(INS).

(6) In paragraph (5), "IPRU(INS)" means the Interim Prudential Sourcebook for Insurers made by the Financial Services Authority under the Financial Services and Markets Act 2000(**6**).

(7) Any estimate of the amount of the liabilities in respect of claims outstanding shall be determined—

(a) net of reinsurance ceded, and

(b) in accordance with paragraph 53 of Schedule 3 to the Accounts and Reports Regulations.

(8) A reference to claims outstanding includes—

(a) the expense of handling a future claim (whether allocated or unallocated), and

(b) a future claim which has been incurred as a liability of the general insurer but which is—

(i) not reported to the general insurer at the time at which the technical provisions are adopted, or

(ii) reported, but not fully reported, to the general insurer at that time.

(9) A reference in this Part to the time at which technical provisions are adopted is a reference—

(a) to the time at which the directors of the general insurer approve the general insurers' annual accounts for the purposes of section 414 of the Companies Act 2006(**7**);

(b) in the case of a general insurer to which that section does not apply, to such similar time as may apply under equivalent provisions of the law of the territory in which the general insurer is domiciled; or

(c) in the case of general business carried on by a permanent establishment in the United Kingdom of a general insurer which is not resident in the United Kingdom and for which accounts of the permanent establishment are prepared for the period of account, the time at which the general insurer approves those accounts.

PART 3 MEMBERS OF LLOYD'S SYNDICATES

Appropriate amount of technical provisions: members of closed Lloyd's syndicates

9.—(1) This regulation applies to a general insurer which is a member of a closed Lloyd's syndicate.

In this regulation, a closed Lloyd's syndicate is a Lloyd's syndicate that is not an open Lloyd's syndicate.

(2) For a period of account, the appropriate amount of the technical provisions for the purposes of paragraph 1 of Schedule 11 is the member's allowable reinsurance to close amount in respect of the syndicate.

(3) For the purposes of paragraph (2), the allowable reinsurance to close amount for the period of account is the lesser of—

(a) the reinsurance to close amount for the period of account which is treated as a technical provision in accordance with regulation 11 (reinsurance to close amounts); and

(b) subject to paragraphs (4), the aggregate of the member's share of—

(i) the amount of the provision for unearned premiums determined in accordance with paragraph 50 of Schedule 3 to the Accounts and Reports Regulations;

(ii) the amount of the provision for unexpired risks determined in accordance with paragraph 51 of that Schedule; and

(iii) the amount of the liabilities in respect of claims outstanding arising from the general business of the syndicate.

(4) For the purposes of paragraph (3)(b), amounts are to be determined on the assumption that—

(a) the syndicate is an open Lloyd's syndicate, and

(b) no reinsurance to close amounts have been paid in respect of the syndicate by any member of the syndicate.

Appropriate amount of technical provisions: members of open Lloyd's syndicates

10.—(1) This regulation applies to any general insurer which is a member of an open Lloyd's syndicate.

(2) For a period of account, the appropriate amount of the technical provisions for the purposes of paragraph 1 of Schedule 11 is the aggregate of the member's share of—

(a) the amount of the provision for unearned premiums determined in accordance with paragraph 50 of Schedule 3 to the Accounts and Reports Regulations;

(b) the amount of the provision for unexpired risks determined in accordance with paragraph 51 of that Schedule 3; and

(c) the amount of the liabilities in respect of claims outstanding arising from the general business of the syndicate.

Reinsurance to close amounts

11.—(1) The reinsurance to close amount to be treated as a technical provision in the case of a member of a Lloyd's syndicate for a period of account is whichever is the lesser of—

(a) the total of the reinsurance to close amounts which the member pays or gives, or is treated as paying or giving, in respect of the underwriting year for which profits or losses are declared; and

(b) the total of the reinsurance to close amounts which the member receives, or is treated as receiving, in respect of the underwriting year for which profits or losses are declared.

This paragraph is subject to paragraph (2).

(2) If a company—

(a) pays or gives, or is treated as paying or giving, a reinsurance to close amount to a member in respect of an underwriting year for which profits or losses are declared, and

(b) the company is connected to the member,

the amount which the member receives, or is treated as receiving, shall also be treated as a reinsurance to close amount paid by the member in respect of that underwriting year.

(3) For the purposes of paragraph (2), section 839(5) to (8) of the Income and Corporation Taxes Act 1988(**8**) (connected persons) applies for the purpose of determining whether a company is connected to a member.

Provisions supplementing regulations 9 and 10: determination of member's share of provisions

12.—(1) For the purposes of regulations 9(3)(b) and 10(2), a member's share of the amounts referred to in those regulations shall be determined by reference to the member's proportionate entitlement to participate in the underwriting business of the syndicate.

(2) For the purposes of regulations 9(3)(b)(iii) and 10(2)(c), in determining the amount referred to in those provisions, regulations 5 to 8 shall apply with the following modifications—

(a) a reference to "the general insurer's general business" shall be treated as a reference to the general business of the syndicate;

(b) the reference in regulation 5(1) to "the general insurer's accounts" shall be treated as a reference to the syndicate's accounts;

(c) references in regulations 5(3), 7(3) and 8(8) to "the general insurer" shall be treated as a reference to the syndicate;

(d) regulation 6(1) shall be treated as omitted;

(e) the reference in regulation 6(4) and (5) to the "general insurer's company tax return" shall be treated as a reference to the syndicate return which relates to the period of account;

(f) the reference in regulation 6(5) to "general insurer" shall be treated as a reference to the syndicate's managing agent;

(g) regulation 6(6) shall be treated as omitted;

(h) the reference in regulation 7(2) to "the general insurer's undiscounted best estimate" shall be treated as a reference to the best estimate of the syndicate's managing agent;

(i) regulation 8(3)(b) shall be treated as omitted; and

(j) for regulation 8(9) there shall be treated as substituted—

"(9) A reference in this Part to the time at which technical provisions are adopted is a reference to the time at which the syndicate's managing agent approves the syndicate's profit or loss accounts for the period of account by signing them.".

Bernadette Kenny
Dave Hartnett
Two of the Commissioners for Her Majesty's Revenue and Customs

17th July 2009

EXPLANATORY NOTE

(This note is not part of the Regulations)

The amount of technical provisions stated in the accounts of a general insurer (which includes members of Lloyd's underwriting syndicates carrying on general insurance business) for a period of account is taken into account in the calculation for tax purposes of the profits of the general insurer's trade for that period unless that amount exceeds the appropriate amount. Where the amount stated in the accounts exceeds the appropriate amount the excess is not taken into account when computing the profits: see paragraphs 1(2) and (3) of Schedule 11 to the Finance Act 2007. These Regulations make provision specifying how the appropriate amount of a general insurer's technical provisions is to be determined for this purpose.

Part 1 of these Regulations comprises regulation 1 which provides for the citation, commencement and effect of these Regulations and regulation 2 which provides for the interpretation of terms used in these Regulations.

Part 2 comprises regulations 3 to 8 and makes provision specifying the appropriate amount in the case of general insurers other than members of Lloyd's underwriting syndicates.

Regulation 3 introduces Part 2.

Regulation 4 specifies that the appropriate amount of the technical provisions is the aggregate of amounts representing unearned premiums, unexpired risks and the liability of the insurer for outstanding claims made against it.

Regulation 5 provides that the amount of the liabilities of the insurer for outstanding claims is the amount stated in the insurer's accounts provided the amount is not excessive and that this is confirmed by the insurer on the basis of an opinion from a suitably skilled person.

Regulation 6 makes provision supplementing regulation 5.

Regulation 7 deals with the case where the conditions for regulation 5 to apply are not satisfied. Where regulation 7 applies the amount of the liabilities of the insurer for outstanding claims is the best estimate of the future cash flows arising for the claims.

Regulation 8 makes further provision supplementing regulation 5 and provision supplementing regulation 7.

Part 3 comprises regulations 9 to 12 and makes provision specifying the appropriate amount in the case of members of Lloyd's underwriting syndicates.

Regulation 9 specifies the appropriate amount of the technical provisions in the case of a member of a Lloyd's underwriting syndicate which has succeeded in closing its accounts through the payment of a reinsurance to close premium.

Regulation 10 specifies the appropriate amount of the technical provisions in the case of a member of a Lloyd's underwriting syndicate which remains open.

Regulation 11 makes provision specifying the how to determine the reinsurance to close amount to be treated as a technical provision for the purposes of regulation 9.

Regulation 12 makes provision modifying regulations 5 to 8 to apply those regulations to Lloyd's syndicates for the purposes of regulations 9 and 10.

A full and final Impact Assessment has not been produced for this instrument as a negligible impact on the private or voluntary sectors is foreseen.

(**1**)
2007 c. 11.

(**2**)
S.I. 2008/410.

(**3**)
S.I. 2005/3338.

(**4**)
1998 c. 36; paragraph 3 was amended by paragraph 385 of Schedule 1 to the Income Tax Act 2007 (c.3).

(**5**)
The Board for Actuarial Standards can be contacted at the Board for Actuarial Standards, Financial Reporting Council, 5th floor, Aldwych House, 71-91 Aldwych, London, WC2B 4HN and the actuarial standards obtained from their website at www.frc.org.uk/bas/standards.

(**6**)
2000 c. 8. The Interim Prudential Sourcebook can be obtained from the Financial Services Authority's website at www.fsa.gov.uk/Pages/handbook.

(**7**)
2006 c. 46.

(**8**)
c.1; section 839 has been amended but none of the amendments are relevant.

Appendix 2 – Extract from Schedule 3 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008(1)

Provision for unearned premiums

50.—(1) The provision for unearned premiums must in principle be computed separately for each insurance contract, save that statistical methods (and in particular proportional and flat rate methods) may be used where they may be expected to give approximately the same results as individual calculations.

(2) Where the pattern of risk varies over the life of a contract, this must be taken into account in the calculation methods.

Provision for unexpired risks

51. The provision for unexpired risks (as defined in paragraph 91) must be computed on the basis of claims and administrative expenses likely to arise after the end of the financial year from contracts concluded before that date, in so far as their estimated value exceeds the provision for unearned premiums and any premiums receivable under those contracts.

Provisions for claims outstanding

General business

53.—(1) A provision must in principle be computed separately for each claim on the basis of the costs still expected to arise, save that statistical methods may be used if they result in an adequate provision having regard to the nature of the risks.

(2) This provision must also allow for claims incurred but not reported by the balance sheet date, the amount of the allowance being determined having regard to past experience as to the number and magnitude of claims reported after previous balance sheet dates.

(3) All claims settlement costs (whether direct or indirect) must be included in the calculation of the provision.

(4) Recoverable amounts arising out of subrogation or salvage must be estimated on a prudent basis and either deducted from the provision for claims outstanding (in which case if the amounts are material they must be shown in the notes to the accounts) or shown as assets.

(5) In sub-paragraph (4), “subrogation” means the acquisition of the rights of policy holders with respect to third parties, and “salvage” means the acquisition of the legal ownership of insured property.

(6) Where benefits resulting from a claim must be paid in the form of annuity, the amounts to be set aside for that purpose must be calculated by recognised actuarial methods, and paragraph 54 does not apply to such calculations.

(7) Implicit discounting or deductions, whether resulting from the placing of a current value on a provision for an outstanding claim which is expected to be settled later at a higher figure or otherwise effected, is prohibited.

54.—(1) Explicit discounting or deductions to take account of investment income is permitted, subject to the following conditions—

(a) the expected average interval between the date for the settlement of claims being discounted and the accounting date must be at least four years;

(b) the discounting or deductions must be effected on a recognised prudential basis;

(c) when calculating the total cost of settling claims, the company must take account of all factors that could cause increases in that cost;

(d) the company must have adequate data at its disposal to construct a reliable model of the rate of claims settlements;

(e) the rate of interest used for the calculation of present values must not exceed a rate prudently estimated to be earned by assets of the company which are appropriate in magnitude and nature to cover the provisions for claims being discounted during the period necessary for the payment of such claims, and must not exceed either—

(i) a rate justified by the performance of such assets over the preceding five years, or

(ii) a rate justified by the performance of such assets during the year preceding the balance sheet date.

(2) When discounting or effecting deductions, the company must, in the notes to the accounts, disclose—

(a) the total amount of provisions before discounting or deductions,

(b) the categories of claims which are discounted or from which deductions have been made,

(c) for each category of claims, the methods used, in particular the rates used for the estimates referred to in sub-paragraph (1)(d) and (e), and the criteria adopted for estimating the period that will elapse before the claims are settled.

Definitions for this Schedule

91. The following definitions apply for the purposes of this Schedule and its interpretation—

"general business" means business which consists of effecting or carrying out contracts of general insurance;

"long-term business" means business which consists of effecting or carrying out contracts of long-term insurance;

"long-term fund" means the fund or funds maintained by a company in respect of its long-term business in accordance with rule 1.5.22 in the Prudential Sourcebook for Insurers made by the Financial Services Authority under Part 10 of the Financial Services and Markets Act 2000(**20**);

"policyholder" has the meaning given by article 3 of the Financial Services and Markets Act 2000 (Meaning of "Policy" and "Policyholder") Order 2001(**21**);

"provision for unexpired risks" means the amount set aside in addition to unearned premiums in respect of risks to be borne by the company after the end of the financial year, in order to provide for all claims and expenses in connection with insurance contracts in force in excess of the related unearned premiums and any premiums receivable on those contracts.

APPENDIX 3 – COPY OF HMRC GUIDANCE

HMRC tell us that this is a pre-final draft of the relevant GIM (General Insurance Manual) guidance.

GIM6600 – Technical provisions: appropriate amount Regulations: background

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The regulations are The General Insurers' Technical Provisions (Appropriate Amount) Regulations 2009, SI2009/xxxx, referred to here as the 'appropriate amount Regulations'. They apply to technical provisions as defined in the accounting Regulations SI2008/410, consisting of provisions for unearned premiums, unexpired risks and unpaid claims. It is the last category which is the main focus of this guidance.

The determination of provisions is a skilled task, usually in the first instance performed by an actuary though sometimes legal or engineering expertise is required. Methods mainly focus on understanding the business and assessing provisions development patterns and claims ratios. From this a best estimate may be calculated applying mathematical techniques of varying degrees of sophistication. Sometimes a range of best estimates may be quoted, depending on different assumptions. It is impossible to be prescriptive about the methods to be used in such a complex area. Moreover, it is normal and sound practice to add a risk margin to the best estimate, reflecting the uncertainties.

There are various ways of doing this. Traditionally, the best estimate is not discounted for the time value of money. As the liabilities the provisions are designed to reflect will be paid over a period of time, in theory it might be appropriate to discount them at a suitable rate. Not doing so is standard industry practice and is consistent with legal requirements. This has the effect of building in an implicit risk margin, though the size of it will vary with the prevailing interest rate environment and claims payment patterns, and it may well be inadequate, particularly for more volatile classes of business. For this reason additional risk margins based on experience are often added. Alternatively, the actuary may construct a probability distribution and allow a risk margin by choosing say the point at which there are three chances in four of the estimate proving sufficient (known as the 75^{th} percentile) rather than one in two (the mean). A further method developed over the last 20 years seeks to calculate the cost of the additional capital a purchaser of the business would require to take on the liabilities and run them off – known as the 'market value method'.

Rather than attempt to specify any such methods the appropriate amount Regulations focus upon obtaining an assurance that the figure appearing in the accounts reflects best actuarial or other suitable practice. This is achieved in most cases by obtaining a confirmation in writing from the insurer that the amount of the liabilities stated in the accounts, that is, the provisions, is not excessive. This confirmation must be founded on or supported by an opinion in writing given by an actuary or other suitably skilled person. Taken with the regulatory requirement for the provisions to be sufficient, this gives confirmation that the provisions are as accurate as they can be in this uncertain area.

This is the main condition, but if it or other supporting conditions (see GIM6610) are not satisfied, there is a straightforward alternative. The appropriate amount is then the undiscounted best estimate without any further adjustment.

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author: \Author\
pageType: \DefaultSchemaCore\PageTypes\normal
description: Explains the background to the appropriate amount regulationsshelfLife: 5Y
keywords: appropriate amount
versionDate:

There are two steps

- an actuary or other suitably *skilled person* must give an *opinion* in writing, current at the time the liabilities are determined, that the amount stated in the accounts is not excessive
- the *company* must give *confirmation* in writing that the liabilities representing unpaid claims are not excessive, founded on or supported by the opinion just mentioned, or propose an alternative figure.

An estimate is considered excessive if it exceeds a best estimate of the liabilities together with a reasonable margin for risks and uncertainties. The skilled opinion is of crucial importance here. The actuarial Institutes may provide guidance to the profession on these issues, and the Government Actuary must be consulted if any enquiries are raised about best estimates or risk margins.

The opinion must also conform with standards (see GIM6630) which apply to both the main rule and its alternative (see GIM6620).

The confirmation is expected to accompany the return to which it relates. Like the return, it is given on behalf of the company. Corporation tax returns may be signed by any person duly authorised on behalf of the company, and a similar approach applies to the confirmation. If, exceptionally, two returns relate to a single period of account, confirmation is only required with the first of them. Notice of confirmation is accepted separately if there is a reasonable excuse, provided there is no unnecessary delay in supplying it.

It is up to the general insurer to decide what the confirmation in writing will consist of. In most cases, the directors will receive a comprehensive actuarial report. The company may decide to supply this, or a summary of it, as the full report may require considerable expertise to understand. On the other hand, the general insurer may simply supply a statement, signed by the authorised person, that the amount of liabilities representing unpaid claims is not an excessive estimate. The supplementary information the general insurer has chosen to supply will be a factor in the risk assessment.

The opinion may be given by any suitably skilled person. This may be an actuary (or exceptionally a lawyer or engineer) employed by the company or by consultants. The actuarial function should be carried out by persons with sufficient knowledge of actuarial and financial mathematics. In small general insurers, it may be that the only person within the company with the necessary experience is also a director with responsibility for signing off the accounts which contain the provision. Where the person giving the confirmation is a director or employee of the company, their status must be identified. If the person is a director of the company, this will be a factor in the risk assessment.

Risk assessment is dealt with at GIM6650. It does not follow that the provision of a simple statement, or non separation of responsibility, will be decisive. They are simply factors that need to be weighed according to the wider background: for example, the company's behavioural history on disclosure, and its size and structure.

DESCRIPTION: EXPLAINS METHOD 1 OF THE APPROPRIATE AMOUNT REGULATIONS

SHELFLIFE: 5Y

KEYWORDS: METHOD 1

VERSIONDATE:

GIM6620 - Technical provisions: appropriate amount Regulations: the alternative rule

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

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

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

AUTHOR: \AUTHOR\3509591

PAGETYPE: \DEFAULTSCHEMACORE\PAGETYPES\NORMAL

DESCRIPTION: SETS OUT AN ALTERNATIVE RULE FOR THE APPROPRIATE AMOUNT IF THE MAIN RULE DOES NOT APPLY

SHELFLIFE: 5Y

KEYWORDS: APPROPRIATE AMOUNT

VERSIONDATE:

GIM6630 – Technical provisions: appropriate amount Regulations: rules applicable to both methods

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A number of rules govern both methods, which are by and large simply a reflection of sound practice

- any calculations of an actuarial nature must be made in accordance with standards in force at the time set by the Board for Actuarial Standards, or by the equivalent standards of the company's domicile, where it is not resident in the UK but is trading through a UK permanent establishment or is a controlled foreign company
- the different risks and volatilities relevant to different lines of business must be taken into account
- the amount of liabilities will be determined in accordance with the provisions of the accounting Regulations SI2008/410, and taking account of anticipated reinsurance recoveries, which are shown separately in the accounting format of those Regulations
- the liabilities relating to claims outstanding include claims handling expenses and those relating to claims incurred but not yet reported (or fully reported).

The Board for Actuarial Standards is part of the Financial Reporting Council. The standards may be found on its website, but any question as to their application should only be raised in conjunction with advice from the Government Actuary. This condition only applies where the calculations and opinions are of an actuarial nature. If they are of a legal or engineering nature, they should be made by a suitably skilled person. The question of whether a person is suitably skilled in this context will not be challenged unless there is an obvious reason to do so.

Lines of business for this purpose can be accepted as those chosen by the general insurer for its reporting purposes. The legislation refers to the 'business categories' in the Financial Services Authority's sourcebook IPRU(INS) at Annex 11.3 to Chapter 11 of Volume I, or the groupings set out in Appendix 9.16 in Volume II.

Any assessment of provisions set in the accounts must be made on the basis of the same facts as would be available at the time they were adopted. It is not permissible to use hindsight in reviewing the decision of the directors.

AUTHOR: \AUTHOR\3509591

PAGETYPE: \DEFAULTSCHEMACORE\PAGETYPES\NORMAL

DESCRIPTION: SETS OUT THE CONDITIONS WHICH APPLY TO BOTH METHOSD FOR SETTING CLAIMS PROVISIONS

SHELFLIFE: 5Y

KEYWORDS: APPROPRIATE AMOUNT

VERSIONDATE:

The issue of tax relief for the claims provisions of general insurance companies has been a thorny one for many years. Discussions on the subject go back at least to 1940, according to HMRC archives. GIM6075 to GIM6140 describe the position as it stood broadly up to 2000 (the position for Lloyd's syndicates was slightly different). GIM6145 to GIM6440 describe the approach of FA00/S107 which attempted to tackle the problem in an objective and systematic way but this proved extremely complex.

Market exposure clearly militates against general insurers over-provisioning to achieve a tax advantage, as this would mean understating profits declared to shareholders. On the other hand, not all general insurers are directly exposed to the market (captive insurers, notably), and in any event there is established evidence that a smoothing 'provisioning cycle' runs closely in phase with the 'underwriting cycle' – see GIM1240. The UK actuary Institutes published a General Reserving Issues Taskforce (GRIT) consultative paper in July 2005 which discussed the issues in great depth and produced proposals for improvement. In approaching this task the authors noted the statistical evidence for existence of the provisioning cycle. Their view was that it was impossible to say whether this was down primarily to companies being forced to strengthen their provisions because they were established at too low a level in a soft market, or whether they were taking the opportunity of profitable times to put money aside and increase prudence – it was probably a bit of both.

The taskforce also polled a sample of actuaries, both those working for insurance companies, and those in the international London Market. The company actuaries thought the most important reason for the cycle and movements in provisions was deliberately booking amounts different from actuarial best estimates. The London Market actuaries saw the main reason as being influence from underwriters. There was also some evidence of systematic flaws in the methodology.

General insurance companies produce accounts for both financial reporting and regulatory purposes. The UK regulator (Financial Services Authority) requires (IPRU(INS) 9.34) its returns to be properly prepared in accordance with IPRU(INS), INSPRU and GENPRU, and the latter (GENPRU 1.3.4) requires a firm to value its assets and liabilities according to applicable financial reporting rules, practices and standards, so for general insurance companies the financial and regulatory returns will be similar.

Analytical techniques and actuarial standards have improved in recent years. There may be a good reason for the directors, in signing off the accounts, to depart from the best estimate, where appropriate augmented by a risk margin, recommended by an actuary; but where this situation is identified it requires explanation. The case of *Owen v Southern Railway of Peru* 36TC602 (GIM6080) remains good law as regards the first of the tests mentioned in the speech of Lord Radcliffe – there is no accounting principle that contradicts it – and this requires the calculation of the provisions to be performed with sufficient accuracy in order to justify their allowance. The appropriate amount Regulations aim to work with the grain of this analysis, and ensure that emphasis is placed on attainable accuracy as well as sufficiency.

AUTHOR: \AUTHOR\3509591

PAGETYPE: \DEFAULTSCHEMACORE\PAGETYPES\NORMAL

DESCRIPTION: DISCUSSES THE BACKGROUND TO OPENING ENQUIRIES INTO CLAIMS PROVISIONS

shelfLife: 5Y

keywords: Appropriate amount; enquiry

versionDate:

This is a technically difficult area and an enquiry should not be undertaken until the various steps set out below have been taken. While (where it has not already been supplied) it is easy to ask for the actuarial report, making sense of it and conducting in depth enquiries if preliminary enquiries are inconclusive is likely to require expert (Government Actuary) assistance. Consequently enquiries are not to be undertaken lightly.

Step 1

Unless, exceptionally, there is a particular reason to challenge the amount of provisions shown in the accounts, an enquiry should only be contemplated if the amount of provisions shown in the financial statements is identified as an 'outlier' by HMRC KAI Directorate. See GIM6660.

Step 2

A review will be needed of the circumstances and history of the case and its features such as its general risk profile and status (notably, whether a captive insurer, or whether there is a history of problems).

Step 3

If the main rule (GIM6610) has been applied, examine

- who gave the confirmation, and in particular note whether it was given by an employee or consultant actuary distinct from the directors of the company
- how much information was supplied with it, for instance an actuarial report or summary.

If the alternative rule (GIM6620) has been applied, and there is no skilled person confirmation this is itself a risk factor.

Step 4

At this stage, it is necessary to decide whether the material justifies approaching the Sector Leader to explain that it is proposed to seek further information that might result in the need to invoke the enquiry powers (GIM6540).

Step 5

If, with the agreement of the Sector Leader, it is decided to proceed, in the first instance enquiries should be pursued in advance of a formal notice (GIM6550). At this stage, evidence should be sought of how the general insurer believed it was complying with the relevant rule. Depending on how matters then develop, it may be necessary to invoke the formal enquiry powers and the procedure set out at GIM6550 to GIM6590. The outcome may depend on obtaining advice from the Government Actuary's Department.

AUTHOR: \AUTHOR\3509591

PAGETYPE: \DEFAULTSCHEMACORE\PAGETYPES\NORMAL

DESCRIPTION: EXPLAINS THE VARIOUS RISK ASSESSMENT AND STEPS PROCEEDING INTO AN ENQUIRY

SHELFLIFE: 5Y

KEYWORDS: APPROPRIATE AMOUNT; ENQUIRY; RISK ASSESSMENT

VERSIONDATE:

GIM6660 - Technical provisions: appropriate amount Regulations: enquiries: risk assessment: identifying outliers

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KAI have developed two tests, reserve estimation and reserve development. They will apply them and produce lists of possible cases for further risk assessment. The following descriptions are in broad terms.

Reserve estimation

This uses a combination of statistical techniques to establish a benchmark for the level of provisions a company would have if it completely followed the average result across the general insurance market and tests this against the result for the particular company. However, because companies vary greatly by reference to the type and risk of business that take on, this simple comparison would not be effective. A second test is then applied to determine whether from one year to the next the result of the first test, the provisioning position relative to the 'whole market' has changed significantly.

The approach does not therefore interest itself in the absolute question of how far the company lies from the benchmark, but rather on whether this position relative to benchmark changes significantly from one year to the next. This is designed to compensate both for the effect of the insurance cycle and for the inherent differences in company characteristics.

Reserve development

This test is designed to complement the reserve estimation test by examining whether the company has a history of over provisioning compared with the market as a whole. The test averages out the last five years of a company's over or under provisioning by calculating the adjustment to the technical provisions for each company as a percentage of the provision carried forward into that year. It then compares this to the average result for the general insurance market as a whole. A combination of statistical techniques is then used to equalise the variations in the companies stemming from differences in the size, type and risk of the business they take on, and to allow also for the effect of the insurance cycle.

AUTHOR: \AUTHOR\3509591

PAGETYPE: \DEFAULTSCHEMACORE\PAGETYPES\NORMAL

DESCRIPTION: OUTLINES THE METHODOLOGU USED BY KAI DIRECTORATE TO IDENTIFY OUTLIERS

SHELFLIFE: 5Y

KEYWORDS:

VERSIONDATE:

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GIM6670 - Technical provisions: appropriate amount Regulations: risk assessment: enquiries: group regulatory returns

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FA07/SCH11, the primary legislation which the appropriate amount Regulations support, is drafted in terms of individual general insurance companies, and their accounts. This is in keeping with the focus of UK tax law on individual companies rather than groups.

However, groups of general insurance companies sometimes take advantage of the modification and waiver power available to the Financial Services Authority under section 148 of the Financial Services and Markets Act 2000. In such cases, the FSA makes a 'direction' that rewrites some of the reporting paragraphs of its sourcebook IPRU(INS), notably IPRU(INS) 9.3(1). The effect of this is to refocus the reporting requirements so that consolidated reporting regulatory accounts are required, substituting 'the principal firm or any of the subsidiary firms' for 'the insurer'. This is purely for regulatory purposes, and the companies must still publish accounts under the accounting and reporting Regulations.

In practice, for general insurance companies, there will be a high degree of convergence between regulatory and financial reporting of liabilities, and the sum of the individual company provisions can be expected to reconcile with the corresponding figures in the group regulatory return.

Where a group return is prepared the group can be expected to focus its efforts on the overall soundness of the group provisions, rather than those of individual companies. Moreover, the risk assessment outlier identification described at GIM6660 will be based for UK companies on regulatory return data that feed into a commercial database.

It follows that, where a group return is prepared, the risk assessment and enquiries should focus on the group figures. Where, however, it becomes necessary to make use of the formal powers (GIM6540), it will be necessary to deconstruct the consolidated figure and apply the powers at company level. In practice, it is unlikely that this will be necessary; it will be in the interests of both the group and HMRC to resolve any enquiries at the group level.

AUTHOR: \AUTHOR\3509591

PAGETYPE: \DEFAULTSCHEMACORE\PAGETYPES\NORMAL

DESCRIPTION: EXPLAINS HOW TO APPLY RISK ASSESSMENT WHERE THERE IS A GROUP REGULATORY RETURN

SHELFLIFE: 5Y

KEYWORDS:

VERSIONDATE:

APPENDIX 4 – EXAMPLE ACTUARIAL OPINION WORDING

This appendix provides an example of the wording for an Actuarial Opinion. This wording applies to the situation where the amount of the claims reserves for tax purposes is the same as that in the Accounts, rather than a lower amount. The wording would need to be modified if the reserves for tax purposes were a lower amount.

Clearly, each insurer and person providing the confirmation and / or Actuarial Opinion will need to determine their own wording, and hence this example wording is not intended to be appropriate for any specific situation. It does not represent any form of "approved" wording from HMRC, the UK Actuarial Profession or the Board for Actuarial Standards.

It is likely that this wording will evolve as companies put the Regulations into practice.

STATEMENT OF ACTUARIAL OPINION
CLAIMS RESERVES FOR <<COMPANY NAME>>
AS AT <<DATE>>

To: **<<COMPANY NAME>>**

Identification

I, <<OPINION SIGNATORY>>, am associated with the firm of <<FIRM OF OPINION SIGNATORY>> who have been retained by <<COMPANY NAME>> ("the Company").

OR

I, <<OPINION SIGNATORY>>, am [employed by/a Director of] <<COMPANY NAME>> ("the Company").

Qualification

I am [a Fellow of the Institute/Faculty of Actuaries / other designation as appropriate and] believe that I have the necessary skills to provide this opinion.

Scope

I have examined the claims reserves listed below for <<COMPANY NAME>> as at <<DATE>>, as reported in <<THE ACCOUNTS/FINANCIAL STATEMENTS>>

prepared by the Company. I have reviewed the claims reserves shown in <<SPECIFIC REFERENCES WITHIN THE ACCOUNTS, IF NEEDED>>.

The claims reserves are the responsibility of the Company; my responsibility is to express an opinion on those claims reserves, based on my review.

	Amount
Total net claims reserves (Conv £000's)	<<AMOUNT>>

NB : "Conv £" figures above are converted <<RATES>>

This amount is for indemnity amounts and claims handling expenses (both allocated and unallocated) in respect of earned exposures only as at <<BALANC SHEET DATE>> and includes provision for reinsurance bad debts, where appropriate. It is net of salvage and subrogation. It [is/is NOT/is PARTIALLY] discounted for the time value of money.

This amount is part of the total Appropriate Amount of <<AMOUNT>> that will be included within the Company's tax return. I will provide a full reconciliation of the above figure with the figures in the Company's accounts <<AND TAX RETURN>> in my report.

I have relied upon data prepared by the responsible employees of the Company. These data have not been checked by me, although the Company has confirmed that the data supplied to me are accurate. In other respects my examination included the use of such actuarial assumptions and methods and such tests of the calculations as I considered necessary.

Relevant Comments

<<ADDITIONAL COMMENTS AS REQUIRED>>

These additional comments do not constitute a qualification of my opinion.

Variability

In evaluating whether or not the claims reserves represent an excessive provision for unpaid claims and claims expenses, it is necessary to project future premium, claim and claim handling expense payments. Actual future premiums, claims and claim handling expenses will not develop exactly as projected and may, in fact, vary significantly from the projections. Further, in most classes of business, the scope for adverse development exceeds the scope for favourable development. In particular, although I have made what I believe to be a reasonable allowance for the risk of adverse development, I have not anticipated the emergence of major new types of classes of claims, nor the emergence of any major new reinsurance disputes.

Opinion

In my opinion, subject to the above comments, the claims reserves identified above do not represent an excessive estimate of the relevant unpaid claims and claims handling

expense as at <<BALANCE SHEET DATE>> and hence complies with <<REGULATION REFERENCE>>. <<POSSIBLE ADDITIONAL STATEMENT TO EXPAND UPON MEANING OF "NOT EXCESSIVE" SUCH AS REFERRING TO A REASONABLE ALLOWANCE FOR UNCERTAINTY>>

An actuarial report, supporting the findings expressed in this statement of opinion, will be provided to the Company.

This statement of opinion is solely for the use of, and to be relied upon only by the Company for the purpose of compliance with <<REGULATION REFERENCE>>.

Signed: ……

Name: <<SIGNATORY NAME>>
<<DESIGNATION – E.G. Fellow of the Institute/Faculty of Actuaries or other as appropriate>>

Date: <<DATE OF SIGNING>>

Address: <<BUSINESS ADDRESS OF SIGNATORY>>