Institute
and Faculty
of Actuaries

Reforms to Corporation Tax Loss Relief

IFoA response to HM Revenue & Customs

18 August 2016

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

Room 3/63
CT Losses, CTIS
Her Majesty's Revenue and Customs
100 Parliament Street
London
SW1A 2BQ

18 August 2016

Dear Sirs,

IFoA response to Consultation: Reforms to Corporation Tax Loss Relief

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to HMRC's consultation on the reform of Corporation Tax Loss Relief. The IFoA's Life Office Taxation Working Party and Life and General Insurance Boards have been involved in the drafting of this response.

2. Our responses to the questions in the consultation document are set out below together with some more general comments on the wider features of the insurance industry, and the consequences of these proposed reforms.

3. The IFoA is a professional body which regulates actuaries and promotes the actuarial profession. While the insurance industry relies significantly on actuarial principles, it is not the role of the IFoA to promote the commercial interests of insurers. However, the IFoA does consider that it has a duty to raise actuarial matters which are in the public interest.

4. Our primary concern is that the proposed changes will increase the capital requirements for insurers, for reasons which are contrary to the fundamental principle of insurance pooling. These additional capital requirements could also give rise to increases in the premiums charged to consumers.

5. We expect these effects to be relevant primarily for life insurers due to the long term nature of their products. However, we also refer briefly to general insurers for whom we expect the impact to be lower.

6. The combination of long term contracts based on a pooling principle, with a regulatory regime which capitalises the impact of changes in expectations over the term of those contracts, is unique to the insurance industry. The proposed changes will reduce the ability of insurance companies to pool profits and losses across generations and to match revenues and costs for tax purposes over the duration of long term contracts.

Questions 1 - 10

7. We have no comment on the detailed application of the calculations and objectives on loss buying or consortia relationships. We also have no comment on the proposals as they relate to banks.

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Q11. Do you have views on the government's proposed approach to oil and gas and life insurance companies?

8. The exclusion of Basic Life Assurance and General Annuity Business (BLAGAB) excess expenses for life assurance companies is appropriate. This is an element of corporation tax that is intended to have a similar taxation effect to personal taxation on investment profits of individuals. It seems appropriate to exclude BLAGAB excess expenses from the restriction proposal.

Q12. What impact could the reforms have on public-private partnership or private finance initiative projects?

9. We have no specific comment on public private partnerships other than to the extent that some contracts may be long term (e.g. in excess of 10 years). In such cases they may suffer volatility and capitalisation concerns that have similar characteristics to those raised here in respect of long term insurance business.

Q13. What other sectors or specialist areas of taxation need consideration as part of these reforms?

10. We have commented below on general insurance.

Q14. What will be the impact of the reforms on insurers' regulatory capital?

11. We anticipate that capital requirements for life insurance business will increase. The IFoA does not have the data to quantify the impact.

12. We would expect the increase in capital requirements to increase premium rates. The increase in capital will likely be reflected in pricing models. These pricing models will charge for the cost of financing that additional capital using each company's assessment of the market cost of the capital. This will differ by company, but the additional annual cost may be as high as 10% of the additional capital requirements.

13. Costs for the increase in capital can increase premiums but the additional tax flow to HMRC will at most be equal to corporation tax applied to the additional premium generated. The remainder of the premium will simply pay investors the required return for the additional capital. We would encourage exploring measures that avoided such 'collateral' costs to policyholders.

14. The cause of the additional capital requirement is as follows:

    i. capital requirements in insurance companies are set equal to the loss anticipated to arise in a 1 in 200 year stress event
    ii. this loss will be net of any immediate tax relief available for losses arising in the stress, and net of any value that may be placed on tax losses carried forward
    iii. the restriction on the use of losses will reduce the value that can be placed on tax losses arising in an assumed stress event because they can no longer be fully matched to future profits from existing or post-stress business
    iv. this increases the after tax loss incurred in a 1 in 200 stress event, and
    v. therefore increases the capital requirements of companies.

15. The severity of the stress scenarios ensures that carry-forward losses arise in most, if not all, capital requirement calculations. As a consequence many companies, particularly larger companies where the £5m unrestricted loss relief is relatively trivial, would expect to see an increase in their capital requirements.

16. The scale of the increase in capital requirements will vary by firm depending on its business profile and its tax characteristics. The key driver is the relative balance between the size of the loss envisaged under the 1 in 200 stress event, and the extent of profits and existing deferred tax liabilities (for instance arising from adjustments for temporary timing differences between IFRS and Solvency II technical provisions) which are available to absorb that loss.

Q15. To what extent could the reforms impact on the business plans of new-entrant companies?

17. The reforms are likely to disadvantage new entrant companies to life insurance. Such companies are likely to suffer losses for several years and those losses are likely to exceed £5m per annum by a considerable margin if they seek to enter the market with viable scale. Valuing these losses fully may be difficult under current accounting and tax rules. The proposals would exacerbate the problem.

General comments:

Principle of pooling in insurance

18. The IFoA believes that the provision of insurance is a socially desirable activity. It is in the public interest that the provision of insurance should be carried out in a capital and cost-efficient manner.

19. It is a fundamental principle of insurance that pooling of experience can help manage the uncertainty of the insured benefits. This pooling can take place in a number of ways: between policyholders, across product lines, and over time.

20. The principle of pooling over time is particularly relevant to life insurance contracts, which can typically have contract terms ranging from 10 years up to the full lifetime of the insured person. The premiums charged take into account the expected experience over that period and it is acknowledged that there will favourable and unfavourable experience over that period of time.

21. It is therefore a natural and expected part of insurance that losses may be incurred in one year and offset by profits in later years.

Impact of regulation on trading profits

22. The insurance industry is subject to a rigorous and prudent regulatory regime which aims to ensure that insurers are appropriately capitalised and will therefore be able to meet the obligations to their customers.

23. A consequence of this regime is that a cautious approach has to be taken when adverse experience arises. If a loss from (for example) adverse mortality experience arises in a year, the insurer will be required to consider whether that experience is likely to be repeated in later years. If it believes that will be the case, the insurer will increase its technical provisions to recognise this expected future experience, effectively capitalising the impact of that experience into the year in which it was recognised. Instead of incurring modest losses year after year, the change in provisions gives rise to a large loss in one year, with an expectation of better performance thereafter.

24. This feature can significantly accentuate the volatility of insurers’ trading profits, making the proposed restrictions on tax relief more likely to bite.

Regulatory capital

25. As noted in the response to Question 14, the capital requirements of insurers are expected to rise due to the proposed changes. The scenario which the insurer has to allow for – a very large loss occurring over the course of one year – is by definition very unlikely since the scenarios are calibrated to a 'one in 200 year' probability of occurring. It is this sort of situation that creates a significant burden under the proposed changes.

26. The resulting increase in capital requirement is further enhanced by the need to hold 'buffer' capital. Typically, firms hold significant capital in excess of their capital requirement so that they remain reasonably solvent in modest stress conditions. This buffer capital is commonly expressed as a percentage of the required regulatory capital. This might typically increase the overall capital by say 30%-50%.

Impact on premiums

27. Proprietary insurance companies will commonly price their products to reflect the cost of providing the benefits and to return a profit to their shareholders. The level of profit sought will have regard to the opportunity or financing cost to the insurer of providing the regulatory capital associated with the policy. As regulatory capital requirements are likely to increase as a result of the proposed changes, the IFoA envisages that the premiums charged for insurance products may increase as a result.

28. The impact on each firm will depend on its tax characteristics, its methodology for determining capital requirements and its commercial pricing philosophy. The IFoA is therefore unable to quantify this impact reliably. However, by way of illustration, an increase of say 1% of premium would not be reflected in additional tax being paid to HMRC. Instead, the additional premium will largely accrue to investors as their reward for providing capital. We would encourage exploring measures that avoided such 'collateral' costs to policyholders.

General Insurance business

29. Although general insurance is short term business, significant losses can arise in a particular year from hurricanes or floods (for example). The proposed reforms may therefore also impact general insurers' tax positions.

30. The impact on capital requirements (and thus premiums) may be less significant, because the short term nature of the contracts means there is less scope to demonstrate the ability of future profits to provide relief against past losses. A 50% reduction in that scope could therefore have a much smaller impact, although this will vary from firm to firm depending on its profit profile and modelling methodology.

31. There could however be circumstances where there were a material impact on capital requirements. This could arise in companies which are generally highly profitable, but which in occasional capital event years are loss making. Under the current tax arrangements the tax losses would be brought forward and earned in the next fully profitable year. The issue for such companies would arise then if there were any curtailment on the number of future years in which the losses could be brought forward. There may not be enough years for the loss to be earned out.

Potential modifications to the proposals

32. We would suggest that there should be two objectives in any modifications aimed at supporting the socially desirable aims of insurance:

    i. avoid the capital effects that increase premiums without any benefit flowing to tax revenues and
    ii. recognise that insurance pools profits and losses across generations, as a fundamental feature of financing stressed insurance claim costs.

33. Potential options to achieve these objectives would be:

    a. ring-fencing insurance - or life insurance - and applying different loss relief rules
    b. recognising the significant impact of capitalisation of future revenue losses in taxable losses on long term contracts, and so applying different rules for loss relief on long term contracts (e.g. contracts with terms of 10 years or more). This would avoid industry-specific exemptions, and
    c. adopting some form of averaging for losses due to insurance risks to recognise the need for cross-generational pooling.

Should you wish to discuss any of the points raised in further detail please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk / 0207 632 2146) in the first instance.

Yours sincerely

Colin Wilson
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