Institute and Faculty of Actuaries

Distributable Profits of Long-Term (Life) Insurers

IFoA response to HM Treasury

16 November 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.

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Distributable Profits Consultation
Insurance, Pensions and Regulators Team
Financial Services Group
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

15 November 2016

Dear Sirs,

IFoA response to Consultation: Distributable Profits of Long Term (Life) Insurers

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to HMT's consultation on amendments to the Companies Act, and in particular, amendments to the distributable profits of long-term (life) insurers.

2. The IFoA's Financial Reporting Group and Life Insurance Board have been involved in the drafting of this response. Members of the Group and Board have significant experience of financial reporting for life insurers, either employed by life insurers or by audit firms/ consultancies with life insurance clients. We would welcome the opportunity to discuss our response in more detail with HMT.

General Points

3. We recognise the urgent need for an amendment to the Companies Act and encourage HMT to finalise the change to law as soon as practicable after the consultation period.

4. We support HMT's aim of bringing distributable profits in line with the Solvency II balance sheet, removing the direct link with IFRS/ UK GAAP accounts. This will help reduce the risk of multiple financial reporting metrics being able to block dividend payments, which would create issues with capital providers. We do note though that UK insurance regulation may change as a result of the UK leaving the EU. We would also encourage thinking about what would happen if, and when, IFRS 17 (and equivalent revisions to FRS 103 for a UK GAAP reporter) were to be implemented. It may be that the use of the regulatory balance sheet should be a short term measure until the new insurance accounting standard is introduced.

5. However, we believe the current proposals suffer from a deficiency: there is no 'cross-check' in the proposals to ensure that amounts are considered as realised (and hence distributable) and instead rely too heavily on the identified deductions to remedy this potential issue. We give examples in our paragraph 8 below but we believe the proposals go beyond what would be recognised as an accounting (IFRS / UK GAAP) profit in other industries by capitalising future fees. Such a treatment would potentially lead to a 'level playing field' issue between life insurers and other companies conducting business giving rise to similar profit flows (such as investment management companies).

Under the paragraphs which follow, we have limited our response to those consultation questions where the IFoA has a particular view.

Question 1: Do you believe that the new approach is stricter than that laid out in section 831 and thus in the case of a public limited company, a distribution which satisfies the new approach will also satisfy section 831? If not, do the two approaches work together in a consistent way?

6. We do not understand why this approach would necessarily be more prudent than the restriction in section 831. Indeed, we give examples below where the approach would be less prudent than the prior one. This may mean UK insurers are not on a 'level playing field' in comparison to overseas insurers, and also other UK industries.

Question 2: Is it in fact possible to determine which profits, losses, assets, liabilities and relevant deductions relate to which part (life or non-life) of the company? If this is not possible for some items, how would apportionment be possible for these?

7. The 'relevant deductions' in the 'A-L-D' calculation should be calculated net of any associated deferred tax. This is not clear in the current drafting.

Question 3: Are there any unintended consequences that arise due to the approach of 'A-L-D' (assets - liabilities - deductions) being equal to profits of the company which are available for the purpose of making a distribution, rather than equal to accumulated realised profits less accumulated, realised losses?

8. As highlighted above, we believe there is an unintended consequence as there is no 'cross-check' in the proposals to ensure that amounts are considered as realised (and hence distributable) before being recognised as an accounting (IFRS / GAAP) profit. This arises because Solvency II allows expected future profit flows such as fees to be capitalised in the technical provisions whereas IFRS/ GAAP accounts do not. A calculation of distributable profits as assets minus such (reduced) technical provisions, therefore allows these items to fall into distributable profits yet these future profit flows have yet to be deducted from policyholders' funds and thus realised. For example:

    - many 'unit linked' policies lead to Solvency II technical provisions generally lower than IFRS/ UK GAAP technical provisions by virtue of discounting the future management charges less expenses. The difference would flow into distributable profits under the A-L-D formula, but is neither distributable nor realised. Investment management companies writing similar unit linked policies in the UK would not be permitted to include such amounts as distributable profits;

    - annual charges are often taken out of unitised with-profits policies, which are recognised under Solvency II as negative technical provisions outside the ring fenced with-profits fund and, therefore, are an addition to the A-L-D formula. Such charges increase distributable profits, but they are future expected charges that are not, and should not be, distributable; and

    - the allocation of the risk margin by product under Solvency II is judgmental and may make the deductions less certain.

Question 6: Can you provide a rationale for including, or not including, Solvency II transitional measures as part of the distributable profits figure?

9. Given the proposed route, we would favour accepting transitional measures as a valid reduction in technical provisions. To do otherwise would contradict the returns and balance sheet accepted by the PRA and would also have the side-effect of encouraging users to focus on the solvency ratio excluding transitional measures, which would have unfortunate and unnecessary consequences for the industry.

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
President, Institute and Faculty of Actuaries