

## FSA proposes £16bn reduction in insurers' reserves and capital requirements

### Background

On 18 September the FSA issued a consultation paper (CP 06/16) which proposes prudential changes for insurers. The CP focuses on proposals affecting life insurers' reserving and capital requirements, in particular looking at ways of extending 'economic realism to the prudential regulation of all life insurance firms.'

The FSA estimates that the effect of the proposals will be to reduce insurers' Pillar 1 mathematical reserves and capital requirements by £16bn. As a result of the Pillar 1 capital reductions being limited by the FSA's Pillar 2 (Individual Capital Assessment (ICA)) requirements, the total regulatory capital reduction across the industry is expected to be somewhat lower than this headline number, but nonetheless significant, at £4bn.

Unsurprisingly the industry is expected to endorse strongly the FSA's proposals. The proposals are a response to industry lobbying and the FSA has carried out extensive pre-consultation with its Insurance Standing Group of insurers. The FSA fully intends to implement its proposals to have effect this year and has shortened the consultation period to six weeks (31 October) to facilitate this.

Prima facie the significant mathematical reserve releases of £7bn will be taxable when made. HMRC is therefore a key stakeholder in the implementation of the FSA's proposals.

This Bulletin considers the implications of the proposals, dealt with in chapter 2 of the CP, in more detail.

### Summary of the proposals

Following the adoption of the 'realistic' basis of reserving for with-profits business in 2004 the FSA, through this CP, is looking at ways to move non-profits business to a more realistic basis, so extending the concept of economic realism to the prudential regulation of all life insurance firms. In doing so the FSA is essentially relying on its ICA (Pillar 2) regime which it sees as having introduced 'more firm [a measure] to deal with the relevant risks to our objectives'. The FSA is yet to review all firms' ICAs but nonetheless is expressing confidence in how implementation of the ICA regime is progressing. (The CP also contains proposals to codify ICA sub-principles in the light of the FSA's experience of good practice in this area.)

The FSA has examined the current prudential regime for both non-profits and with-profits business to identify specific areas of the Pillar 1 requirements that are super-equivalent to the Life Assurance Directive (LAD). The EC Treaties require all member states to incorporate the LAD into domestic law and regulations, and so constrain the extent to which regulators can modify their capital adequacy frameworks. However, there are a number of super-equivalent features in the current UK regime, and the FSA proposes removing these elements.

For non-profits firms, the following proposals would incorporate elements of economic realism into their reserving requirements:

- Setting technical provisions for expenses not directly attributable to one particular contract at a homogenous risk group level and not, as currently, at an individual contract level for all non-profits business. Firms will be required to document and

justify their approach to determining homogeneous risk groups. Considerable additional valuation basis and expense reserve disclosures are proposed in the regulatory valuation report.

- Recognising the economic effect of making a prudent lapse rate assumption within technical provisions for all classes of long-term business rather than just for realistic basis firms as currently. Additional disclosure of the lapse rate assumptions is proposed in the regulatory valuation report.
- Changing the calculation of technical provisions for all classes of long-term business to allow contracts that do not include guaranteed surrender values in the contract wording to be valued as assets.

The FSA estimates that the changed approach to expenses would reduce mathematical reserves across the industry by £3bn. The impact of the other non-profit changes is estimated at £4bn i.e a total potential reserves release of £7bn before any resulting tax charge.

The FSA describes its approach on lapse rates and valuing contracts as assets as representing 'best estimate plus risk margins' which 'would in principle generate sufficiently high technical provisions to enable firms to transfer their life protection liabilities to a third party if necessary'. In proposing this approach the FSA appears to be implementing into the UK now principles that are being espoused in the development of the Solvency II Directive and Phase II IFRS for insurance contracts.

For realistic basis life firms, which are firms that carry out the 'twin peaks' calculations for with-profits business, the following changes to the rules that govern reserving and capital requirements are proposed:

- Recognising the economic value of the future internal transfers made out of the with-profits fund, with the benefit recognised as a credit within the calculation of the With-Profits Insurance Capital Component (WPICC). The FSA estimates that this will reduce capital requirements by £8bn.
- Removing the Resilience Capital Requirement (RCR) with a net impact of £1bn. (It is notable that the proposals will remove the RCR for non-profit funds of realistic basis firms but not for non-profit funds of non-realistic firms despite this being super-equivalent to the LAD.)

The CP details the associated proposed changes to insurers' FSA returns and the regulatory valuation report. If there has been a significant change in the valuation methodology since the previous year an estimate of the effect on mathematical reserves for broad product groups needs to be given. Disclosure is required of the effects of the changes introduced by the CP when implemented by the firm.

The cost-benefit analysis within the CP assumes that firms will take immediate and full advantage of the proposed new rules. It is noted however in the CP that the FSA's rules set out the minimum basis for mathematical reserves and hence firms might choose not to change their existing reserving practices provided they can demonstrate that their approach is more prudent than the prescribed minimum standard. Thus, the actual extent of reserves reductions will depend upon a firm's own decisions. We understand that in some companies the initial indications are that the full benefit might not be taken due to systems, data and actuarial resource constraints. Similarly, the FSA expects the extent of any actual capital reductions to be significantly limited by ICA requirements and commercial factors such as maintenance of credit rating.

The CP explicitly recognises that these changes, in particular any reserves releases, may have tax consequences and specifically includes comments from HMRC on them. It also invites representations to HMRC on the issues.

Feedback/representations on the CP to both the FSA and HMRC is sought by 31 October. This short timescale has been driven by the need to give the FSA sufficient time to consider responses adequately before bringing the final rules into force at 31 December 2006. The FSA has consulted already on the issues with the Insurance Standing Group, and indeed the proposals are in response to lobbying by the industry. Accordingly the proposals are expected to be strongly endorsed by the industry,

Individual firms and groups will, however, need to consider both the potential reserves/capital releases and the extent to which the firm intends to make those releases taking account of factors such as:

- Whether systems and data are sufficiently robust to enable the required assumptions to be derived and reserves and capital requirements computed on the revised bases. Justification, analysis and disclosure of key assumptions needs to be to an auditable standard.
- Any limitations imposed by the ICA (Pillar 2) basis including whether the ICA is considered sufficiently robust.
- Commercial factors (such as credit rating and the ability to price competitively.)
- The potential impact on financial reporting. One issue not covered within the CP, and which may lead to debate within the accounting profession, is what long term business provisions it will be appropriate to recognise for financial reporting purposes given these regulatory proposals and not least.
- Associated tax costs, risks and planning opportunities. Further details of tax implications are given below and we expect discussions between HMRC and the industry on these. The results of those will be key to establishing the net of tax implications of the proposals.

## Tax implications

Our initial reaction is that the following items will need to be considered internally and/or discussed with HMRC:

- Prima facie, any reserves release would, for a non profit fund or company, give rise to incremental profits in the Case I rules computations and thus, subject to available losses, additional tax liabilities. The impact of that will need to be assessed, not least as it may in turn be a factor in determining the extent to which companies do or do not make the maximum possible reserves release.
- The CP does however at least suggest that whilst this would be the normal tax consequence, HMRC may be willing to consider modification if they can be satisfied by industry representations that this would be 'appropriate'. The most obvious parallel might be with the recent discussions following the 2004 changes dealing with resilience reserves/resilience capital requirements, where for non-profit companies the (ultimate!) effect of the Finance Act 2006 changes (s83YA) was to spread the reserves release rather than taxing it in full ab initio. However, a variation to the normal tax rules on a change of accounting basis will be achieved only if there are consistent representations or other lobbying by the industry. See below for further discussion on this point.
- As with the s83YA changes, the proposals here will raise concerns for some, perhaps many, companies as to the possible impact of the Crown Option to assess companies on an Actual Case I basis. Particularly in a year which has, thus far at least, had low returns on gilts and bonds, a significant reserves release could result in a situation where 'gross' I + G is less than the Case I measure of profit (particularly perhaps for those with significant pension business losses brought forward). The recent discussions with HMRC as part of the Tcondoc discussions have suggested that HMRC see the Crown Option as very much an 'exceptional case' issue, and as less of an issue than it is seen by the industry. Nevertheless, if a significant reserves release

is proposed by an individual company, it is likely that management will want some greater certainty that an Actual Case I assessment, and all its consequences, will not arise.

- At the risk of being accused of undue cynicism, we would also be concerned as to whether HMRC (collectively or individual Inspectors) might seek to argue that, given the comments in the CP that firms may hold reserves in excess of the prescribed minimum, any such excess is general rather than specific in nature and thus disallowable. The proposals require disclosure of the effect of the changes in the valuation report only when implemented, so there will be no disclosure of any potential future releases if the changes are not made in full in 2006. Nonetheless, HMRC questions as to what has or has not been done could well be raised. We would recommend that this issue should be raised with HMRC, the fundamental point being that provided the reserves are set at a level which meets FSA requirements and other professional standards then they should be regarded for tax purposes as specific in nature and as falling within an acceptable range. (The outcome of the debate on the consequences for financial reporting referred to above might well inform HMRC's conclusions.)
- Companies should also consider the likely impact, if any, of the proposals on their 2006 FSA return when determining the amount of their quarterly payments on account for 2006 – the first of which falls even before the deadline for responses to the CP. It thus remains possible that the final format of any 2006 changes will be different from the proposals, although given the prior consultation with the Insurance Standing Group and the prior industry lobbying substantive change is perhaps unlikely.

### **Modification of the normal rules on a change of accounting basis**

As noted above, the CP does at least suggest that HMRC may be persuaded to agree that tax should not simply follow the release of reserves in all circumstances.

The fundamental underlying issue is, once again, the treatment of capital kept within a long term fund.

For a with profits fund, any release of reserves would be likely to be balanced by a change in the Form 40 Line 13 amount unless a positive decision was made to change the bonus declarations which would otherwise have been made ie no change in surplus emerging. For a non profit fund, any reserves release would come through as additional surplus emerging unless again matched by a change to the Form 40 Line 13 amount. However, for a non profit company, any such transfer to the investment reserve would, in turn, simply be taxable under the provisions of s83YA.

Where any reserves release is reflected in surplus emerging and that surplus is transferred to shareholders, we would suggest it is unlikely that HMRC would be persuaded that any change to the normal tax rules would be appropriate,, perhaps even if the company can demonstrate retention of the amount within the company for business reasons. Where however a company has taken the decision to retain the amount within the fund, whether for the commercial reasons set out in the CP or otherwise, then HMRC may be persuaded to agree to a deferral of the tax consequences possibly until the release is reflected in a transfer to shareholder funds, or perhaps simply on a prescribed spreading basis as with the s83YA regime. The industry will need to consider in what circumstances and in what way it would wish to argue for a change to the normal rules.

There may well also be an overlap between the arguments used here and the arguments which would be used to defend as specific in nature any reserving in excess of the FSA minimum standards. The key issue is what commercial response a company chooses to make to the CP proposals if implemented and what the non-tax factors might be that would prompt it to hold prudent reserves rather than retain capital in another form. Differential tax

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treatment will be a further determining factor. The question might thus be, should there be a differential tax treatment?

## The way forward

As noted above, firms will need to consider the potential reserve and capital releases which could arise and the extent to which they will make these releases. This will include consideration of whether systems, data, actuarial resource, Pillar 2 and commercial factors etc. might prevent them from taking full advantage and whether these constraints can be relieved.

Firms should give careful consideration to the taxation implications of any change to their reserving methodology.

Firms will also need to understand, where the changes do result in reductions in capital requirements, what the consequences, including tax consequences, will be - for example, will there be transfers from the long term fund to shareholder funds and/or dividend payments or other returns of capital to a parent? Such steps will have different tax and other consequences which will need to be assessed in the company's own situation.

In the light of those assessments, firms will need to consider what representations they may wish to make to the FSA or HMRC, whether directly and/or via the ABI or other trade bodies.

PwC's insurance, regulatory and tax teams will continue to discuss the proposals with our clients and others in the industry. We expect to make representations, both formally and informally to the FSA and HMRC, and would welcome your suggestions on points to include. We will, as ever, aim to work here in tandem with the ABI and other trade bodies.

## PwC contacts

If you would like to discuss these proposals in more detail please contact one of those named below, or your usual PwC contact.

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