



HM Treasury

Distributable profits of long-term (life) insurers:

a consultation

October 2016



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1 Introduction

Current rules on distributable profits

1.1 The Companies Act 2006 (“the Act”) sets out the legal basis on which companies are formed and run. It is an important part of the legal framework within which business is conducted in the United Kingdom.

1.2 The basic requirement in respect of distributions is set out in Part 23, section 830 of the Act: “A company's profits available for distribution are its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made.”

1.3 Long-term insurance differs from many businesses in that its business cycle from initiation to final contract settlement has a term that may span multiple financial periods. The obligation under the contract appears as a liability on the company balance sheet during this time. Given this, where the pattern of settlement of liabilities can be predicted, insurers are able to maintain asset portfolios designed with the intention of settling the liabilities as they fall due. These assets are sometimes illiquid, though this is compensated for by the illiquidity of the liabilities they hedge. If long-term insurance companies were to be treated like any other company under the Act, it could potentially create a mismatch between the status of movements in assets and the liabilities that they represent. For this reason the concept of a “long-term fund” has existed within the UK for over a hundred years, allowing for the segregation of such investments.

Proposed changes

1.4 Changes to the Act became necessary following the implementation of the Solvency 2 Directive (“Solvency 2”) on 1 January 2016. Solvency 2 mandated insurers to segregate life and non-life business. Previously, firms were able to maintain life funds within a “long-term fund”. A change in the Prudential Regulation Authority (PRA) rulebook following the introduction of Solvency 2 means that the “long-term fund” concept, as referenced by the Act in section 843, is no longer used for Solvency 2 firms.

1.5 HM Treasury, with the support of the Department for Business, Energy and Industrial Strategy, has led the development of an alternative approach, laying out a methodology that will meet the original policy aim of ensuring firms only make distributions out of realised profits and drawing on the Solvency 2 regulatory framework. It is proposed that this new methodology is contained within a new section 843A within Part 23 of the Act. Minor changes are also proposed to sections 830, 843 and 853 as a consequence of the introduction of section 843A.

Consultation

1.6 This consultation should be read by those who are involved in the process of calculating and distributing life insurers’ profits, as well as investors who receive the profits, their representatives and other interested parties. The government invites feedback on the draft secondary legislation, found in Annex B, in addition to the specific questions raised in this consultation document.

1.7 Extensive discussion with industry has already taken place during the preparation of this consultation. As the industry has shown an interest in a swift resolution of the issues, this formal stage of the consultation will run for a brief period from **25 October 2016** to **15 November 2016**. The government cannot guarantee that responses received outside of this period will be considered.

1.8 Following the consultation, the government will consider the responses received, with the intention of finalising the amendments and incorporating necessary changes. It will then make the changes through a negative statutory instrument laid in Parliament. Subject to Parliamentary procedure, the government expects the changes will come into force 21 days after being laid.

How to Respond

1.9 Responses can be sent by email to distributableprofits@hmtreasury.gsi.gov.uk. Alternatively, they can be posted to:

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

1.10 When responding, please state whether you are doing so as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make clear who the organisation represents and, where applicable, how the views of members were assembled.

Confidentiality

1.11 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 and the Environmental Information Regulations 2004).

1.12 If you would like the information that you provide to be treated as confidential, please mark this clearly in your response. However, please be aware that under the FOIA, there is a Statutory Code of Practice with which public authorities must comply and which deals, among other things, with obligations of confidence.

1.13 In view of this, it would be helpful if you could explain why you regard the information you provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. In the case of electronic responses, general confidentiality disclaimers that often appear at the bottom of emails will be disregarded unless an explicit request for confidentiality is made in the body of the response.

2 New approach

Overview

2.1 The first step in the new approach is to begin with an insurance firm's assets and then deduct the firm's liabilities. Solvency 2 and the directly applicable regulations made under it contain detailed rules on how the assets and liabilities of a life insurer or reinsurer should be identified and valued. Insurers and reinsurers are required to submit annual returns to the PRA, setting out their assets and liabilities in accordance with these rules. For the purpose of the new approach, a firm's assets and liabilities should be identified and valued in accordance with the Solvency 2 rules.

2.2 However, there are certain assets of the firm which cannot reasonably be considered distributable. These deductions relate to regulatory restrictions (such as ring-fenced funds and matching adjustment portfolio surpluses); to the inherently non-distributable nature of assets (such as the asset represented by the surplus in a defined-benefit pension scheme) and others to the way realised profits can be determined from the valuation methodologies used in Solvency 2 (such as in the valuation of undertakings). Therefore, the second step of the new approach is to deduct the value of these assets from the excess of assets over liabilities. The result will be the amount of profit which the firm may distribute to shareholders.

3 Amendments

3.1 This chapter runs through the sections to which amendments have been made to allow for the introduction of the new section 843A (Distributable profits for long-term insurance business: Solvency 2 firms). The next chapter has been dedicated to the new section. Where the government would like feedback on specific issues, questions are given. However, the government invites feedback on all of the draft legislation as given in Annex B.

Amendments to Section 830

3.2 Section 830 (Distributions to be made only out of profits available for the purpose) sets out the general rule that the amount available for distribution equals accumulated realised profits less accumulated realised losses. The government proposes to amend subsection (3) of Section 830 to make it clear that the basic rule is subject to the new provision for Solvency 2 firms, as set out in section 843A.

Section 831 – Public Limited Companies

3.3 A life insurer or reinsurer may be a public limited company, so the restriction in section 831 (Net asset restriction on distributions by public companies) may also apply to it. This section requires the company to meet a net assets test prior to distribution of profits. The amount by which its accumulated, unrealised profits exceed its accumulated, unrealised losses, so far as not capitalised, makes up part of the distributable reserves. The government believes the new approach to insurers and reinsurers may be stricter than section 831, so a distribution which satisfies our new approach should also satisfy section 831.

Q1. 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?

Amendments to Section 843

3.4 Section 843 (Realised profits and losses of long-term insurance business) sets out the current rule for companies which are life insurers and reinsurers. There is in fact a small class of insurers to whom Solvency 2 does not apply and section 843 needs to be maintained for these insurers. The government proposes to amend subsection (1) to carve out insurers and insurance special purpose vehicles which have been authorised under Solvency 2, as these firms are now subject to the new section 843A. Article 14 is the article in the directive in accordance with which insurance firms are authorised, hence the reference to this when carving out insurers.

Section 853

3.5 The government proposes to amend section 853 to include a definition of “Solvency 2 Directive” as this is to be referred to in the amended section 843 and new section 843A.

4 Section 843A

4.1 Section 843A (Distributable profits for long-term insurance business: Solvency 2 firms) of the proposed regulations lays out the new process by which Solvency 2 firms which undertake long-term insurance business (i.e. life firms) will calculate their distributable profits. As with the previous chapter, where amendments are not completely self-explanatory, the reason and effects of changes are stated, along with specific topics on which the government would like feedback.

4.2 Subsection (1) is intended to capture insurers and reinsurers authorised under Solvency 2. The drafting follows a similar structure to subsection (1) of section 843. However, in this case there is no need to refer to insurance special purpose vehicles as they are not authorised in accordance with Article 14 of Solvency 2. Note that the drafting refers to life business in general rather than any particular class of life business.

4.3 Subsection (2) makes provision for a very small class of insurance companies which for historical reasons are permitted to carry out both life and non-life business – known as “composites”. Internal segregation of life and non-life business is required within such companies, and the government understands that it is possible to apply the new approach purely in relation to the life part of their business.

Q2. 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?

4.4 As previously stated, the basic rule for distributable profits in section 830 are subject to the new provision for Solvency 2 firms carrying out long-term business. In line with this, subsection (3) disapplies the general rule on distributable profits set out in section 830.

4.5 Subsection (4) sets out the new rule, which is that we take the assets of the insurer or reinsurer and deduct liabilities and then certain other items referred to as “relevant deductions”. A formula is used in order to set out this process in the clearest and simplest way. The formula gives “the profits of a company which are available for the purpose of making a distribution” – bypassing any reference to accumulated, realised profits or losses. The general rule stated in section 830 is that the difference between accumulated, realised profits and accumulated, realised losses is the profits available for distribution, when greater than zero. For this reason, within s843A, s830 is disapplied. It is made clear here that the amount available for distribution is “(if greater than zero) given by the formula $A-L-D$ ”. This means that if $A-L-D$ (assets-liabilities-relevant deductions) is less than zero, the amount available for distribution is zero.

Q3. 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?

4.6 Subsection (5) lists all the “relevant deductions”. The first relevant deduction, in subsection 5(a), is any gain in value of shares held in a “qualifying undertaking”. A “qualifying undertaking” is defined in subsection 8(e) as an undertaking in which the company holds a participation, other than for the purpose of portfolio management. The definition of “participation” used is as given by Article 13(20) of Solvency 2, where it is defined as “the ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking.” The intention here is to distinguish between undertakings which carry out the life insurance or reinsurance business

and those which represent part of the insurer or reinsurer's portfolio of investments. However, the government is aware that holding a portfolio of investments is part of the life insurance or reinsurance business and are therefore welcomes views on whether the wording successfully achieves the objective.

Q4a. Do you believe the wording in subsection 5(a) achieves the objective of distinguishing between undertakings which carry out the life insurance or reinsurance business and undertakings which represent part of the insurer or reinsurer's portfolio of investments?

Q4b. Do you believe that "undertaking", given its definition within in subsection 8(e), that references "participation" (as defined in Solvency 2) is appropriate in this case? If not, what would be a more appropriate way of defining this deduction?

Q4c. Should the cost price of the "undertaking" be adjusted for inflation when determining if/by how much shares at their current value exceed cost price?

4.7 The second relevant deduction, in subsection 5(b), is an asset representing a surplus in a defined benefit pension scheme, as this is an inherently non-distributable asset. The concept of a defined benefit pension scheme is defined in subsection 8(b).

Q5. Do you agree that the concept of a defined benefit pension scheme is sufficiently clear without further definition? If not, how would you propose it be changed?

4.8 The third relevant deduction, in subsection 5(c), is a surplus in a "ring fenced fund". This refers to pools of assets and liabilities which are managed by the insurer or reinsurer as if they were separate undertakings. It is defined in subsection 8(a) to have the same meaning as in Solvency 2 and thus its deduction when calculating profits available for distribution should be straightforward.

4.9 Subsection 5(d) allows for the deduction of a portfolio of assets which the insurer or reinsurer is using to match a portfolio of liabilities, commonly referred to as the "matching adjustment portfolio". Where this occurs, the insurer can obtain permission from the PRA to reduce the amount of own funds it must hold. Where such permission is granted, regulatory restrictions would preclude any surplus of assets over liabilities to be distributed to shareholders. Permission is granted under regulation 42 of the Solvency 2 Regulations 2015, and the phrasing in this provision comes from that regulation, which itself comes from Article 77b of Solvency 2.

4.10 A list of capital items which should not be distributed to shareholders is given in subsection 5(e). Ordinary shares and preference shares are defined in subsection 8(a). Capital redemption reserve is an account into which amounts are payable by a company after the purchase or redemption of shares and this is generally non-distributable. The reference to any other reserves in sub-paragraph (iv) is self-explanatory.

4.11 There is uncertainty regarding whether an item could fall into two or more categories of relevant deductions. The requirement in subsection (4) is to deduct "D" which is the total value of the company's relevant deductions. Though the government believes that this precludes any double counting of items, subsection (6) has been added to ensure this does not happen.

4.12 Subsection (7) of the proposed regulations states how the assets and liabilities of an insurer or reinsurer are to be identified and valued. The approach in subsection (a) is commonly used when implementing financial services directives and the government considers that those reading paragraph (a) will not have any difficulty identifying the correct rules. Ultimately, assets and liabilities are intended to be identified from the Solvency 2 balance sheet.

4.13 The benefit of Solvency 2 transitional measures within the valuation of assets and liabilities is incorporated in subsection (7), paragraph (a). The transitional measures allow insurers to

calculate their technical provisions using Solvency 1 rules or discount rates. They only apply to technical provisions for insurance contracts concluded before the start of the Solvency 2 regime and are designed to phase out in a linear way over the transitional period (16 years). The impact of these transitional measures, which are effectively notional, is expected to be material and it is unclear to the government whether their inclusion will result in significantly higher distributable profits figures under the proposed regulations compared to the previous companies act approach.

Q6. Can you provide a rationale for including, or not including, Solvency 2 transitional measures as part of the distributable profits figure?

4.14 Subsection (8) of the proposed regulations contain definitions for this section. "Best estimate", "paid-in ordinary share capital", "paid-in preference share capital", "relevant risk free interest rate term structure" and "ring fenced fund" have been grouped together since the definitions cross-refer to Solvency 2. The definitions of general insurance and long-term insurance are aligned with definitions used in the Financial Services and Markets Act 2000, which are themselves broadly aligned with definitions used in Solvency 2 and as such the government is satisfied that there will be no confusion surrounding these.

A Summary of questions

Amendments (Chapter 2)

Q1. 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?

Section 843A (Chapter 3)

Q2. Is it in fact possible to determine 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?

Q3. 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?

Q4a. Do you believe the wording in subsection 5(a) achieves the objective of distinguishing between undertakings which carry out the life insurance or reinsurance business and undertakings which represent part of the insurer or reinsurer's portfolio of investments?

Q4b. Do you believe that "undertaking", given its definition within in subsection 8(e), that references "participation" (as defined in Solvency 2) is appropriate in this case? If not, what would be a more appropriate way of defining this deduction?

Q4c. Should the cost price of the "undertaking" be adjusted for inflation when determining if/by how much shares at their current value exceed cost price?

Q5. Do you agree that the concept of a defined benefit pension scheme is sufficiently clear without further definition? If not, how would you propose it be changed?

Q6. Can you provide a rationale for including, or not including, Solvency 2 transitional measures as part of the distributable profits figure?

B Draft secondary legislation

STATUTORY INSTRUMENTS

2016 No.

FINANCIAL SERVICES AND MARKETS

Companies Act 2006 (Solvency 2 Consequential Amendments) Regulations 2016

<i>Made</i> - - - -	***
<i>Laid before Parliament</i>	***
<i>Coming into force</i> - -	***

The Treasury are a government department designated for the purposes of section 2(2) of the European Communities Act 1972 in relation to financial services.

The Treasury, in exercise of the powers conferred by section 2(2) of the European Communities Act 1972, make the following Regulations:

Citation and commencement

1.—(1) These Regulations may be cited as the Companies Act 2006 (Solvency 2 Consequential Amendments) Regulations 2016.

(2) These Regulations come into force on [x].

Amendment to the Companies Act 2006

2.—(1) The Companies Act 2006 is amended as follows.

(2) In section 830 (distributions to be made only out of profits available for the purpose), at the end of subsection (3), insert “and 843A (distributable profits for long-term insurance business: Solvency 2 firms)”.

(3) In section 843 (realised profits and losses of long-term insurance business)—

- (a) in the heading, at the end, insert “: non-Solvency 2 firms”; and
- (b) for subsection (1) substitute—

“(1) The provisions of this section have effect for the purposes of this Part as it applies in relation to an authorised insurance company carrying on long-term business, other than—

- (a) an insurance company which is authorised in accordance with Article 14 of the Solvency 2 Directive; or
- (b) an insurance special purpose vehicle.”;

(c) for subsection (8) substitute—

“(8) In this section “insurance special purpose vehicle” means a special purpose vehicle within the meaning of Article 13(26) of the Solvency 2 Directive.”.

(4) After section 843, insert—

“Distributable profits for long-term insurance business: Solvency 2 firms

843A.—(1) The provisions of this section have effect for the purposes of this Part as it applies in relation to an authorised insurance company which—

- (a) carries on long-term business; and
- (b) is authorised in accordance with Article 14 of the Solvency 2 Directive.

(2) Where the company carries out general insurance and long-term business, then the provisions of this section have effect only in relation to its long-term business.

(3) Subsection (2) of section 830 does not apply to the company.

(4) The profits of the company which are available for the purpose of making a distribution are the amount (if greater than zero) given by the formula $A - L - D$, where—

- “A” is the total value of the company’s assets,
- “L” is the total value of the company’s liabilities, and
- “D” is the total value of the company’s relevant deductions,

(and if the amount given by that formula is zero or less, there are no profits of the company available for distribution).

(5) For the purposes of subsection (4), the following are relevant deductions of the company—

- (a) if the value of shares held by the company in a qualifying undertaking exceeds the value of the consideration provided by the company for the purchase of those shares, the amount by which the value of the shares exceeds the value of that consideration;
- (b) an asset of the company that represents a surplus in a defined benefit pension scheme;
- (c) a surplus in a ring-fenced fund held by the company;
- (d) where—
 - (i) the company has permission under regulation 42 of the Solvency 2 Regulations 2015 to apply a matching adjustment to a relevant risk-free interest rate term structure to calculate the best estimate of a portfolio of the company’s life insurance or reinsurance obligations, and
 - (ii) the value of the portfolio of the company’s assets assigned by the company to cover the best estimate exceeds the value of the portfolio of the company’s life insurance or reinsurance obligations,

the amount by which the value of that portfolio of the company’s assets exceeds the value of that portfolio of the company’s life insurance or reinsurance obligations;

- (e) the following capital items of the company—
 - (i) paid-in ordinary share capital and the related share premium account;
 - (ii) paid-in preference shares which are not liabilities of the company, and the related share premium account;
 - (iii) capital redemption reserve;
 - (iv) any other reserve that the company is prohibited from distributing by any enactment (other than one contained in this Part) or by its articles.

(6) Where a relevant deduction of the company, or any part of a relevant deduction, falls within two or more paragraphs of subsection (5), the value of that relevant deduction or that part of a relevant deduction is to be taken into account only once in calculating the total value of the company’s relevant deductions.

(7) For the purposes of subsections (4) and (5), the assets and liabilities of the company must be identified and valued in accordance with—

- (a) rules made by the Prudential Regulation Authority under Part 9A of the Financial Services and Markets Act 2000 implementing Articles 75 to 85, and 308b to 308e, of the Solvency 2 Directive; and

- (b) Articles 7 to 61 of Commission Delegated Regulation (EU) 2015/35 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).
- (8) In this section—
- (a) “best estimate”, “paid-in ordinary share capital”, “paid-in preference shares”, “relevant risk-free interest rate term structure” and “ring-fenced fund” have the meanings given in the Solvency 2 Directive and any directly applicable regulations made under the Solvency 2 Directive;
 - (b) “defined benefit pension scheme” means a pension scheme (as defined by section 1(5) of the Pension Schemes Act 1993) which is a defined benefits scheme within the meaning given by section 2 of the Pension Schemes Act 2015;
 - (c) “general insurance” means business that consists of effecting or carrying out contracts of general insurance;
 - (d) “long-term business” means business that consists of effecting or carrying out contracts of long-term insurance;
 - (e) “qualifying undertaking” means an undertaking in which the company holds a participation within the meaning given by Article 13(20) of the Solvency 2 Directive and which is not used by the company for the purpose of managing a portfolio of assets.

The definitions of general insurance and long-term business must be read with section 22 of the Financial Services and Markets Act 2000, any relevant order under that section and Schedule 2 to that Act.”.

(5) In section 853 (minor definitions), after subsection (6), insert—

“(7) “The Solvency 2 Directive” means Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).”.

Distributions made before [coming into force date]

3.—(1) This regulation applies to a distribution which—

- (a) is made by a company referred to in subsection (1) of section 843A of the Companies Act 2006;
- (b) is made on or after [1st September 2016] and before [coming into force date];
- (c) did not comply with the requirements of Part 23 of the Companies Act 2006 when it was made; and
- (d) would have complied with the requirements of Part 23 of the Companies Act 2006 if the amendments made by regulation 2 had been in force when the distribution was made.

(2) Any person who would (apart from this regulation) be liable under section 847 (consequences of unlawful distribution) of the Companies Act 2006 to repay all or any part of the distribution, or to pay the company a sum equal to the value of the distribution or any part of it, is released from that liability.

Name

Name

Two of the Lords Commissioners of Her Majesty’s Treasury

Date

EXPLANATORY NOTE

(This note is not part of the Regulations)

HM Treasury contacts

This document can be downloaded from
www.gov.uk

If you require this information in an alternative
format or have general enquiries about
HM Treasury and its work, contact:

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