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Briefing note

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Distribution of long term (life) insurance profits

On 7 April 2017, the Institute of Chartered Accountants in England and Wales ("**ICAEW**") and the Institute of Chartered Accountants of Scotland published TECH 02/17 (the "**Technical Release**") which sets out guidance on realised and distributable profits under the Companies Act 2006 (the "**Act**"). The change in the Act concerning distributable profits in relation to long-term insurance business is addressed in paragraphs 2.48 to 2.60 of the Technical Release.

Significantly, the combination of the Technical Release and amendments to the Act should make the calculation and distribution of long-term insurance profits more manageable for insurers.

Key Points

The Technical Release confirms that for insurers subject to Solvency II:

- Section 833A of the Act came into force on 30 December 2016 and effects distributions of any long-term insurer made on or after that date by reference to relevant accounts prepared for any period ending on or after 1 January 2016.
- A long-term insurer's profits available for distribution are limited to an amount that does not exceed its accumulated profits less accumulated losses shown in its relevant accounts, whether realised or not. The realised profit (or loss) of any given long-term insurer is calculated by the formula A-L-D in subsection 833A(4).
- The A-L-D formula is prepared using Solvency II based values (see section 833A(7)) as at the balance sheet date of the relevant accounts.
- A company's liabilities (L) are deducted from its assets (A), and a number of specific adjustments (D) are also made to recognise some differences between the bases of compiling Solvency II and Companies Act balance sheets. The formula is, therefore, designed to recognise the special characteristics of a long-term insurance business in determining its realised profit or loss.
- An insurer that carries out both long-term business and other business should apply section 833A only to the former, using apportionments between the two that are just and reasonable (see section 833A(8)).

Background

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."

However, long-term insurance differs from other insurance 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 insurer's 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 insurers were treated like any other company under the Act, it could potentially result in a mismatch in volatility between the status of movements in assets and the liabilities that they represent.

The historic solution to this problem was the concept of the "long-term insurance fund", which allowed long-term insurers notionally to segregate their long-term insurance business from the rest of their assets and liabilities, and to apply a separate calculation to the long-term insurance fund for the purposes of calculating their distributable profits. Section 843 of the Act expressly allowed a surplus in a long-term insurance fund to be treated as a realised profit irrespective of whether the assets held in the fund were readily realisable.

This position has now changed for most insurers as a result of the introduction of Solvency II. Solvency II legislation does not refer to a separate long-term insurance fund and the PRA Rulebook has removed this concept for those insurers who are subject to Solvency II. Hence, section 843 can no longer be relied upon by those insurers, although it will continue to apply for insurers who do not fall within the scope of Solvency II.

How can we help?

Our leading global corporate insurance practice regularly advises the world's insurance and reinsurance companies on a full range of areas including M&A and other corporate transactions as well as reinsurance agreements, collateral arrangements, distribution and capitalisation queries, Solvency II and other financial services regulation.

The Treasury consulted in October 2016 on proposals to provide a new solution for Solvency II insurers. This consultation resulted in The Companies Act 2006 (Distributions of Insurance Companies) Regulations 2016 (SI 2016/1194) which came into force on 30 December 2016 and amended the Act, principally resulting in a new section 833A which applies to insurance companies that carry on long-term insurance business and are subject to the Solvency II and section 843 which applies to those that are not. The Technical Release sets out guidance on these sections of the Act.

Contacts

Katherine Coates
Partner
T: +44 20 7006 1203
E: katherine.coates@cliffordchance.com

Alex Erasmus
Partner
T: +44 20 7006 1344
E: alex.erasmus@cliffordchance.com

Hilary Evenett
Partner
T: +44 20 7006 1424
E: hilary.evenett@cliffordchance.com

Ashley Prebble
Partner
T: +44 20 7006 3058
E: ashley.prebble@cliffordchance.com

Narind Singh
Partner
T: +44 20 7006 4481
E: narind.singh@cliffordchance.com

Amera Dooley
Senior Associate PSL
T: +44 20 7006 6402
E: amera.dooley@cliffordchance.com