

EXPLANATORY MEMORANDUM TO
THE COMPANIES ACT 2006 (DISTRIBUTIONS OF INSURANCE COMPANIES)
REGULATIONS 2016

2016 No. 1194

1. Introduction

1.1 This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

2. Purpose of the instrument

2.1 This Statutory Instrument amends Part 23 of the Companies Act 2006 (“Companies Act”). Part 23 restricts the amount of assets which a company may distribute to its shareholders, and the provisions which apply to life insurance companies need updating as a result of the coming into force of Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business or Insurance and Reinsurance (Solvency II) (“the Solvency 2 Directive”). This Statutory Instrument updates Part 23 by inserting a new section for life insurance companies authorised in accordance with that directive whilst maintaining existing provision for other life insurance companies.

3. Matters of special interest to Parliament

Matters of interest to the Joint Committee on Statutory Instruments

3.1 None.

Other matters of interest to the House of Commons

3.2 As this instrument is subject to negative resolution procedure and has not been prayed against, consideration as to whether there are other matters of interest to the House of Commons does not arise at this stage.

4. Legislative Context

4.1 The Solvency 2 Directive establishes the framework for the prudential supervision of insurance undertakings and reinsurance undertakings in the European Union. It is implemented in the United Kingdom by the Financial Services and Markets Act 2000, secondary legislation made under that Act, rules made by the Prudential Regulation Authority and the Solvency 2 Regulations 2015 (S.I 2015/575).

4.2 The Solvency 2 Directive has been amended on a number of occasions, in particular by Directive 2014/51/EU (the Omnibus II Directive). Both the Solvency 2 Directive and the delegated act made under it by the European Commission were subject to the following scrutiny:

- (a) EM 11978/08 on the Commission draft Directive of the European Parliament and the Council on the taking up and pursuit of insurance and reinsurance: Solvency II was submitted by HM Treasury on 7th August 2007. It was cleared by the House of Commons European Scrutiny Committee on 23rd May 2008 as politically important. It was cleared by the House of Lords EU Select Committee on 25th November 2008;

- (b) EM 5523/11 on the Commission proposal for a Directive of the European Parliament and of the Council amending Directives 2003/71/EC and 2009/138/EC in respect of the powers of the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority (Omnibus II) was submitted by HM Treasury on 3rd February 2011. It was cleared by the House of Commons European Scrutiny Committee on 1st March 2011 as politically important. It was cleared by the House of Lords EU Select Committee on 29th March 2011;
- (c) EM 10230/12 on the Commission proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC (Solvency II) as regards the dates for its transposition and the date of its application, and the date of repeal of certain Directives: the first “Quick Fix” Directive was submitted by HM Treasury on 8th June 2012. It was cleared by the House of Commons European Scrutiny Committee on 14th June 2012 as not politically important. It was cleared by the House of Lords EU Select Committee on 12th June 2012;
- (d) EM 14513/13, EM 10230/12 on the Commission proposal for a Directive of the European Parliament and of the Council amending Directive 2009/138/EC (Solvency II) as regards the dates for its transposition and the date of its application, and the date of repeal of certain Directives: the second “Quick Fix” Directive was submitted by HM Treasury on 24th October 2013. It was cleared by the House of Lords EU Select Committee on 29rd October 2013. It was cleared by the House of Commons European Scrutiny Committee on 30th October 2013;
- (e) EM 14263/14 on the Commission delegated regulation (EU) no [.../..] of [xxx] 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) was submitted by HM Treasury on 10th November 2014. It was cleared by the House of Commons European Scrutiny Committee on 20th November 2014. A follow-up letter was sent by the Economic Secretary to the Treasury to the House of Lords EU Select Committee on 18th November 2014. It was cleared by the House of Lords EU Select Committee on 24th November 2014.

4.3 Part 23 of the Companies Act restricts the amount of assets which companies may distribute to shareholders. Section 843 of the Companies Act makes specific provision for life insurance companies. As a result of the coming into force of the Solvency 2 Directive, Part 23 needs to be updated for life insurance companies authorised in accordance with the Solvency 2 Directive. The Regulations therefore insert a new section 833A into Part 23 for life insurance companies authorised under the Solvency 2 Directive, with section 843 remaining in place for life insurance companies not authorised under that Directive.

5. Extent and Territorial Application

5.1 This instrument extends to all of the United Kingdom.

5.2 The territorial application of the instrument is the same as the Act it amends (that is, the Companies Act 2006).

6. European Convention on Human Rights

- 6.1 The Economic Secretary to the Treasury, Simon Kirby MP has made the following statement regarding Human Rights:

“In my view the provisions of the Companies Act 2006 (Distribution of Insurance Companies) Regulations 2016 are compatible with the Convention rights.”

7. Policy background

What is being done and why

- 7.1 On 23 June, the EU referendum took place and the people of the United Kingdom voted to leave the European Union. Until exit negotiations are concluded, the UK remains a full member of the European Union and all the rights and obligations of EU membership remain in force. During this period the Government will continue to negotiate, implement and apply EU legislation. The outcome of these negotiations will determine what arrangements apply in relation to EU legislation in future once the UK has left the EU.
- 7.2 This instrument deals with the calculation of realised profits and realised losses for a certain subset of companies (life insurance companies). For companies in general, profits or losses are treated as realised in accordance to accepted accounting principles at the time when the accounts are prepared. The underlying principle is that profits are treated as realised only when realised in the form of cash or other assets where the ultimate cash realisation of which can be assessed with reasonable certainty. However, there are in fact only a few instances in which losses will be unrealised. The playing field is deliberately tilted so that it is easier to have a realised loss than a realised profit; this owes its origins to the prudence concept in accounting standards of the early 1980s.
- 7.3 Section 843 of the current legislation makes specific provision for companies carrying out “long-term business” (essentially, life business). This is because life business differs from many other businesses because a relatively large proportion of their assets are invested in very long-dated assets, to match the life businesses’ long-term liabilities (annuities). Under the current generally accepted accounting principles, any upward revaluation of long-term liabilities is immediately recognised as realised, but upward revaluation of long-term fixed assets is not realised. If the current practices of other companies were adopted for life insurance firms, there would be high volatility in distributable profits for life firms – whenever an increase in liabilities was matched by an increase in investments that were not readily realisable, the increase in liabilities would be deducted from distributable earnings. This would distort life firm’s investment incentives.
- 7.4 The Solvency 2 Directive came into force on 1 January 2016. The Directive requires a separation of life business and non-life business into different companies (except in relation to a class of insurers called “composites”), which is inconsistent with the concept of funds used in the current section 843. Therefore, section 843 can no longer be applied to life insurers authorised in accordance with the Solvency 2 Directive. But not all insurance companies carrying out long-term business will be authorised in accordance with the Solvency 2 Directive, so the existing section 843 needs to be maintained for those insurance companies.

- 7.5 For insurance companies which are authorised in accordance with the Solvency 2 Directive, section 843 needs to be replaced with a different provision. For these firms, we propose to define the realised profits and realised losses by reference to the surplus or deficit in the company's balance sheet (so broadly following the existing section 843). The new provision will also set out a method for calculating realised profits and realised losses for Solvency 2 life-insurance companies by reference to the surplus or deficit in the company's Solvency 2 balance sheet. The method for calculating this is set out in a formula in the new section 833A.

Consolidation

- 7.6 There are no plans to consolidate the Companies Act at the present time.

8. Consultation outcome

- 8.1 HM Treasury has extensively consulted with the industry, the Prudential Regulation Authority, and other Government Departments over the course of 2016 to formulate these changes for Solvency 2 authorised firms.
- 8.1 The Government also ran a formal consultation between 25 October and 16 November 2016, where it sought views on a draft Statutory Instrument¹. The consultation period was shorter than normal given the extensive informal consultation with the industry to date, and to ensure the amendments will be in place before the end of the year.
- 8.2 Fourteen responses were received to the formal consultation, including 6 from industry (including the Association of British Insurers and the Investment & Life Assurance Group, as well as individual firms), 4 from individual accountancy firms and responses from the Institute of Chartered Accountants in England and Wales (ICAEW) and the Institute and Faculty of Actuaries (IFoA). There was one additional unaffiliated respondent.
- 8.3 An overwhelming majority of responses stated that they agreed with the overall approach proposed in the consultation document, though some wanted to make further technical changes and further drafting alterations were also suggested. An overwhelming majority of responses also highlighted the importance of the changes to the Companies Act being made before the end of the year.

9. Guidance

- 9.1 Guidance on realised and distributable profits under the Companies Act 2006 is issued by the Institute of Chartered Accountants in England and Wales and the Institute of Chartered Accountants of Scotland in Tech 02/10².
- 9.2 Extensive guidance on how to comply with the Solvency 2 Directive is set out on the Prudential Regulation Authority's website³.

10. Impact

- 10.1 There is no impact on charities or voluntary bodies.
- 10.2 There is no impact on the public sector.

¹ <https://www.gov.uk/government/consultations/distributable-profits-of-long-term-life-insurers>

² <http://www.icaew.com/-/media/corporate/files/technical/technical-releases/legal-and-regulatory/tech-02-10-guidance-on-realised-and-distributable-profits-under-the-companies-act-2006.ashx>

³ <http://www.bankofengland.co.uk/pru/Pages/solvency2/default.aspx>

10.3 An impact assessment has not been produced for this instrument as the legislation places no additional burdens on business.

11. Regulating small business

11.1 The legislation does not apply to activities that are undertaken by small businesses.

12. Monitoring & review

12.1 This instrument does not contain a requirement to conduct a separate review in relation to it. The Economic Secretary to the Treasury, Simon Kirby MP, has made the following statement: “In my view, and having had regard to “Small Business, Enterprise and Employment Act 2015 – Statutory Guidance for Departments”, it is not appropriate to make provision requiring the review of the provisions of the Companies Act 2006 (Distribution of Insurance Companies) Regulations 2016. Such a provision would be disproportionate taking into account the economic impact of these Regulations.”

13. Contact

13.1 Umair Choudhry at the HM Treasury, email: umair.choudhry@hmtreasury.gsi.gov.uk can answer any queries regarding the instrument.