LEGAL FOCUS

# Eiopa QIS5 report confirms demand for longevity risk

ON MARCH 14, the European Insurance and occupational Pensions Authority (Eiopa) announced the results of the Fifth Quantitative Impact Study for Solvency II (QIS5), report Mike Munro and James Parker are Partners at CMS Cameron McKenna.

The QIS5 report confirms, while market risk is the largest component of the standard formula solvency capital requirement across the European insurance industry, underwriting risk is the second most material module for life undertakings.

Longevity risk is, in turn, one of the two most significant sub-modules. The importance of longevity risk for life undertakings has been further emphasised by Aegon's recent announcement of substantially increased levels of longevity-related provisioning, driven by strong projected increases in life expectancy in the Netherlands.

Improvements in mortality clearly present opportunities for European life undertakings.

As populations age, the demand for products which protect individuals and defined-benefit pension schemes against the associated financial risks is projected to grow significantly.

However, there are also important challenges. Many European life undertakings have significant existing exposure to longevity risk through existing annuity portfolios, and their ability to manage that exposure in a cost- and capital-efficient manner may depend heavily on the availability of cost-effective risk-transfer solutions in secondary markets.

Demand for secondary market capacity has, in recent years, been reflected in an increase in the number of reinsurers offering longevity-only products and, in the UK market, a number of substantial longevity-only reinsurances have been closed.

Most of these transactions have been entered into in respect of risks originating from defined-benefit pension schemes and transferred into the insurance markets under pension buy-in policies or longevity swaps.

However, although reinsurance capacity has expanded, it seems unlikely to be sufficient in itself to support anticipated demand, even in the relatively short term. The importance of developing alternative capital markets solutions and, in the longer term, a liquid market for traded longevity risk is now widely acknowledged.

For now, however, the longevity risk-trading market remains relatively nascent.

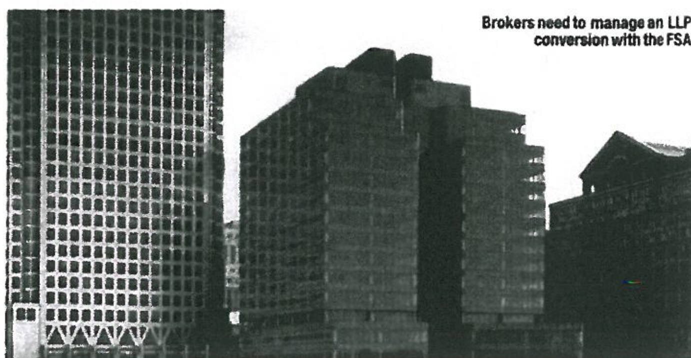
In the meantime, the QIS5 findings and the Aegon announcement suggest, in the run-up to Solvency II and beyond, demand for longevity risk-transfer solutions from European life undertakings, whether in reinsurance form or otherwise, is likely to grow.

If demand for similar solutions from defined-benefit pension schemes develops as widely predicted, there is likely to be healthy competition for available reinsurance capacity in the coming years.

Amsterdam: strong projected life expectancy increases have led to Aegon increasing longevity-related provisioning

# Why conversion to an LLP is attractive for brokers

TOWARDS the end of 2010, Lockton announced it was planning to convert to a limited liability partnership (LLP) as its choice of business vehicle in the UK, reports Doug Preece, a partner in the professional practices group at Fox Williams.



Brokers need to manage an LLP conversion with the FSA

It was not the first broker to become an LLP but, given Lockton's position in the market, firms should consider why this presented an attractive proposition for Lockton.

Commenting on the change in status, Julian James, chief executive at Lockton, revealed one of reasons for change: "We feel, as part of the continuing culture change within Lockton, a partnership model gives our associates a greater say in the running of the business and it engenders more of a partnership-style culture than a management-led one."

The impact of managers having the status of partner and the effect of the alignment of interests between the business and its partners are something which can only be measured going forward, but it must be more than purely coincidence the LLP vehicle has been adopted by the more successful professional service firms in the UK.

An LLP gives great flexibility in structuring ownership interests and remuneration systems.

These arrangements are private, apart from an obligation to disclose the earnings (but not the name) of the highest-paid member.

There is no obligation to disclose the details of an LLP members' agreement and ownership interests, unlike the position of a limited company where details of share ownership and the articles of association have to be available to the public. Another primary reason for the conversion is the tax position.

Generally, members of an LLP are not employees.

For tax purposes, members are taxed as self-employed partners in a partnership. This means no employer's National Insurance contributions are payable on the earnings of the members. These contributions are currently payable at 13.8%.

An LLP, which pays its members £10m ($16.1m) in earnings, would have an additional £1.38m to allocate, compared to a limited company. This is a persuasive argument for professional service businesses considering becoming LLPs, where the cost of staff is a major expense.

With the increase in income tax on earnings to a top rate of 50%, more LLPs now have corporate members as part of their structure to take advantage of the difference between income tax and corporation tax rates.

For a long time, converting to an LLP status was considered to be an issue for clients.

However, the experience of professional service firms shows clients do not have a problem with the change.

There are, of course, costs involved in converting a limited company business to one operating through an LLP, not least managing the process with the Financial Services Authority – a key timetable component.

However, the National Insurance saving gives an immediate benefit against which firms can budget the cost of a change in status. Given these circumstances, it is surprising more brokers have not converted to LLPs.

# Take note of the validity of tax-mitigation scheme structures

TAX-MITIGATION schemes making use of capital allowances are of concern to insurers of professionals involved in such schemes, report Julian Miller, a partner and Tom Pangbourne, an associate at Beachcroft.

They are defending litigation arising from several high-profile tax schemes.

Claims continue to be made against barristers, solicitors, accountants and financial advisers. The recent decision of the Supreme Court in *HMRC v Tower MCashback* [2011], is likely to lead to further claims by disappointed investors.

Tax-mitigation schemes make use of legislation allowing generous tax relief on investment in, for example, British films or software. In *Tower MCashback*, relief was sought under s45 of the Capital Allowances Act 2001.

Bank loans on attractive terms were obtained, so the cash committed by the investor was less than the tax relief they sought.

The tax relief was introduced in an effort to increase investment in the British film industry and in technology start-up ventures, by allowing relief on losses incurred on qualifying investments. Yet some tax schemes were promoted with a "cash in – tax relief out" mentality and were often highly artificial.

In *Tower MCashback*, investors had argued 100% of the claimed expenditure on software (the bank loan as well as the investors' cash) qualified for the relevant tax relief, and any artificiality in the underlying transactions could be ignored.

The Supreme Court disagreed.

Lord Hope agreed with Lord Walker a significant part of the claimed expenditure "was returned to its source immediately ... [and] did not go to MCashback as payment for the rights in the software, even temporarily".

The court held the tax relief should not apply to 100% of the expenditure but only to 25%.

This effectively disallowed tax relief against the expenditure represented by the bank loans.

The Supreme Court decision in *Tower MCashback* was based on an unusual and complex factual scenario.

The validity of the tax structure of any given scheme will be highly dependent on how the scheme was structured, administered and other extraneous facts.

The legislation was intended to promote investment, not merely to provide wealthy individuals with tax breaks.

The Supreme Court decision restricted tax relief to the cash investment in part because the bank loan was simply being used to increase the tax relief available, rather than for investment in the relevant technology.

Where such tax schemes adopt artificial structures in an effort to boost the available tax relief, there is now an increased prospect the schemes will fail.

If they do, the conduct of professionals involved is likely to be scrutinised.

Those insuring them should take note of involvement in such schemes at renewal and underwrite the risk accordingly.

# O'Connors for buyers

O'CONNORS LLP has launched a new legal service for insurance buyers, offering direct access to a comprehensive package of legal support to help them secure best value and protection from their insurance arrangements.

Paul O'Connor, partner at Liverpool-headquartered O'Connors LLP, said: "Insured-Legal has been developed for the insurance-buying community, in response to a demand for specialist insurance-related legal advice that is not readily available outside of a small number of 'Magic Circle' law firms in London.

"Buying insurance involves putting in place some of the most important contracts a business enters in to each year, as investor confidence in a company is determined by the strength of its balance sheet which – in major part – is underpinned by its risk transfer arrangements.

"Market research, such as the recent Mactavish report, suggests there is inadequate legal input into the contractual part of the process," he added.