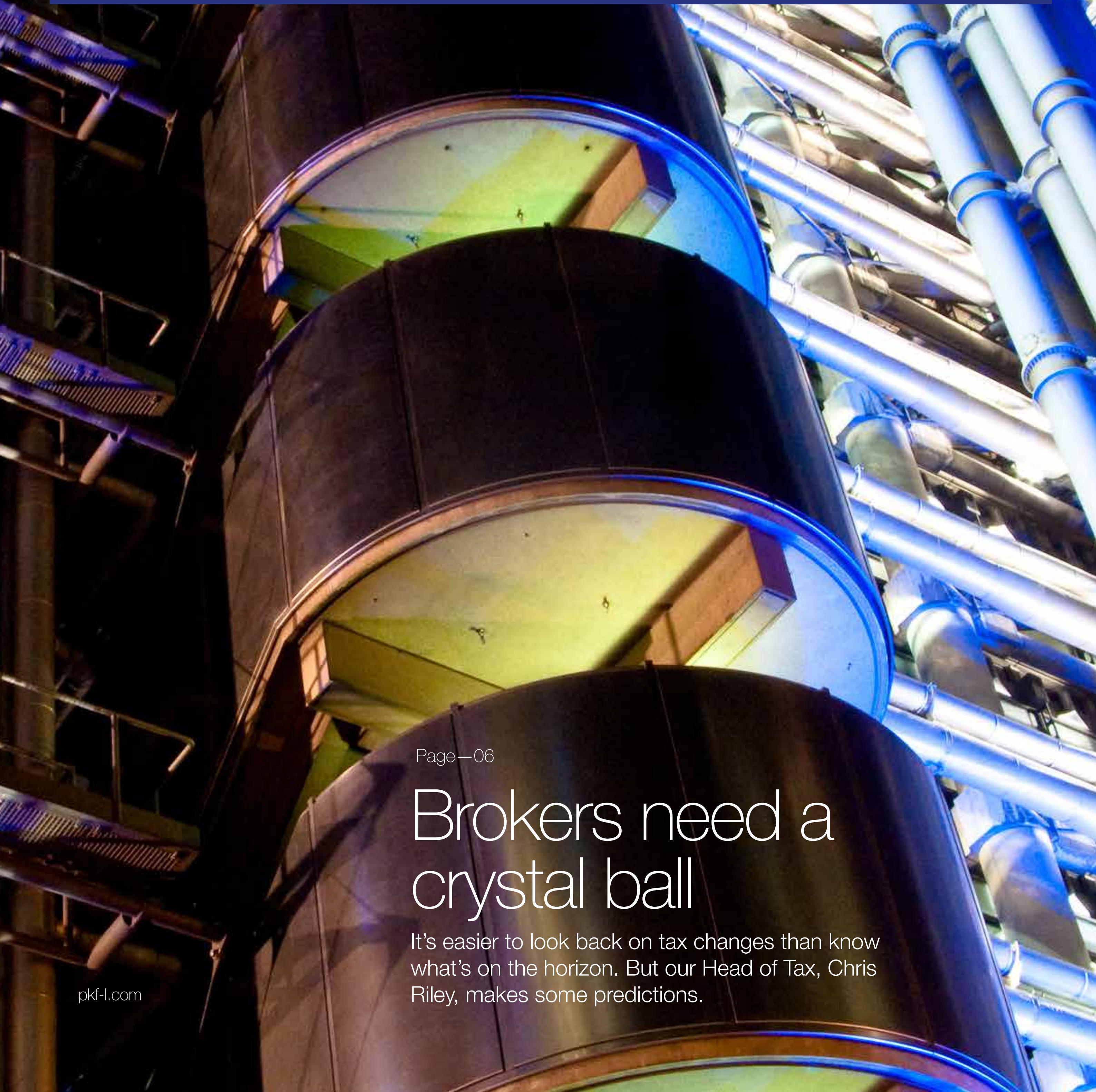
The newsletter for insurance brokers and MGAs.

Issue one
February 2021

PKF

Broking Business

In this issue

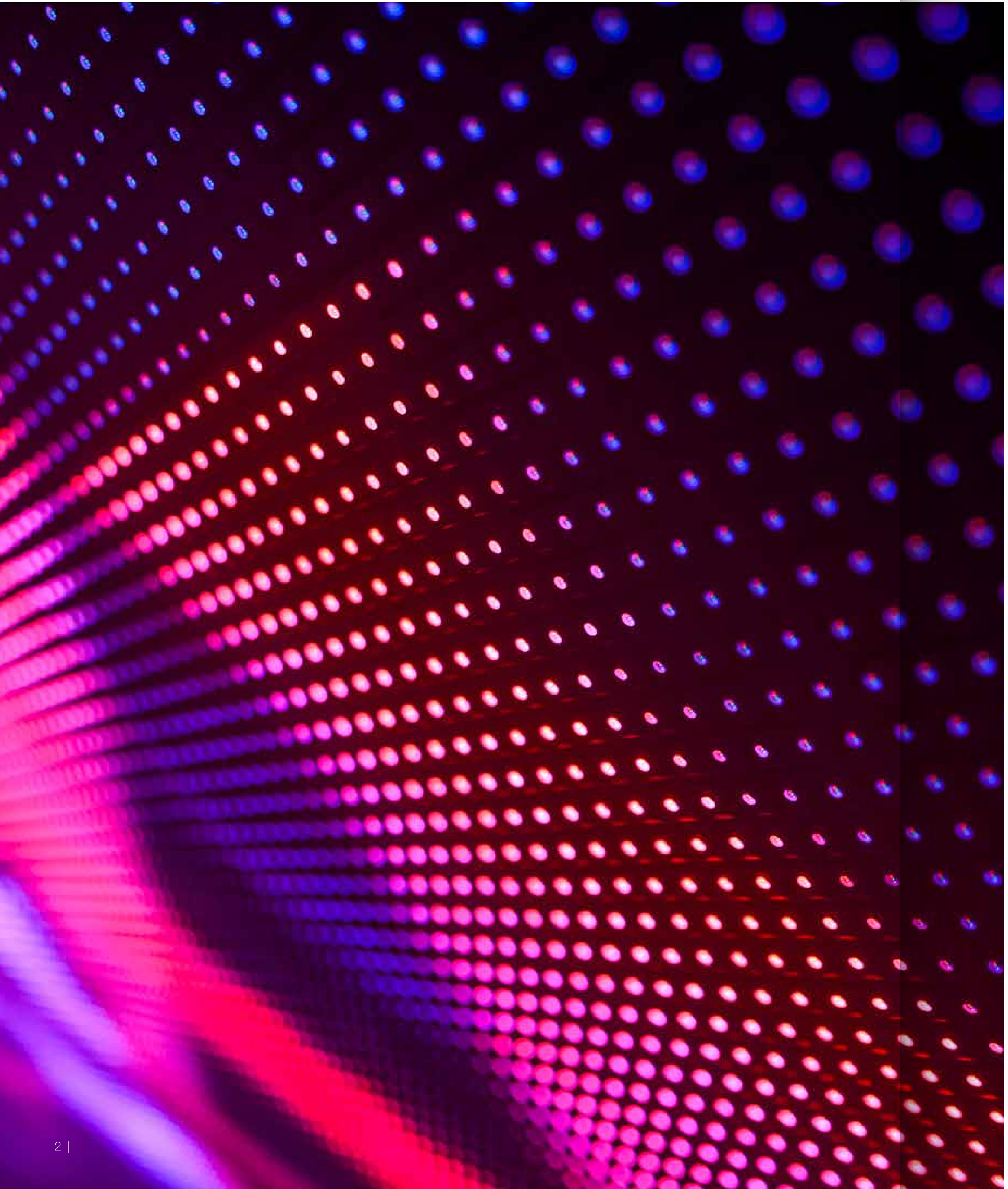


Page—06

Brokers need a crystal ball

It's easier to look back on tax changes than know what's on the horizon. But our Head of Tax, Chris Riley, makes some predictions.

Contents



Broking Business
In this issue...

Welcome to our latest issue of Broking Business...

None of us could have imagined a year ago where we would be today as a result of the Covid-19 pandemic. Intermediaries have generally coped well but the FCA is predicting many firms will be under stress in 2021. Operational and financial resilience will be more important than ever.

Tax is never far from the agenda. Tax Partner, Howard Jones summarises recent changes that Brokers and MGAs should be looking out for, that have taken, or will take, effect (and in some cases, won't!). As I write, a Budget announcement is on the horizon. Head of Tax, Chris Riley looks into his crystal ball and makes some predictions on the next round of tax changes.

We also include a reminder of the contents of the Dear CEO letter issued last September following the FCA's concerns about the handling of client money, and our views on what it means in practice.

Finally, we take a look at how Covid has affected the M&A market which, after a short lull in March and April 2020, bounced back with a flurry of deals made public at the end of 2020. As 2021 gets underway, we can't see any sign of slowdown.

We hope you find this edition useful. As always, we are keen to hear your views and suggestions for future articles.

Paul Goldwin
Head of Insurance Intermediaries

+44 (0)20 7516 2251
pgoldwin@pkf-l.com

Brokers need a crystal ball

Chris Riley
Head of Tax

+44 (0)20 7516 2427
criley@pkf-l.com

It's easier to look back on tax changes than know what's on the horizon. But our Head of Tax, Chris Riley, makes some predictions.

Later on in this edition, my fellow Tax Partner, Howard Jones summarises recent changes that have taken, or will take, effect (and in some cases, won't!). But there's also a budget on the horizon, and another promised in November, what changes to the tax system affecting brokers do we think we'll see? And which do we hope for?

Is capital gains tax (CGT) rising?

It's been impossible to avoid media coverage on potential increases to capital gains tax. The rumours follow the big change that cut availability of entrepreneurs' relief to £1m of gains in 2019 and changed the name of the relief to business asset disposal relief (BADR). One thing we learned last year was that the government wasn't shy to make a shock change, with the reduction taking immediate effect rather than at the end of the tax year.

So, in case the rate of CGT increases significantly, brokers in the process of selling their business should make sure the transaction concludes for tax purposes before 3 March 2021. While some media comments imply that any bad news will be deferred until the economy is back on its feet in November, 99% of people do not pay CGT and it is only paid on gains realised. So the suggestion that CGT rates could increase to align with income tax rates is unlikely to upset them. For that reason, I'm not sure the argument to delay any such change stacks up politically.

What I would hope, however, is that if CGT rates do change in line with income tax, there might be some compensation by improving BADR. Even if we retain the current relief of £1 million of gains taxed at 10%, the CGT system for many business owners will be more aggressive than at any time since 1998. And this would affect the retirement plans of many brokers.

The effect on employee shareholders

If CGT rates are aligned with income tax, we'd hope to see parallel measures to keep share incentive arrangements relevant, since a key benefit is access to lower rates of CGT on sale. The enterprise management incentive (EMI) scheme ensures that BADR is available to qualifying shareholders. But access to this scheme is limited to certain businesses. Brokers and MGAs do qualify in principle, though many are prevented from issuing options due to the size cap. Since 1 January 2021, the UK has greater flexibility on state aid rules than before, which may allow the government to remedy this position.

Unless some tax benefits remain available to employee shareholders, we would at least demand a loosening of the complex (and expensive when things go wrong) employment related securities (ERS) regime. This exists primarily to prevent converting income tax into CGT for employees, and there's no reason to do that if the rates are aligned.

What's fair for corporation tax?

As with CGT, an increase in corporation tax rates appears to be a question of when, rather than if. It's also unclear what that future rate will be. The media has suggested every possibility between 23% and 28%.

What's more, just like CGT, the average voter sees corporation tax as someone else's problem. They may consider it fair that any increase is being paid by those businesses that have made profits during the pandemic. So, I wouldn't be surprised to hear the announcement of an increase, albeit perhaps from next year, to provide better optics of supporting business.

Will VAT and IPT stay the same?

All signs are that the government will stick firmly to its manifesto commitments not to increase VAT, income tax or national insurance, so I would not expect significant changes in VAT.

Insurance premium tax (IPT), whose rates have been increasing for years and have doubled since 2015, is considered a stealth tax. But with a hardening market it may be the case that a rise in IPT would have a disproportionate impact on struggling small businesses. So, it may not be the time to increase the rate further.

New freedom for EIS

As with the EMI scheme I mentioned above, the enterprise investment scheme (EIS) has so far been limited by EU state aid rules. So let's hope the government applies the new flexibility to provide better access to relief for those in the insurance intermediary sector. But we must also recognise that such changes are unlikely to be specifically targeted, and may take time to introduce to the benefit of all UK businesses.

There's been significant lobbying to clarify the treatment of insurance intermediaries for EIS purposes, with many start-ups encountering a hit and miss approach when seeking HMRC approval. Resolving these challenges would help many brokers to access the relief. In turn, they could grow their business, employee base and tax revenues. And, in the long term, that would benefit the Treasury itself.

Resilience versus wind-down in 2021

Many insurance firms have coped well with the effects of the pandemic. But, as the fallout continues, what should their focus be this year?

Covid-19 has had a mixed impact on insurance intermediary firms, very much depending on their sector expertise.

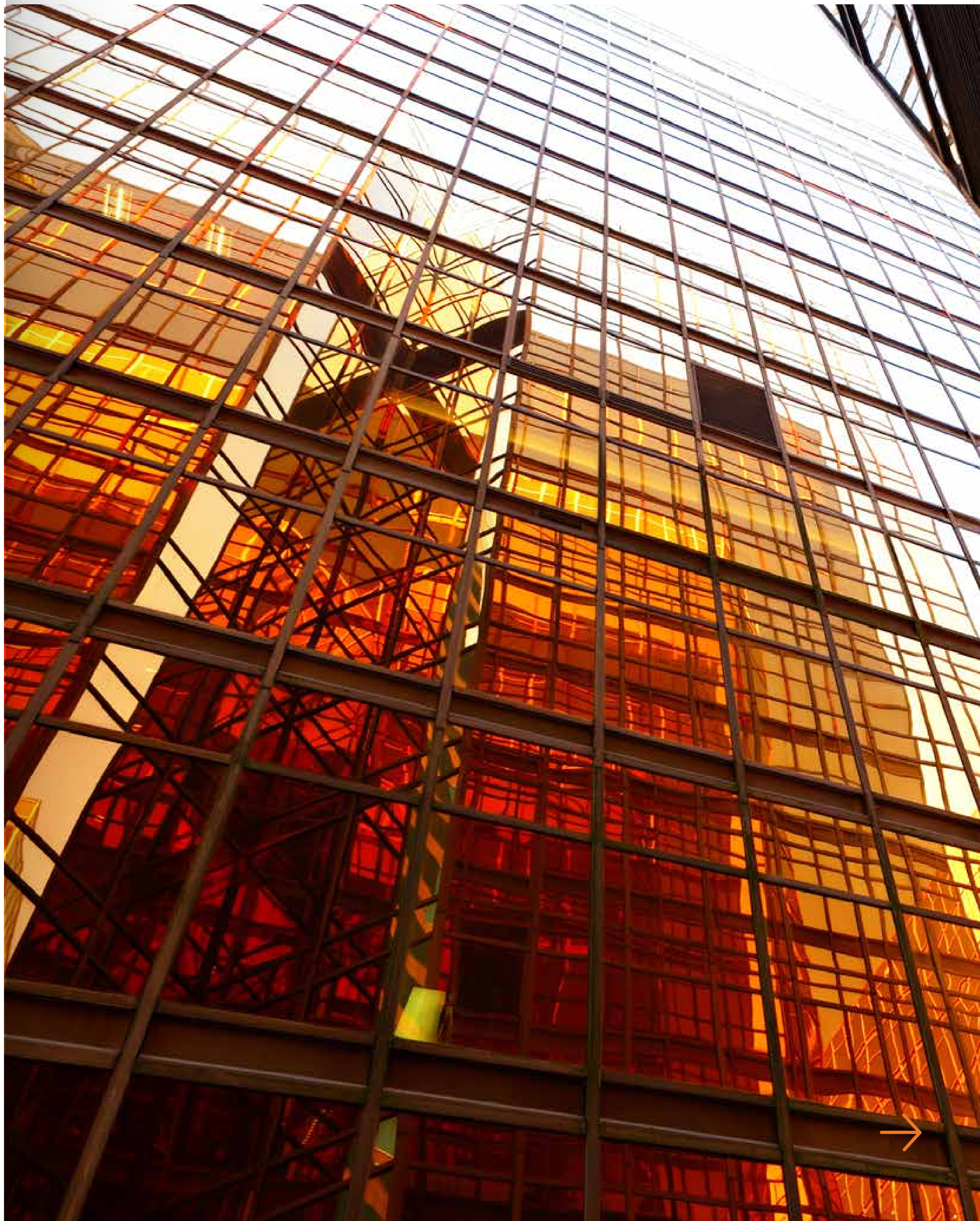
2020 was a year of survival for many firms, buoyed up by several factors. The rate increases across the markets, combined with firms' ability to reduce expenses, have helped them preserve profits through the Covid-led restrictions imposed on us all. And they've benefited from various Government-led initiatives such as the furlough scheme, bounce-back loans and CBILs.

This year is going to be more of a challenge. It's strongly predicted that there will be an economic slowdown caused by the inevitable end to the Government initiatives, the need to repay debt and the wider exposure to customer bad debts arising from these conditions.

In preparation for this, the FCA has been monitoring the situation and engaging with firms to try to prevent outcomes that harm customers and to protect client money.

Its initiatives have included:

- the Covid impact assessment survey sent to some 13,000 firms across various sectors
- the 'Dear CEO' letter on operational resistance and client money procedures
- guidance notes on financial and operational resilience and
- the insistence on firms establishing 'wind-down plans' – in case it all goes wrong.



It's clear the FCA is predicting many firms will be under financial stress in 2021. It therefore expects them to have sufficient capital and operational resources to get through this period and, if not, to give them early warning that they will be unable to do so.

Operational resilience

The FCA expects firms to be operationally resilient and, in particular:

- consider their business services and how disruption to these can have an impact beyond their own commercial interests
- set a tolerance level for disruption and ensure they can deliver their services within these limits during severe (but plausible) scenarios
- map and test important services to identify vulnerabilities in their operational resilience, and drive change where needed.

Financial resilience

Similarly, the FCA expects firms to be financially resilient. They should:

- plan ahead and ensure sound management of their financial resources, rather than employing a 'wait and see' approach
- assess their current capital requirements against their current capital availability and make sure they meet their regulatory capital requirements at all times. They must also have a sufficient buffer to account for any plausible eventualities
- if they find they have insufficient capital, plan to add more to make up for any shortfall. And, if difficult, engage with the FCA early on to plan how to exit the market in an orderly manner, taking steps to reduce harm to customers and the market and, where relevant, protect client money at all times
- maintain an up-to-date wind-down plan that takes into account the current challenges posed by Covid.

Wind-down plans

Wind-down is the process by which a firm:

- identifies the steps and resources needed to wind down its business, especially in a situation where resources are limited
- evaluates the risks and impacts of a wind-down and considers how to mitigate them.

A wind-down plan is designed to reduce the risk of negative effects on the consumers and market participants when a firm closes out its regulated business, and to safeguard client money at all times.

Wind-down plans will be different for every firm, and will be based on circumstances. But they share some common characteristics. What should they all consider?

01 **The scenarios that could lead to a firm no longer being economically viable.**

02 **The adequacy of governance processes for the wind-down.**

03 **The procedures to monitor, control and support timely wind-down decision-making.**

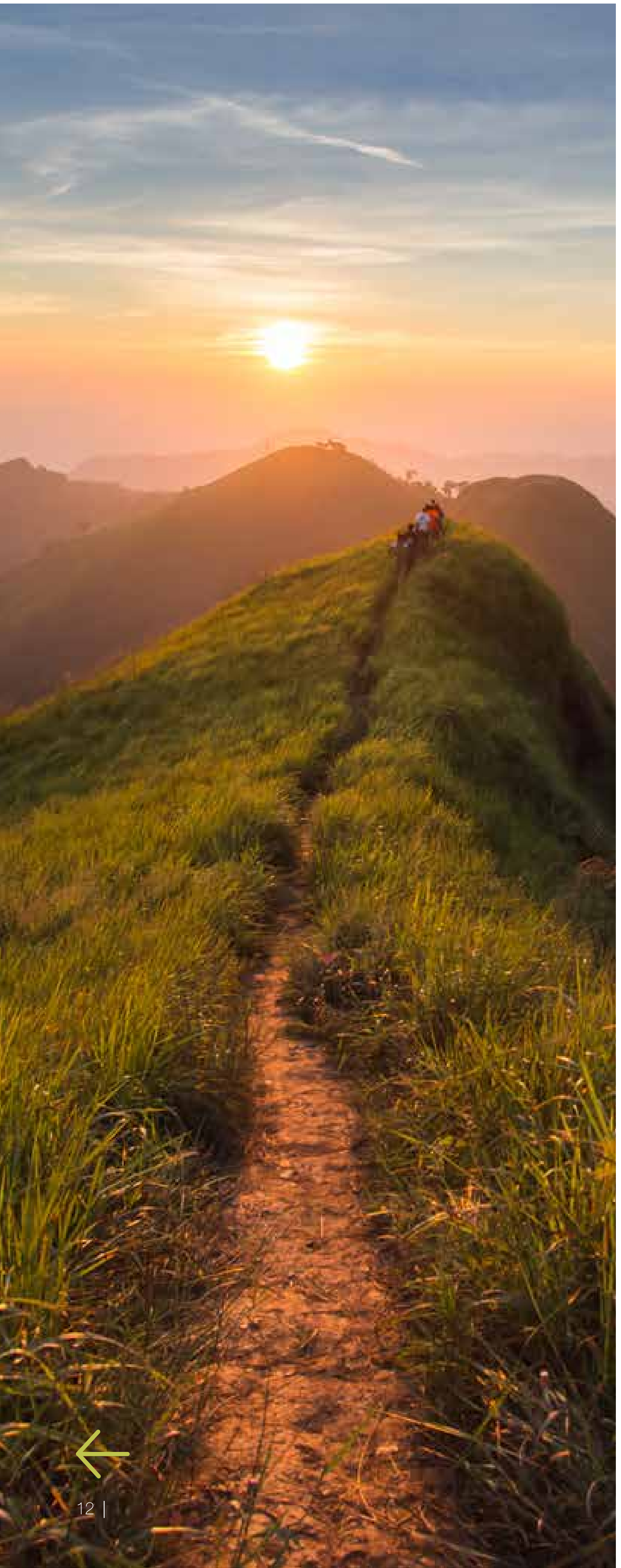
04 **The overall plan to steer the firm to wind down its business in an orderly way.**

05 **The resources, both financial and non-financial, needed to carry out and support an orderly wind-down process.**

The concept of a wind-down plan has always been there. In these difficult times it is now a regulatory requirement where circumstances dictate.

Paul Goldwin
Partner

+44 (0)20 7516 2251
pgoldwin@pkf-l.com



Tax issues: stay on top

What should brokers and MGAs be looking out for from the tax world? Here's our digest.

The Coronavirus Job Retention Scheme (CJRS)

The Chancellor announced in December that the CJRS for furloughed employees would be extended until 30 April 2021. The government confirmed that they would support 80% of wages for hours not worked, up to a maximum of £2,500 per month. Employers have been able to use the scheme, even if they haven't done so before and regardless of whether or not they're still open for business. Employers are required to pay national insurance contributions, holiday pay for holidays taken, and pension contributions.

The government will publish the names of employers who have claimed CJRS since 1 December, grouped by the size of claim. Employers can ask for their names to be withheld where there is a serious risk of violence or intimidation towards individuals. Employees are now able to check details of any claims made from that date, via their personal tax account.

HMRC may charge penalties when overpayments are made to companies under coronavirus support schemes that have not been reported to HMRC within 90 days of receipt of the payment.

Insurance premium tax (IPT)

Consultation

The consultation on ways to improve the operation of IPT and make its administration easier for all closed on 5 February. One of its aims is to be stricter on insurers that have not registered for IPT. To reduce the loss of IPT where it is due but is not accounted for by the insurer, brokers may become jointly and severally liable instead.

Anti-avoidance rules are likely to be introduced to counter insurers using various corporate structures to reduce or avoid IPT. The tax may also be payable on administration fees charged by connected insurance brokers and on all fees charged on personal lines business. Such fees have become more common recently, and it's clear HMRC has concerns in this area.

Post-Brexit environment

Now that the Brexit transition period has ended, EU insurers and insureds will be brought in line with those in the rest of world. Where an insurer has no business nor other fixed establishment in the UK and fails to pay IPT due, HMRC can issue liability notices to insureds. This will tell them the insurer is not complying and that they, the insureds, will be liable to pay future IPT if they continue to use the non-compliant insurer.

But from a VAT perspective, intermediaries placing business in respect of risks situated in the EU may see a positive outcome. These risks will fall under the 'rest of the world' definition, so they'll be outside the scope of VAT - with input VAT recovery potential. This may lead to significant increases in partial exemption recovery rates for EU-focused brokers.

Off-payroll rules (IR35)

These changes will apply from 6 April 2021, having been delayed from 2020. IR35 already seeks to establish whether an individual is employed or self-employed for tax purposes and applies payroll taxes where relevant, regardless of the legal definition of the contract.

> Off-payroll rules (IR35) will apply from 6 April 2021, having been delayed from 2020.

The underlying determination is as before. But the changes mean that, where a contractor uses a personal service company (PSC) or other intermediary entity, the requirement to identify and account for payroll taxes moves from the intermediary entity to the ultimate user of the services (in this case, likely the broking business). This aligns with the existing rules for contractors who do not use an intermediary entity.

From 6 April all medium and large-sized brokers will be responsible for deciding if the rules apply in respect of individuals providing their services through an intermediary, such as contractors. For small brokers, the individual's intermediary or PSC remains responsible for deciding the individual's employment status and whether the rules apply.

Diverted profits tax (DPT) and transfer pricing (TP)

HMRC has made clear that it believes many multinationals still don't pay the correct amount of UK tax. DPT at 25% targets contrived arrangements from 1 April 2015, where groups divert profits earned in the UK to another jurisdiction where they pay little or no tax. Often the arrangements or entities used lack economic substance or avoid the creation of a UK taxable presence which would make the foreign company liable for UK corporation tax.

Although TP can be applied legitimately to prevent DPT arising, HMRC has further questioned whether TP policies in some groups are truly representative of the activities undertaken.

As the government seeks to balance the books, it seems clear this will be a key line of attack for HMRC to raise revenues. It's likely to focus on TP, avoidance activities and, potentially, expansion of the digital services tax. So large businesses should act now to ensure their policies are valid.

Delays and cancellations

Notification of uncertain tax treatment by large businesses:

Implementation of the notification policy has been postponed to April 2022, which is good news for large businesses. In the meantime, the government will revise the legislation to clarify the circumstances in which a requirement to report arises, and make its application more objective.

DAC6 cross border disclosures

The International Tax Enforcement (Disclosable Arrangements) Regulations 2020, which came into effect on 1 July 2020, implementing the EU's DAC6 disclosure requirements. Surprisingly, the trade deal with the EU meant that the UK government could, and did, cancel the implementation on 31 December 2020. Only arrangements that seek to avoid exchange of information or beneficial ownership (Hallmark D) are now reportable in the UK. Cross border arrangements with other EU countries remain reportable in those jurisdictions.

However, to ensure there is still automatic disclosure of aggressive or abusive tax schemes, the government will introduce new legislation this year implementing the OECD's Mandatory Disclosure Rules (MDR).

If you have any questions please contact

Howard Jones
Partner - Corporate Tax

+44 (0)20 7516 2295
hjones@pkf-l.com

Dear CEO: reading between the lines

Insurance intermediaries may have forgotten, or be unclear, about the FCA's letter issued in the autumn. Here's a reminder.

The FCA had concerns about the handling of client money. So last September it issued a "Dear CEO" letter to insurance intermediaries that addressed the subject.

The letter dealt with several elements of client assets and continued from other FCA communications sent since the start of the pandemic. The FCA was direct in its approach, saying it expected the letter to be discussed at board level. It also wanted firms to be able to demonstrate actions taken as a direct response.

Reactions to the letter

We anticipated a certain level of activity in the market related to the letter's content and were ready to help with subsequent remediation plans rolled out by firms.

Several larger firms carried out internal reviews to satisfy themselves that they met the requirements. And many firms responded positively to the commentary we released, setting out [our interpretation of the FCA's letter].

These firms were typically our regular client base who want to get things right and, at times, even go above and beyond to ensure client money is protected. If we're honest, these firms were likely not the real targets of the Dear CEO letter.

What has surprised us is that we haven't seen a deluge of enquires from non-clients, nor has our network of lawyers and compliance advisors in the market.

What are the difficulties?

So why is this? The obstacle may be that, although the FCA's letter covered a wide variety of important and fundamental compliance points, it was drafted at a relatively high level. Whilst this is positive, as it lets firms interpret the requirements based on their size and type, it may have meant that some smaller firms missed what the FCA was really getting at.

Firms that don't have sophisticated finance and compliance teams and perhaps don't yet have a firm grasp of the CASS rules on client money, may well have been unable to link together the FCA's comments and the underlying rules.

Since the letter has come out, we have carried out several CASS due diligence exercises and taken on new CASS audits. And we haven't seen a noticeable change in client money environments. In fact, we've seen little evidence of any acknowledgement of the Dear CEO letter within these engagements. This leads us to wonder if the messaging has been lost.

What can be done?

Perhaps the FCA would benefit from a more prescriptive approach in order for firms to properly address the points covered in their letter? In our view it would be helpful if the FCA did get more specific and provided examples of what it intends firms to do in response. This may be the only way to resolve the mismatch between expectation and reality.

If your firm is one that has struggled with the contents of the letter, or if it's passed you by and you'd like more guidance, we'd encourage you to use your advisor to help you read between the lines. Alternatively, please contact John Needham from our Financial Services team for guidance.

Please contact us for guidance

John Needham
Partner

+44 (0)20 7516 2284
jneedham@pkf-l.com

How has Covid affected M&As?

After a short lull in March and April, M&As in the insurance intermediary market have bounced back.

Since the start of the pandemic in early 2020 there has been a variety of buyers and the appetite of consolidators and others has remained strong. This trend continued in Q4, with a flurry of deals made public at the end of 2020. And we can't see any sign of slowdown as 2021 gets under way.

Effects on insurance intermediaries

There has been obvious disruption to the market, with some intermediaries more affected than others. But it's good to see that the majority have kept their income stable, or managed the impacts effectively so that their EBITDA has not dropped significantly.

This has been achieved thanks to effective management of the reduction of underlying insured values through higher renewal rates, and rate increases in many sectors. There has also been reduced expenditure because of reduced travel, furlough savings and office cost reductions.

Along with many businesses from different sectors, our insurance intermediary clients have quickly adapted to working from home and have still been able to provide good customer service.

But, despite the high renewal rates, new business has been a challenge, as intermediaries have found it difficult to get in front of new clients.

Consolidators going strong

What hasn't changed is investors' appetite in this sector and their faith in 'buy and build' strategies. This is because the investment hypothesis, which has been so successful for many investors, has remained the same and the market has been reasonably resilient.

The end of 2020 saw a number of deals, with consolidators making the majority of the acquisitions. Aston Lark, GRP, Ardonagh and PIB have all carried out a number of transactions. Private equity firms have remained keen to come into the market, with the acquisition of JM Glendinning by Synova of particular interest, after the recent success of their 'buy and build' strategy with Stackhouse Poland. We also saw the recent acquisition of SRG by HGGC. And we expect further new entrants in 2021.

Capital gains fears

Owner managers of SME insurance intermediary businesses are looking to lock in their 'gains' at the current capital gain and entrepreneur relief tax rates. There's a worry that these rates may increase in the short term, so this has accelerated the M&A timetable for those already looking at exits. While there have been a number of accelerated sales in the market, this doesn't seem to have reduced pricing.

Valuations still buoyant

Although the full effects of Covid are still uncertain, we didn't see any significant reduction in valuations during 2020. Well-run and profitable insurance intermediaries remain coveted assets and this, combined with the high levels of 'dry powder' at private equity houses, has kept valuations high.

Distressed assets prediction

Among insurance intermediaries we have not seen a significant number of distressed assets coming to the market. The government is still supporting companies with financial packages and we therefore expect this situation to continue until mid-way through 2021. Once these government schemes are removed, we may see more of these assets coming to the market.

Will Lanyon
Senior Manager - Transaction Services

+44 (0)20 7516 2411
wlanyon@pkf-l.com

About PKF
Simplifying complexity for our clients

PKF is one of the UK's largest and most successful accountancy brands.

With over 100 years' experience in the insurance market, PKF has built up a solid and comprehensive reputation as one of a small number of UK accounting firms with in-depth expertise in supporting businesses, their owners and investors across the insurance industry.

Ranked as the 7th largest auditor of general insurers and the largest auditor of insurance intermediaries in the UK, our dedicated insurance team acts for major carriers and syndicates, brokers and MGAs including many businesses harnessing the power of technology to transform the insurance industry.

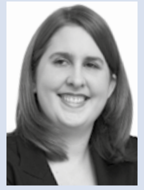
How we can help

- Statutory Audit →
- Governance, risk and control →
- Tax →
- Transaction advisory →
- Restucturing →
- Business outsourcing →

PKF UK in numbers	Insurance intermediaries in numbers	PKF International in numbers
10th Largest accountancy brand in the UK	**1st** Largest auditor of insurance intermediaries	**Part of the 14th** Largest global accounting network
30 Offices across the UK	**90+** Insurance intermediary clients	**480** Offices in 150 countries
2,300+ Employees and 158 partners	**30%** Advisor to one third of the UK's Top 50 Brokers	**$1bn+** In aggregate fee income
£140m Fee income and growing rapidly	**15** PE backed insurance intermediary clients	**20,000** Employees

Get in touch today
to see how we can help...

Paul Goldwin
Partner – Audit & Assurance
+44 (0)20 7516 2251
pgoldwin@pkf-l.com



Jessica Wills
Partner – Goverance, Risk & Control
+44 (0)20 7516 2229
jwills@pkf-l.com

John Needham
Partner – Transaction Services
+44 (0)20 7516 2284
jneedham@pkf-l.com

Chris Riley
Partner – Tax
+44 (0)20 7516 2427
criley@pkf-l.com

Howard Jones
Partner - Corporate Tax
+44 (0)20 7516 2295
hjones@pkf-l.com

Azhar Rana
Partner - Audit & Assurance
+44 (0)20 7516 2232
arana@pkf-l.com

Nick McChesney
Partner - VAT
+44 (0)20 7516 2262
nmcchesney@pkf-l.com

Ian Singer
Senior Consultant - IT Assurance
+44 (0)20 7516 2236
isinger@pkf-l.com

Will Lanyon
Senior Manager - Transaction Services
+44 (0)20 7516 2411
wlanyon@pkf-l.com

PKF Littlejohn LLP
15 Westferry Circus
Canary Wharf
London E14 4HD

Tel: +44 (0)20 7516 2200
www.pkf-l.com