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Facing the Challenges of Life Tax under Solvency II

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10 November 2014

Agenda

- Background
- Tax in the market consistent balance sheet
- Assessing the loss absorbency of tax in determining the SCR
- Practical issues with supervisory material on deferred tax
- Update on tax accounting

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Background

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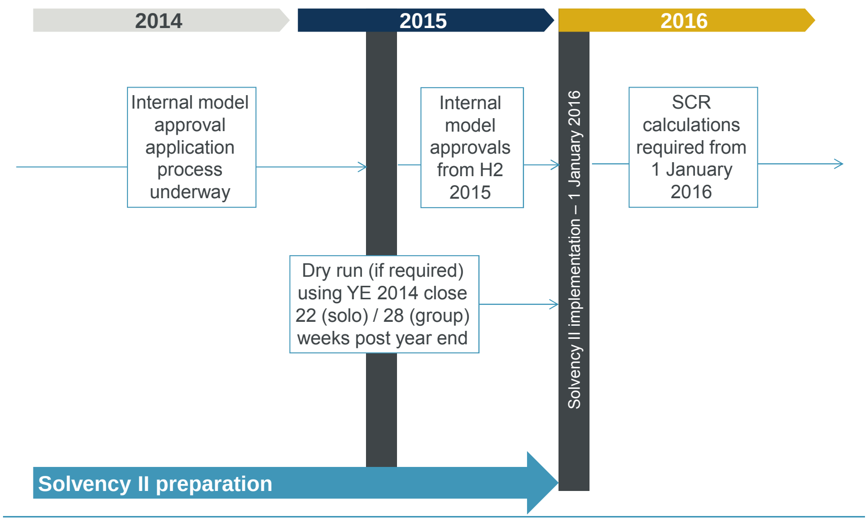
Retrospect

- Directives (all enacted):
  - Solvency II directive - 2009/138/EC
  - Postponement of commencement directive - 2013/58/EU
  - Omnibus II amending directive - 2014/51/EU
- Level 2 draft text:
  - Commission delegated regulation of 10 October 2014
- Guidelines:
  - Consultation on guidelines on Solvency II relating to Pillar 1 – EIOPA 14/036 – 2 June to 29 August 2014

Prospect



Remaining uncertainties

- High level of commitment by current legislators to make the remaining process work
- Level 2 already reflects compromise position in many areas
- Much of the required Level 2.5 and Level 3 material already exists
- Process to develop required legislation and apply Solvency II in all member states now vital
- PRA still navigating its powers under Solvency II

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Tax in the market consistent balance sheet

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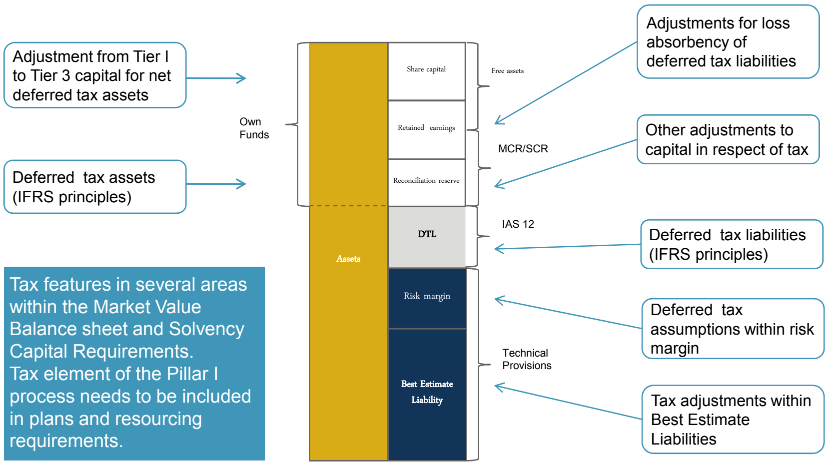
Level 2 draft text - *Article 15*

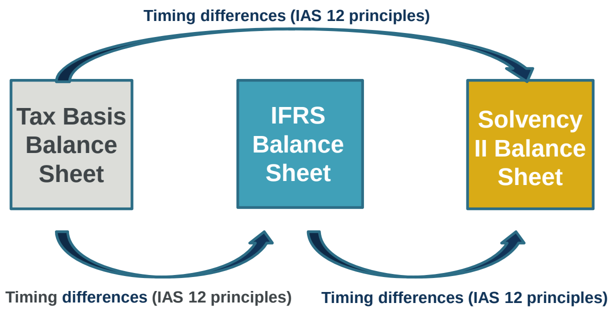
1. Insurance and reinsurance undertakings shall recognise and value deferred taxes in relation to all assets and liabilities, including technical provisions, that are recognised for solvency or tax purposes in accordance with Article 9 [EU adopted IFRS].
2. Notwithstanding paragraph 1, insurance and reinsurance undertakings shall value deferred taxes, other than deferred tax assets arising from the carry forward of unused tax credits and the carry forward of unused tax losses, on the basis of the difference between the values ascribed to assets and liabilities recognised and valued in accordance with Article 75 of Directive 2009/138/EC and in the case of technical provisions in accordance with Articles 76 to 85 of that Directive and the values ascribed to assets and liabilities as recognised and valued for tax purposes.
3. Insurance and reinsurance undertaking shall only ascribe a positive value to deferred tax assets where it is probable that future taxable profit will be available against which the deferred tax asset can be utilised, taking into account any legal or regulatory requirements on the time limits relating to the carry forward of unused tax losses or the carry forward of unused tax credits.

Where tax fits into the Solvency II balance sheet



Tax features in several areas within the Market Value Balance sheet and Solvency Capital Requirements.
Tax element of the Pillar I process needs to be included in plans and resourcing requirements.

Deferred tax - identification of tax basis balance sheet



Identification of tax basis balance sheet

- Differences between tax value of assets and liabilities (e.g. where historical cost is used) and Solvency II value of assets and liabilities produced on a market consistent basis
- Tax base may differ widely from the accounting base, where the tax base is not IFRS
- Consider different tax rules in different jurisdictions
- Practically, it may make sense to incorporate IFRS as an intermediary step

Risk margin

Technical issue	Commentary
• The risk margin represents the cost of transferring insurance liabilities to a third party, calculated by applying an interest rate to the SCR. • Would the risk margin be deductible for tax applying tax legislation to the Solvency II balance sheet?	• Source and reliability of anticipated costs • Consistency with accounting recognition criteria • Reversal of a deductible risk margin could support deferred tax asset recognition

Offset of deferred tax assets and liabilities

Technical issue	Commentary
• Offset of deferred tax assets and liabilities permitted under IAS 12 where they are of the same nature and to the same fiscal authority	• Loss relief rules in each jurisdiction need to be considered in order to offset deferred tax assets and liabilities. • Some jurisdictions have lack of offset of different types of DTL/DTA

Net deferred tax assets

- Own-fund items are classified into three tiers.
- An amount equal to the value of net deferred tax assets is deemed to possess the characteristics and features used to classify own funds into tiers set out in Article 93(1)(b) of Directive 2009/138/EC.
- This amount is then specifically ascribed to Tier 3 and Tier 1 correspondingly reduced (Commission delegated regulation dated 10 October 2014 Article 76)

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Assessing the loss absorbency of tax in determining the SCR

Matthew Taylor - EY

Level 2 draft text - *Article 207*

1. The adjustment for the loss-absorbing capacity of deferred taxes shall be equal to the change in the value of deferred taxes of insurance and reinsurance undertakings that would result from an instantaneous loss of an amount that is equal to the sum of the following:
   - the Basic Solvency Capital Requirement referred to in Article 103(a) of Directive 2009/138/EC;
   - the adjustment for the loss-absorbing capacity of technical provisions referred to in Article 206 of this Regulation;
   - the capital requirement for operational risk referred to in Article 103(b) of Directive 2009/138/EC.

Level 2 draft text - *Article 207 (continued)*

2. For the purposes of paragraph 1, deferred taxes shall be valued in accordance with Article 15. Where the loss referred to in paragraph 1 would result in the increase in deferred tax assets, insurance and reinsurance undertakings shall not utilise this increase for the purposes of the adjustment unless they are able to demonstrate that future profits will be available in accordance with Article 15(3), taking into account the magnitude of the loss referred to in paragraph 1 and its impact on the undertaking's current and future financial situation.
3. For the purposes of paragraph 1, a decrease in deferred tax liabilities or an increase in deferred tax assets shall result in a negative adjustment for the loss-absorbing capacity of deferred taxes.
4. Where the calculation of the adjustment in accordance with paragraph 1 results in a positive change of deferred taxes, the adjustment shall be nil.

Level 2 draft text - *Article 207 (continued)*

5. Where it is necessary to allocate the loss referred to in paragraph 1 to its causes in order to calculate the adjustment for the loss-absorbing capacity of deferred taxes, insurance and reinsurance undertakings shall allocate the loss to the risks that are captured by the Basic Solvency Capital Requirement and the capital requirement for operational risk. The allocation shall be consistent with the contribution of the modules and sub-modules of the standard formula to the Basic Solvency Capital Requirement. Where an insurance or reinsurance undertaking uses a partial internal model where the adjustment to the loss-absorbing capacity of technical provisions and deferred taxes are not within the scope of the model, the allocation shall be consistent with the contribution of the modules and sub-modules of the standard formula which are outside of the scope of the model to the Basic Solvency Capital Requirement

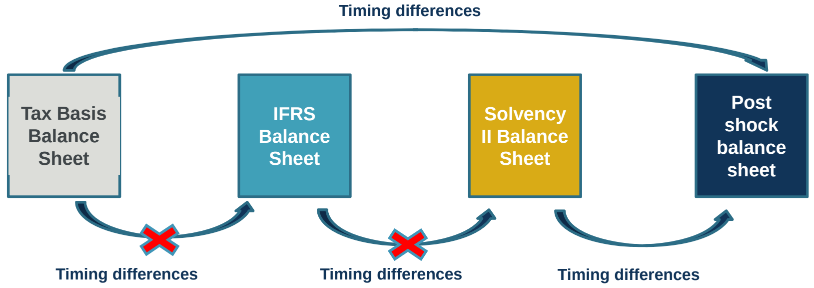
Preliminaries

Identify:

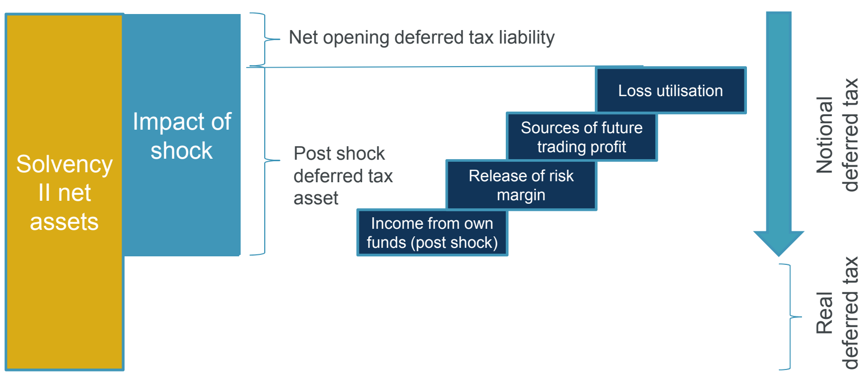
- the differences between the tax basis balance sheet and Solvency II balance sheet and how they are tax effected
- any DTAs in the Solvency II base balance sheet and any future profits (or DTLs) against which they are recognised
- the status of any internal model application
- how the internal model / standard formula deals with multiple jurisdictions
- for the aggregate shock, what rules are applied for ‘notional’ and actual deferred tax
- what the pre / post shock tax impact is on capital

Summary of key principles

- Calculated by stressing the Solvency II balance sheet in many scenarios
- Tax only applied at aggregate level (ie not to each scenario)
- Comparison between tax basis balance sheet and post shock balance sheet (current and deferred)
- Recalculate deferred tax applying IAS 12 valuation principles
- Must be performed at sufficient granularity to reflect all material relevant regulations of applicable tax regimes



Diagrammatic approach



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Practical issues with supervisory material on deferred tax

Matthew Taylor - EY

Topical issues

Cyclicality

- Loss absorbency against current tax

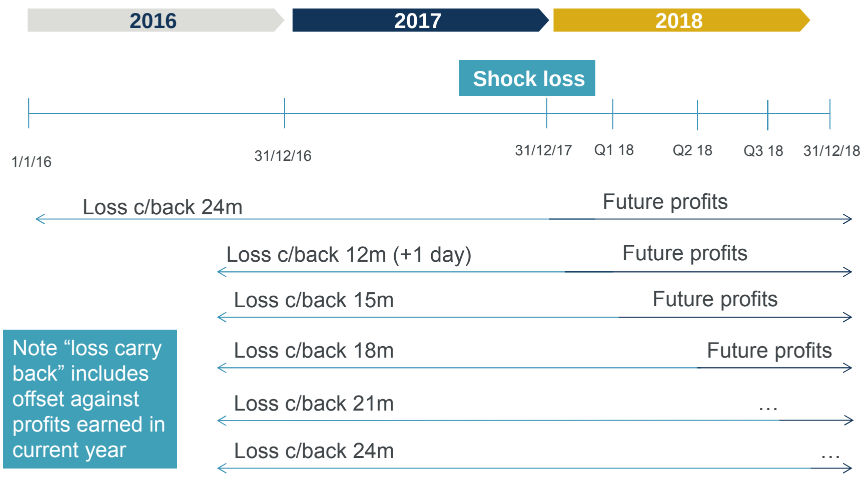
Future profit recognition

- Future profits not reflected in base balance sheet
- Impact of shock on future profits
- Ability to write new business
- Compare net DT position if netting allowed in base balance sheet

Systems and data quality

- Granularity of (taxable) profit data
- Capture and accuracy of tax attributes
- Coping with multiple tax jurisdictions

Loss carry-back – current tax asset



Group relief - overview

- EIOPA guideline needs to cover wide range of tax regimes
- Fiscal consolidation makes losses fungible and does not necessarily involve payment
- Legal requirements or contractual agreements to transfer losses should be taken into account in loss absorbency calculation (EIOPA 2014/036 draft guideline 9 (§1.30))
- Any contractual arrangement must be legally enforceable (§1.33)
- In UK, dummy group relief documentation should be drawn up for both surrendering and claimant companies
- Consistent with EIOPA approach to loss absorbency in group SCR

Group relief – current state

EIOPA 2014/036 guideline 9	PRA SS 2/14
Value should be amount receivable in exchange for losses, but capped by reference to amount which could be recognised absent the surrender (§1.32) Requirement to check that claimant could take and pay for losses post-shock (§1.35) Claimant should not recognise loss in its own loss absorbency calculation (§1.37)	• UK companies should take account of impact of shock on each group company and the sensitivity and combined effect of the assumptions relating to it (§4.6) • Before undertaking this work, UK companies should consider the likely quality of the output as evidence to support recognition of a tax asset (§4.7)

Topical issues

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Recognition of net deferred tax assets

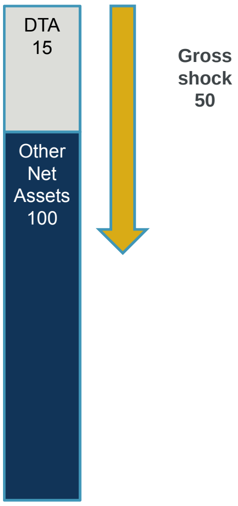
Technical issue	Commentary

• Deferred tax asset recognition under IFRS principles:
  • Probable taxable profits will emerge
  • No discounting
  • No defined timeframe
	• Deferred tax asset recognition varies significantly across Europe depending on class of business and jurisdiction
	• Reliance on new business forecasts (consider contract boundaries)
	• Practical issues regarding the use of accounting principles in a formulaic internal model produced on a market consistent basis

Future profits

- Requirements:
  - Post shock
  - Tax basis as tax loss to be monetised
  - Robust assumptions – more likely than not
  - Sufficient granularity
  - Demonstrably not double-counted
- May include:
  - Future profits of existing business and renewals
  - Future profits from fresh sales
  - Release of risk margin in run-off environment
  - Income from remaining capital

DTA recognition example



Facts
- Base balance sheet 115
- DTA on base balance sheet 15
- SCR shock creates additional tax losses of 50

Result
- What is the post shock balance sheet?
  - 75?
  - 65?
  - 50?

Topical issues

Cyclicality
- Loss absorbency against current tax

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Granularity example

Facts
- UK headquartered life insurer with BLAGAB and non-BLAGAB
- Solvency II base balance sheet contains some I minus E DTLs and DTAs, but overall DTL
- SCR shock creates loss to all aspects of business

Impact on calculation
- Principles must be applied computation by computation
- Is shock allocated to each business to compute tax separately?
- In BLAGAB, different elements of shock have different tax effects (e.g. I minus E investment gains and losses vs trade mortality and longevity impacts)
- Cannot treat overall DTL as 'loss absorbing'
- Loss offsets need to be computed business by business
- Future taxable profits must be computed business by business
- Cyclicality of loss carry backs could affect different businesses in different ways

Double counting of profits

Order of utilisation →

Existing business	Taken into account to reduce BEL and increase Tier 1 capital	Supporting pre-shock DTA	Eliminated by shock	Available post-shock
Renewals Return on capital	Excluded by contract boundary	Supporting pre-shock DTA	Eliminated by shock	Available post-shock
New business to be sold	Required for risk margin	Supporting pre-shock DTA	Eliminated by shock	Available post-shock
Risk margin	Required for new business	Supporting pre-shock DTA	Available post-shock	

The group dimension

- EIOPA 14/036 contains guidance (Guideline 23) on how to allocate tax to group diversification benefit:
- $$\text{Adj}^{\text{group DT}} = \frac{\text{SCR}^{\text{diversified}}}{\sum \alpha^{\text{solo}} \times \text{SCR}^{\text{solo}}} \times \sum \alpha^{\text{solo}} \times \text{Adj}^{\text{solo DT}}$$
- The basic approach is to determine the proportion of aggregate solo SCRs represented by the diversified group SCR and multiply this by the aggregate solo deferred tax adjustments for loss absorbency. If a solo company has minority interests and is not 100% consolidated the figures taken for that company are reduced proportionately before aggregation in the group diversification calculation.

Summary

- Insurers must have a methodology in place to satisfy the PRA
- This must cover, document and justify for all jurisdictions:
  - Data sources
  - Judgements
  - Assumptions
  - Detailed reconciliations
  - Must be of sufficient granularity
- Potential benefits are huge but bar is high
- More work to be done in this area?

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Update on tax accounting

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IFRS

There are no changes to IAS 12 currently being proposed, but

- The IASB is adamant to get the insurance contracts project finalised!
- Resolving the issue of participating contracts will be key
  - Alternative proposals are picking up momentum
- It is likely middle ground needs to be found for some key areas to get the project done
- Will the timing of the final standard fit with the 2018 window for alignment with IFRS 9 effective date?
- How to deal with all the implementation issues?
- Preparation and implementation- operational impact will be huge:
  - Systems, models and data
  - Reporting framework
  - Explaining the results

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UK GAAP

From 1 January 2015 companies using UK GAAP must follow either:

- FRS 101 – essentially IFRS with reduced disclosures or
- FRS 102 and FRS 103 – not IFRS bur closely aligned to it

FRS 102 – Section 29 Income Tax

Condensed version of IAS 12 which supersedes FRS 16 and 19

- Covers corporation tax and VAT
- Current tax reflects balance of account with HMRC for current and past reporting periods
- Deferred tax required in respect of timing differences by reference to total comprehensive income, but not
  - If recovery of a net deferred tax asset is not probable
  - If, in the case of subsidiaries et c, reversal is under the control of the entity and is not probable in the foreseeable future
- No discounting
- Requirement for substantive enactment at the reporting date
- Real estate investments assumed taxed on a sale
- Balance sheet accounting for withholding taxes
- Requirements of legal right of offset before offsetting

Questions **Comments**

Expressions of individual views by members of the Institute and Faculty of Actuaries and its staff are encouraged.

The views expressed in this presentation are those of the presenters.

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Thank you

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