Institute
and Faculty
of Actuaries

CP3/14 Solvency II: recognition of deferred tax

Institute and Faculty of Actuaries consultation response to the Prudential Regulation Authority

19 March 2014

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute
and Faculty
of Actuaries

Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

19 March 2014

Dear Sir/ Madam

IFoA response to CP3/14 Solvency II: recognition of deferred tax

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the PRA on the recognition of deferred tax under Solvency II. This response has been drafted by members of the IFoA's Life Taxation Working Party, who have expertise in Life Office tax with additional input from members of our General Insurance community.

General

Practitioners have expressed differing views about the interaction between the Solvency II Directive and the IAS 12 provisions. This has particularly been the case in connection with deferred tax assets in the Solvency II balance sheet, or losses arising from the 1 in 200 year shock, assumed in the calculation of the solvency capital requirement. The discussion has been more difficult to conclude because of the perceived mismatch of principles between the market consistent approach inherent in Solvency II and the approach taken by accounting standards in IAS 12, which is imported into Solvency II, to address the recognition and measurement of deferred tax.

Applying IAS 12 involves:

- Using a "more likely than not" test for ability to offset losses
- Allowing for the release of risk margin on existing business
- Allowing for future post-stress new business profits and creation of risk margin on new business; and
- Real world investment returns

Applying a Solvency II approach would involve:

- Using full cash flow runoff
- No release of risk margin, as it is supposed to be paid to the transferor undertaking
- No future new business, as Solvency II ignores new business and assumes the existing business is transferred elsewhere: and
- Risk neutral investment returns adjusted for matching premium, volatility adjustment etc.

Given the potential for confusion arising from the apparent conflict between IAS 12 and Solvency II methodologies, we regard the publication by the PRA of guidance in the form of a supervisory statement on the treatment of deferred tax in these circumstances, as a very helpful development.

Solvency II directive requirements

Paragraphs 2.1 and 2.2 summarise the intention of the Solvency II Directive and the Draft Delegated Acts, with regard to deferred tax, and set out the recognition criteria from IAS 12. IAS 12 and its approach are already built into Solvency II at Article 11 V7 of the Draft Implementation Guidance. There is no alternative "Solvency II principles" approach. More importantly, the aim in valuing a deferred tax asset is to calculate how much tax will be saved in the future from the existence of the attribute being valued. Tax is charged in the UK on profits, as shown in financial statements in the real world, not on Solvency II cash flows, if these are different. Support for a deferred tax asset must, therefore, come from an estimate of future real world profits, accounting for changes in the risk margin and future profits not already taken into account whether from renewals, new business or returns on excess assets.

Paragraphs 2.3 and 2.4 could benefit from greater consistency. Paragraph 2.4 explains the recognition criterion of IAS 12 for a deferred tax asset, by reference to probable future profits; but paragraph 2.3 does not acknowledge the use of such deferred tax assets in calculating the solvency capital requirement.

UK tax legislation provides for the offset of losses against profits of the current and preceding accounting period. Relief available to a loss at the beginning of a period may be very different from relief available at the end. There could also be a cyclical variation through the quarter ends. It would be helpful to have guidance on the assumption to be made about the timing of the shock and, hence, any loss.

Paragraph 2.4 requires the test of probability of relief to be the future taxable profit test used in IAS 12. This is a different approach from the Solvency II balance sheet, which specifically assesses future cash flows using Solvency II guidance.

Some members of the IFoA's Life Taxation Working Party have expressed a view that any cash flows used in the derivation of the balance sheet, or which would be used in such a derivation following a stress event, should also be available to be used in the valuation of a tax asset without further reference to IAS 12 criteria. Using IAS 12 guidance to limit valuation of tax assets available from these cash flows could effectively be seen as calling into question the value of the cash flows themselves, and hence the value reported in the rest of the balance sheet.

It is far from clear, however, why this should be the case. The cash flows from each policy may well be scheduled differently for the purposes of the Solvency II balance sheet and the reported financial statements, but the aggregate profit or loss recognised over the whole life of the policy, should be the same. Thus the difference at the balance sheet date between the "profit" recognised in the Solvency II balance sheet, and that recognised in the financial statements, gives rise either to a deferred tax liability if the "profit" in the Solvency II balance sheet is greater, or a deferred tax asset, if it is less. This analysis is just as valid after the shock as before, although the "profit" in the post-shock balance sheet will be lower, or will be a loss.

Whether or not a loss has value in terms of tax is dependent on tax legislation, as well as the timing of cash flows. If the "profit" in the Solvency II balance sheet is less than that in the financial statements, the additional profit in the financial statements will have been taxed already on that basis. The "profit" which has yet to be recognised in the Solvency II balance sheet will emerge free of current tax to the extent that it has been taxed already on the basis of the financial statements. A tax loss has no value against such profits, as they are already free of current tax. A tax loss only has monetary value against profits emerging to be taxed on the basis of the financial statements and this aspect is addressed by the use of IAS 12. There should, however, be a clear presumption for the reliability of the Solvency II cash flows, regardless of the timing of their being brought into account in the financial statements.

Areas requiring particular attention

It could be useful to expand the guidance at paragraph 3.1 to address the level of granularity expected in applying tax in standard or internal models. Different scenarios may have significantly different tax outcomes, particularly for business subject to the I minus E tax regime, and these outcomes may need to be addressed statistically. It will not necessarily be the case that applying tax to the results of the model will give the same result as applying it scenario by scenario.

While it is clear this guidance would apply to both standard formula and internal models, there could usefully be more information on how the scenarios within the standard formula should be interpreted, especially for companies with branches in multiple countries – to allow companies to determine which tax rate would be applicable. It would be helpful if any expansion of the guidance on granularity here could address this aspect.

The guidance at paragraph 3.2 could acknowledge that, in most cases, there will only be one net deferred tax balance, whether asset or liability, in the Solvency II balance sheet.

The guidance at paragraph 3.3 is helpful. Differences in contract boundaries between Solvency II and the financial statements may be one reason for differences between the "profit" in the Solvency II balance sheet and that in the financial statements –particularly if the effect is to remove profits from "renewals" from the Solvency II balance sheet. In this case, profit from renewals could be a source of future profits for assessing the values of deferred tax assets for Solvency II – but it must not have been already taxed or double counted as new business.

Paragraphs 3.4 to 3.6 address the ability to use tax liabilities expected on profits arising from the unwinding of the risk margin. It is suggested that, where the existing risk margin will simply be replaced by new risk margins on new business or other activity, the unwinding of the existing risk margin should not be recognised.

Firms closed to new business appear to be able to recognise tax assets justified on profits from risk margin unwind; but firms writing new business appear to have further constraints on the recognition of tax assets. This would be inequitable if not corrected.

If new business is self financing, the setting up of the corresponding risk margin does not draw on the margin released from existing business, but is charged as a cost in forecasting the profits from the new business. There is a risk of double counting the cost of the risk margin in respect of new business. The recognition of a deferred tax asset by reference to profits from the release of the risk margin on existing business should either be allowed, subject to offset by any strain arising from new business, or, alternatively, an equivalent amount of the cost charged for setting up the risk margin on new business which could be added back to the value of future profits from new business. These issues will be most significant for long term business, where the margins will unwind over a number of years.

Paragraph 3.7 confirms the application of IAS 12 principles to the Solvency II balance sheet.

Paragraphs 3.8 and 3.9 belong together, as paragraph 3.9 addresses the possibility of a rebuttal of the position in paragraph 3.8. Paragraph 3.8 seems a logical position but it may help to set out two circumstances where it should not apply. One of these is the position where under paragraph 3.7, a deferred tax asset is valued in the Solvency II balance sheet against a deferred tax liability of greater amount. There should be no reason for not allowing loss absorbency for the net deferred tax liability. Another circumstance is where the unrecognised deferred tax asset has a specific nature, such as excess expenses of management for I minus E. This should not prevent the recognition of deferred tax assets in respect of trading losses on other long-term business.

Demonstrating the credibility of projected future taxable profits

Paragraphs 4.1 to 4.4 deal with demonstrating the quality of future profits. In the light of the detailed comments already made, the paragraphs should be applied specifically to profits and cash flows not otherwise recognised in the Solvency II balance sheet. This could include investment return from any free assets in excess of the SCR remaining after the shock. It could also include a reasonable estimate of real world returns from any remaining risk premium not previously taken into account in the deferred tax calculations.

Paragraphs 4.5 and 4.6 are also relevant to the recognition of deferred tax for group solvency reporting purposes. Guidance could usefully be given on the attribution of tax to diversification benefits in the group solvency calculation. Group companies may exhibit different tax rates, not only by reference to the rates ruling in different jurisdictions, but also by reference to differences in the ability of companies to recognise deferred tax assets. The tax effect of the diversification benefit needs to be calibrated by reference to the contribution to it made by different group companies.

Should you want to discuss any of the points raised please contact Paul Shelley, IFoA Policy Manager (paul.shelley@actuaries.org.uk/ 07917604985) in the first instance.

Yours sincerely,

David Hare

David Hare
President, Institute and Faculty of Actuaries