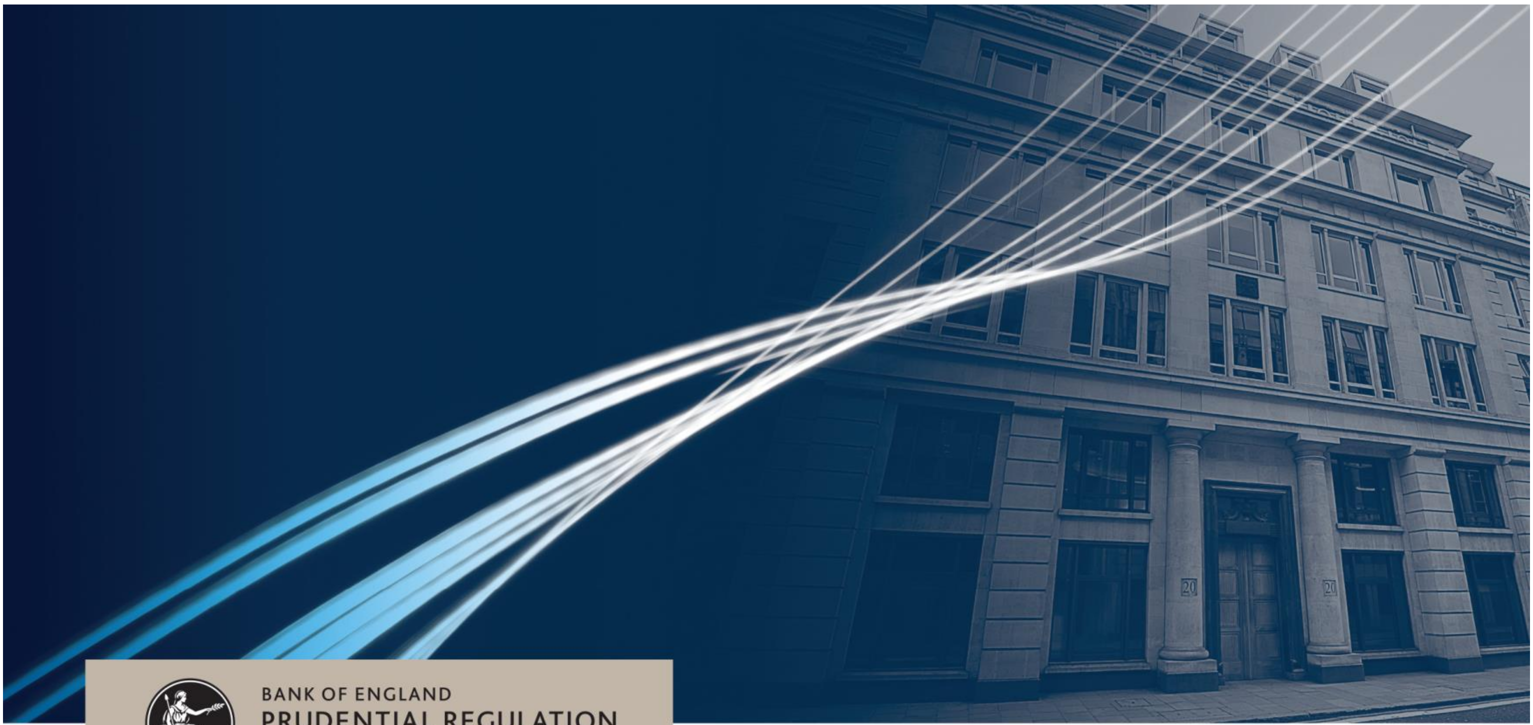

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP27/18

Solvency II: Adjusting for the reduction of loss absorbency where own fund instruments are taxed on write down

October 2018

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Consultation Paper | CP27/18

Solvency II: Adjusting for the reduction of loss absorbency where own fund instruments are taxed on write down

October 2018

By responding to this consultation, you provide personal data to the Bank of England. This may include your name, contact details (including, if provided, details of the organisation you work for), and opinions or details offered in the response itself.

The response will be assessed to inform our work as a regulator and central bank, both in the public interest and in the exercise of our official authority. We may use your details to contact you to clarify any aspects of your response.

The consultation paper will explain if responses will be shared with other organisations (for example, the Financial Conduct Authority). If this is the case, the other organisation will also review the responses and may also contact you to clarify aspects of your response. We will retain all responses for the period that is relevant to supporting ongoing regulatory policy developments and reviews. However, all personal data will be redacted from the responses within five years of receipt. To find out more about how we deal with your personal data, your rights or to get in touch please visit bankofengland.co.uk/legal/privacy.

Information provided in response to this consultation, including personal information, may be subject to publication or disclosure to other parties in accordance with access to information regimes including under the Freedom of Information Act 2000 or data protection legislation, or as otherwise required by law or in discharge of the Bank's functions.

Please indicate if you regard all, or some of, the information you provide as confidential. If the Bank of England receives a request for disclosure of this information, we will take your indication(s) into account, but cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system on emails will not, of itself, be regarded as binding on the Bank of England.

Responses are requested by Wednesday 2 January 2019.

Please address any comments or enquiries to:
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

Email: CP27_18@bankofengland.co.uk

Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) sets out its proposals to amend Supervisory Statement (SS) 3/15 'Solvency II: the quality of capital instruments' (see Appendix). It proposes an expectation that insurers will deduct the maximum tax charge generated on write-down, when including items listed in Articles 69(a)(iii) and (b) of the Solvency II Regulation (the 'Solvency II Regulation') or certain items approved under Article 79 of the Solvency II Regulation to be recognised as restricted Tier 1 own funds (rT1) in their own funds.[1]

1.2 This is in the light of the proposed tax changes introduced by HMRC in the Budget on Monday 29 October 2018 pertaining to hybrid instruments. The CP specifically addresses the implications of those proposed tax changes on rT1.

1.3 The CP is relevant to UK insurance firms within the scope of Solvency II, the Society of Lloyd's, and firms that are part of a Solvency II group that will determine and classify capital instruments under the Solvency II own funds regime, together with their advisors.

Background

Budget tax changes by HMRC

1.4 On Monday 29 October 2018 the Government announced that it will introduce new rules for the taxation of hybrid capital instruments.[2] These will replace the Taxation of Regulatory Capital Securities 2013 as amended by the Taxation of Regulatory Capital Securities Regulations (Amendment) Regulations 2015. From Monday 1 July 2019 any credit arising on writing down or conversion of externally issued hybrid capital instruments will be subject to corporation tax unless it falls within one of the exceptions in section 322 of the Corporation Tax Act 2009.[3] The PRA considers Conditions B and E in section 322 will be most relevant to the status of rT1.

1.5 Condition B applies if the hybrid capital instrument is released in consideration of shares forming part of the ordinary share capital of the issuer. That being the case, rT1 instruments which convert will not be taxed on that conversion.

1.6 Condition E applies if 'immediately before the release, it is reasonable to assume that without the release and any arrangements of which the release forms a part, there would be a material risk that the debtor company (that is, the issuer) would be unable to pay its debts within the next 12 months'. To determine whether Condition E applies, HMRC notes that 'it may be necessary to consider how markets would react if there were no write down, particularly where this would leave the institution with equity levels below the accepted minimum for the industry. If the write down occurs only at a level where, without a write down, there would be a material risk of a collapse of confidence in the institution within 12 months, then condition E is likely to be met.'

1.7 The mandatory triggers for rT1 instruments are set at a level where it is not likely that there would be a material risk of a collapse of confidence in the institution within 12 months. Solvency II (SII) is a going concern regime; Article 101(2) of the SII Directive requires that capital requirements are calculated on the presumption that the undertaking will pursue its

1 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2015:012:TOC.
2 Chapter 3 of https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752083/Hybrid_and_Mismatch_Technical_Note_FINAL_2510118_UC_291018.pdf.
3 In this CP 'external' is used to mean that the investors in the rT1 instrument are not in the group of the issuer.

business as a going concern and Article 93 requires loss absorbency of own funds to be considered both in going concern and on winding up. The SII regime recognises that at rT1 trigger 'material risk of collapse' (as referred in the HMRC note) may be some way off; it requires a breach of the Solvency Capital Requirement (SCR) to be remedied within six months, which the supervisory authority may extend by another three months if appropriate. And in an exceptional adverse situation firms may have up to seven years to restore their SCR coverage.[4] In addition, even where insurance firms are unable to continue trading, they are frequently able to enter solvent run-off.

1.8 Given this, the PRA considers it reasonable to conclude at the point of issuance that Condition E is unlikely to apply to any future writedown of rT1 capital instruments: taxation of the gain created on write-down should therefore be assumed.

Purpose

1.9 The purpose of the proposal is to prevent the amount of loss-absorbency provided by rT1 from being overstated.

Implementation

1.10 The intended implementation date for the final policy following this CP is Friday 1 February 2019.

Responses and next steps

1.11 This consultation closes on Wednesday 2 January 2019, the short consultation period being necessary to provide certainty as soon as possible to firms considering issuing rT1 instruments. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP27_18@bankofengland.co.uk.

2 Proposals

2.1 The PRA proposes to update SS3/15 (see Appendix), to add an expectation that insurers would deduct the maximum tax charge generated on write-down, when including external rT1 capital instruments which write down on trigger in their own funds. The PRA would introduce that expectation for all new issuances of rT1 instruments after 31 January 2019.

2.2 Where firms have already issued external rT1 instruments which write down on trigger, their supervisory team would discuss appropriate arrangements with each firm on a case-by-case basis.

Implications of the tax charge on Solvency II own funds

2.3 The gain recognised on writedown of external rT1 instruments will generate a tax charge. This will be reflected on the Solvency II balance sheet as either a separate liability, or as a reduction in deferred tax assets (DTA). This Solvency II balance sheet impact would usually result in a reduction in own funds.

2.4 The PRA considers that there may be situations where the loss-absorbing capacity of the write-down feature would not be limited by this tax effect where the DTA used in the own funds calculation does not reflect all potential DTA. This could occur if:

4 Article 138(4) of the SII Directive.

- the firm has losses that do not meet DTA recognition criteria under Article 15 of the Solvency II Delegated Regulation; or

- before the rT1 triggered, the firm had a net DTA adjustment which created Tier 3 own funds greater than the eligibility limits,[5] so that creating a DTL reduced the 'excess' DTA rather than that included in the own funds calculation.

2.5 Such circumstances are uncommon and it would not normally be possible to anticipate at the point of issuance that a firm will be in this position when rT1 triggers.

2.6 In all other situations, the tax effect of writing down the instrument will result in a corresponding reduction in loss-absorbing capacity, regardless of whether the firm is making a taxable profit at that point. Therefore the valuation of the instrument is expected to be greater than the loss-absorbency it offers.

Regulatory requirements supporting the proposal

2.7 The PRA considers that the contribution of the instrument to own funds should take into consideration the extent to which it is able to provide policyholder protection through its ability to absorb losses. This is supported by the Solvency II requirement that an own funds item 'is available, or can be called up on demand, to fully absorb losses on a going-concern basis, as well as in the case of winding up.'[6] The PRA considers that where a write-down of a basic own funds item would generate a tax charge, the capacity of that item to provide policy holder protection through loss absorbency is reduced. This should be reflected in the own funds calculation.

Current uncertainty regarding recognition of rT1 instruments

2.8 Tax treatment similar to that being introduced by HMRC already exists in several other EU Member States and the European Insurance and Occupational Pensions Authority (EIOPA) concluded that the risk of triggering rT1 instruments would lead to a worsening of a firm's own funds position in its second set of advice on SII Delegated Regulation.[7]

2.9 EIOPA concluded:

> 'From a prudential perspective, in order for the basic own funds to reflect the loss absorbing characteristics of the instrument, it can be seen as reasonable for the principal value to be adjusted to reflect the amount of tax that would be expected to be paid on trigger; it is not available to provide policy holder (sic) protection since it would be paid to the tax authorities on trigger.
>
> However, EIOPA recognises that whilst the theoretical maximum tax consequences could be calculated, and deducted from the principal to obtain the amount of own funds to be recognised, the likelihood of this tax actually being payable on trigger is expected to be low. Therefore mandatory deduction of the maximum possible tax that could be due on write down would seem to be unduly stringent. EIOPA therefore considered the possibility for regulatory authorities to be able to waive the requirement for a write down at the point of trigger if a tax liability was likely to arise.'

---

5 In accordance with Articles 76(a)(iii) and 82 of the SII Delegated Regulations.
6 Article 93(1)(a) of the SII Directive.
7 February 2018: https://eiopa.europa.eu/Publications/Consultations/EIOPA-18-075-EIOPA_Second_set_of_Advice_on_SII_DR_Review.pdf.

2.10 The PRA agrees with EIOPA that from a prudential perspective it would be reasonable for the extent to which the instrument is recognised in own funds to reflect the amount of tax that would be expected to be paid on trigger. However, the PRA analysis has also considered those instances where loss absorbency is overstated via deferred tax effects even when an undertaking is not making taxable profits.

2.11 The proposals in this CP have been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including those arising once any new arrangements with the European Union take effect.

2.12 The proposal is to be implemented by adding two paragraphs to Chapter 4 in SS3/15 as shown in the appendix to this CP.

3 The PRA's statutory obligations

3.1 In carrying out its policy making functions, the PRA is required to comply with several legal obligations.

3.2 The PRA is required by the Financial Services and Markets Act 2000 (FSMA)[8] to consult when setting its general policies and practices. In doing so, it is required to comply with several statutory and public law obligations. The PRA meets these obligations by providing the following in its consultations:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with the PRA's duty to act in a way that advances its general objective,[9] insurance objective,[10] and secondary competition objective;[11]
- an explanation of the PRA's reasons for believing that making the proposed policy are compatible with its duty to have regard to the regulatory principles;[12] and
- a statement as to whether the impact of the proposed policy will be significantly different to mutuals than to other persons.

3.3 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[13]

3.4 The PRA is also required by the Equality Act 2010 to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.[14]

8 Section 2L of FSMA.
9 Section 2B of FSMA.
10 Section 2C of FSMA.
11 Section 2H(1) of FSMA.
12 Sections 2H(2) and 3B of FSMA.
13 Section 30B of the Bank of England Act 1998.
14 Section 149.

Cost benefit analysis

3.5 HMRC's proposed change in the tax treatment of rT1 instruments with write-down features will impose costs on the affected firms because it will increase the cost to them of servicing loss-absorbing capital. The proposals in this CP will generate benefits by ensuring that the affected firms do not overstate their solvency position.

Compatibility with the PRA's objectives

3.6 The PRA considers that the proposals in this CP are compatible with the PRA's statutory objectives to promote the safety and soundness of PRA-authorised firms and to contribute to policyholder protection. The PRA is seeking to ensure the delivery of the main objective of the Solvency II Directive as described in Article 27 of the SII Directive (ie the protection of policyholders and beneficiaries) by providing guidance to firms.

3.7 The PRA also has a duty to facilitate effective competition as a secondary objective subordinate to its safety and soundness and policyholder protection objectives. Firstly, the proposal facilitates this as it will prevent firms from overstating their capital position with respect to future issuances. In addition, this proposal also facilitates effective competition by seeking to minimise the impact of the proposed policy to instruments already in issuance, which were issued on the basis of law applicable at that time.

Regulatory principles

3.8 In developing the proposals in this CP, the PRA has had regard to the regulatory principles as set out in FSMA. Two of the principles are of particular relevance:

- The principle that a burden or restriction which is imposed on a person, should be proportionate to the benefits that are expected to result from the imposition of that burden. The PRA considers it has followed this principle when developing the proposals outlined in this CP as the proposal is proportionate to the benefit of not having firms overstate their own funds.

- The principle that the PRA should exercise its functions in a way that recognises differences in the nature of, and objectives of, businesses carried on by different persons (such as mutuals). The following section sets out the way in which the PRA has followed this principle.

Impact on mutuals

3.9 Many insurance mutuals would need the passing of secondary legislation under the Mutual Deferred Shares Act 2015 to allow them to issue Tier 1 capital (including rT1). On 23 October 2018 HM Treasury published 'Government response to Mutual Deferred Shares: Consultation on Technical Policy Details'.[15] This explained that, having considered all the consultation responses the Government had decided not to lay those regulations.

3.10 That being the case, the number of insurance mutuals that might be impacted by the PRA proposals is small.

15 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/750563/MDS_response_document_FINAL_PDF.pdf

HM Treasury recommendation letter

3.11 HM Treasury has made recommendations to the PRC about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.[16]

3.12 The PRA considers that better outcomes for consumers is particularly relevant to this proposal since it will help to ensure that policyholders are afforded an appropriate degree of protection, and that firms do not overstate the amount of loss absorbing capital that they hold.

Equality and diversity

3.13 The PRA does not consider that the proposals give rise to equality and diversity implications.

16 Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at https://www.bankofengland.co.uk/about/people/prudential-regulation-committee.

Appendix: Draft amendments to Supervisory Statement 3/15 'Solvency II: the quality of capital instruments'

In this appendix deleted text is struck through and next text is underlined.

...

4 Principal loss-absorbency mechanism

...

4.8 For any external rT1 instrument which writes down on trigger, issued on or after 1 February 2019, the PRA expects the issuing firm to deduct an amount to reflect the maximum tax charge generated on write-down when calculating its own funds. Firms are expected to do this both when calculating solo own funds and, where relevant, group own funds of a SII group to which the issuer belongs.

4.9 That deduction should be calculated using the corporation tax rate applicable at the date the own funds is calculated. That being the case, the PRA expects that the deduction may change over the life of the instrument, if the relevant tax rate changes.

...