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Supervisory Statement | SS2/14

Solvency II: recognition of deferred tax

April 2014



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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1 Introduction

1.1 This supervisory statement is aimed at all insurance firms that will be subject to Solvency II (SII), whether life or general, standard formula or internal model. It sets out the Prudential Regulation Authority's (PRA's) expectations of firms in relation to the recognition of deferred tax in SII.

1.2 In particular this statement:

- highlights areas (in respect of both balance sheet recognition and the solvency capital requirement (SCR) calculation) to which a firm should pay particular attention when considering whether it can recognise a deferred tax asset (DTA) or the tax effects of a 1-in-200 shock; and
- explains what the PRA expects in relation to the credibility of profit projections. Unless otherwise stipulated, this relates to the SCR calculation.

1.3 While the SII Directive will not come into force until 1 January 2016, the PRA is publishing this statement now to enable firms to consider the PRA's expectations as part of their planning for SII implementation. This may be particularly important for firms that are developing or amending IT systems affected by deferred tax considerations, whether those developments concern internal models, accounting or other management applications. The PRA acknowledges that further directly applicable regulations or guidelines from the European Insurance and Occupational Pensions Authority (EIOPA) may, in due course, be issued in relation to the treatment of deferred tax under SII, and draws firms' attention to the fact that this statement may be subject to review at that time.

1.4 This statement expands on the PRA's general approach as set out in its insurance approach document.⁽¹⁾ By clearly and consistently explaining its expectations of firms in relation to the particular areas addressed, the PRA seeks to advance its statutory objectives of ensuring the safety and soundness of the firms it regulates, and contributing to securing an appropriate degree of protection for policyholders. The PRA has considered matters to which it is required to have regard, and it considers that this statement is compatible with the Regulatory Principles⁽²⁾ and relevant provisions of the Legislative and Regulatory Reform Act 2006.

1.5 This statement has been subject to public consultation⁽³⁾ and reflects the feedback that was received by the PRA.

2 Solvency II Directive requirements: the recognition of deferred tax assets and the tax effect of the stress scenario

2.1 Provided firms comply with the recognition criteria set out in relevant international accounting standards (particularly IAS 12),⁽⁴⁾ they can:

- recognise DTA on the SII balance sheet, thus increasing own funds; and
- reflect the tax effects of the 1-in-200 shock when calculating the SCR (known as the loss-absorbing capacity of deferred tax in the context of standard formula firms) thus lowering their SCR.

Either of these aspects may have a material impact on a firm's SII solvency position.

2.2 Under the UK tax regime a firm can recognise DTA in accordance with IAS 12 (for either balance sheet or SCR purposes) if it can:

- offset DTA arising from temporary timing differences against a deferred tax liability (DTL) arising from temporary timing differences, to the extent that the temporary difference related to the DTL is expected to reverse in the same period as the DTA, or in periods to which the tax loss can be carried back or forward; or
- develop forward projections to demonstrate that it will earn future taxable profits against which the DTA can be set in future.

2.3 The future taxable profits against which the DTA can be set in the future do not include profits on any insurance business already included within the relevant technical provisions, see paragraphs 2.4 and 2.5 below.

2.4 When supporting the utilisation of DTA on the SII balance sheet, the PRA expects that the relevant technical provisions will be the technical provisions on the SII balance sheet.

(1) www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1304.pdf.

(2) Section 3B of the Financial Services and Markets Act 2000 (FSMA).

(3) PRA CP3/14 — Solvency II: recognition of deferred tax, available at www.bankofengland.co.uk/pr/Pages/publications/policy/2014/solvency2deferredtaxcp-14.pdf.

(4) http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias12_en.pdf.

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2.5 When supporting the utilisation of the tax effects of stress, the relevant technical provisions will depend upon how the SCR is calculated:

- if the standard formula is used, the relevant technical provisions are again the technical provisions on the SII balance sheet; or
- if an internal model is used, the relevant technical provisions are those of the biting scenario.⁽¹⁾

2.6 As well as the means of recognition mentioned in paragraph 2.2 a firm can also recognise the tax effects of the 1-in-200 stress for the purposes of calculating its SCR if it can demonstrate that the tax loss created could be:

- set against tax due in the period of the stress; or
- carried back to reclaim tax paid in prior periods to the extent permitted by applicable tax regimes.

2.7 Given the restrictions on carry-back of loss in some applicable tax regimes, the timing and duration of the loss associated with the stress event may be important when firms calculating their SCR using an internal model consider utilisation. In such cases the biting scenario might not be instantaneous, and might extend for a period of time within or beyond the twelve-month period following the preparation of the SII balance sheet. Firms with internal models are expected to consider the extent to which the timing of the loss will influence their ability to use carry-back.

2.8 Judgement both by firms and supervisors will be required to decide whether future taxable profits are 'probable' in accordance with IAS 12 and can be used to justify recognition of relevant DTA.

2.9 Supervisory judgement will be based on knowledge of the firm and information, primarily related to business projections, provided by firms.

2.10 The determination of the SCR calculated by an internal model is likely to require firms to consider the extent to which the gross shock can be reduced by the tax effect, having regard to:

- the source of the loss;
- the ability to offset that type of tax; and
- the ability to utilise the tax effect if it can be offset.

This will be the case regardless of whether the firm uses a gross or net model.

3 Areas requiring particular attention

Inappropriate set-off

3.1 The PRA expects firms' calculation processes to be at a sufficient level of granularity to address the relevant detail of all applicable tax regimes, and to prevent inappropriate offsetting being used to support the recognition of DTA. Inappropriate offset would include, but is not restricted to, offset of different types of tax which is not permitted in the relevant tax regime.

3.2 When assumptions are made for the purposes of these calculations, the PRA expects firms to ensure that these assumptions are reasonable, and that any simplifications have been subject to a sufficient degree of testing.

Double counting of deferred tax liabilities

3.3 If firms have both DTA and DTL in the SII balance sheet, any DTL they wish to use to support utilisation of the tax effects of the SCR shock should not already be in use to support utilisation of the balance sheet DTA.

SII contract boundary assumptions

3.4 Different contract boundaries as between statutory accounting and SII may be a credible source of future taxable profits. If firms calculate this impact separately from projections of new business, they are reminded to take care to prevent double counting.

Risk margin

3.5 Article 77 of the SII Directive makes clear that the risk margin is an integral part of technical provisions and will need to be determined each time a firm calculates its solvency position.

3.6 The SII regime assumes that firms will continue in business after the shock, and as such, the risk margin is maintained from year to year. Any risk margin released on liabilities which run-off would usually be replaced with risk margin to be provided in respect of new liabilities. Where this is the case, it is not appropriate to include the amount of the current risk margin as an element of future taxable profits in a firm's projections.

3.7 Following the PRA's consultation some firms have asked whether the current risk margin could be permitted as a source of future taxable profits if an allowance for risk margin was made in projections of future new business profits. While this approach might address concerns about double counting, the issues concerning the replacement of risk margin set out in paragraph 3.6 would still be relevant. The approach may also

(1) The biting scenario is that which determines the SCR corresponding to the value at risk of the basic own funds subject to a confidence level of 99.5%.

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run the risk of introducing additional complexity into the projections of new business and future risk margin, as well as further interdependencies between assumptions. The PRA considers that such an approach is likely to provide less robust supporting evidence that future taxable profits are probable.

3.8 Different considerations might apply to firms which are completely closed to new business. These firms would be expected to have regard to the:

- time the firm has already been in run-off;
- nature of the firm's business and business model;
- availability of historical data regarding differences between actual and projected experience;
- likely period until run-off is complete; and
- credibility of the planning period of the firm.

Firms with unrecognised DTA in their statutory accounts

3.9 Own funds implications: the deferred tax effects of revaluing items from a statutory balance sheet basis to a SII balance sheet basis may result in the creation of some DTL. If this occurs, it might justify the recognition of some further DTA on the SII balance sheet.

3.10 SCR implications: the PRA does not expect a firm to reflect any tax effects of the shock in its SCR calculation if the notes to its statutory accounts disclose that:

- it has unrecognised tax losses; and
- those tax losses were not recognised because it was considered not probable that future profits would arise against which they might be utilised.

3.11 The PRA expects any rebuttal of this expectation to include a credible explanation as to why the firm's taxable profitability would improve to such a material extent after the stress scenario, or why losses generated in the stress scenario might otherwise be expected to be utilised, for example because they relate to a different type of tax or another jurisdiction.

4 Demonstrating the credibility of projected future taxable profits

Projection horizons (applies also to balance sheet recognition)

4.1 Neither IAS 12 nor SII stipulates a maximum time frame for forward projections. As with any projection, the further out the prediction, the less credible it is likely to become. The PRA expects that firms will consider and be able to support the credibility of timescales in their assessment of whether future profits are 'probable'. In particular, firms wishing to make projections beyond their medium-term planning horizon

would be expected to pay particular attention to their ability to do so with an appropriate degree of certainty.

Assumptions regarding the post-shock position and subsequent trends

4.2 Any projection of profit will require assumptions about the future. This is particularly difficult when projecting new business after a 1-in-200 shock. The PRA expects that a firm would consider assumptions regarding both the immediate effect of the stress and the way the market might subsequently develop. For example, the PRA expects a firm to pay particular attention to its assumptions both on new business volumes immediately after the stress and how the stress would influence subsequent growth patterns.

4.3 In projecting future profits, a firm may wish to reflect proposed management actions, including tax planning opportunities or changes in investment strategy. Where it does so, the PRA expects that the firm will be able to support the reasonableness of assumptions regarding management actions, including consideration of:

- the extent to which such actions would be consistent with the PRA's expectations of the firm;
- what constraints to management actions would arise from the fact that other firms in the sector would have been subject to the same shock, and would therefore be likely to consider similar changes; and
- how the firm expects to be able to comply with any policyholder commitments or regulatory requirements regarding the make-up of its investment portfolio following such management actions.

4.4 The PRA expects that firms will have identified the assumptions that are particularly critical to the projected outcome and hold evidence to support the reasonableness of each of these.

Income from surplus assets

4.5 While income from assets in excess of liabilities in the post-stress scenario may be capable of providing taxable profits, the PRA expects that firms' projections of income from such assets will reflect likely changes arising from the reduction in value to dividend levels, default rates of debt etc after the 1-in-200 shock.

Group relief

4.6 Firms may wish to assume that they can obtain value for the tax effects of the stress loss by selling tax losses to other group companies which have taxable profits. To be credible, such an assumption would be expected to take account of:

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- the impact of the shock on the taxable profits of each company within the group (not just those falling under SII);
- the combination of tax assumptions regarding each company within the group; and
- how sensitive the availability of taxable profits is to assumptions on the impact of the shock on non-SII-group members.

4.7 Before committing resources to such work, firms may find it useful to consider whether the results from such complex assumptions and inter-related calculations are likely to result in output of sufficient quality to justify the recognition of a tax effect. If the calculation is so complex that credibility is doubtful, then neither reflecting more inter-relationships nor increasing the volume of assumptions and data used in the modelling is likely to address the underlying concerns.