BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP3/14

Solvency II: recognition of deferred tax

February 2014

Prudential Regulation Authority
20 Moorgate
London EC2R 6DA

Prudential Regulation Authority, registered office: 8 Lothbury, London EC2R 7HH.
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1 Introduction

1.1 This consultation seeks views on a draft supervisory statement which sets out the Prudential Regulation Authority's (PRA) expectations of firms in relation to the recognition of:

- deferred tax assets on the Solvency II (SII) balance sheet; and
- the tax effects of the 1-in-200 shock loss on the solvency capital requirement calculation.

1.2 The supervisory statement is aimed at firms and groups ('firms') within the scope of SII, together with their advisors. It is equally relevant for life and general insurers, regardless of whether they plan to use the standard formula or will be applying to use an internal model.

1.3 The purpose of this statement is to:

- highlight areas 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
- explain the PRA's expectations in relation to evidence supporting the credibility of profit projections.

1.4 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 Solvency II, and draws firms' attention to the fact that this statement may be subject to review at that time.

1.5 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.

1.6 The PRA is also required to have regard to the need to minimise any adverse effect on competition in relevant markets. No adverse effects on competition have been identified in connection with this consultation.

1.7 In light of the imminent introduction of a statutory secondary competition objective for the PRA,(3) it has also assessed whether the content of this consultation facilitates effective competition in markets for services provided by PRA-authorised persons in carrying on regulated activities. This statement is designed to assist firms to prepare for the implementation of harmonised prudential capital standards under SII. The PRA therefore considers the content of this consultation as compatible with the facilitation of competition.

1.8 This draft supervisory statement is intended to apply to all firms within the scope of SII. This includes mutuals which, the PRA considers, are unlikely to be affected any differently from other firms.

1.9 The PRA has considered the equality and diversity aspects of the content of this consultation and is of the view that it does not give rise to equality and diversity implications.

1.10 The PRA welcomes views on the statement.

(1) www.bankofengland.co.uk/publications/Documents/praapproach/insuranceappr1304.pdf.
(2) Section 3B of the Financial Services and Markets Act 2000 (FSMA).
(3) In accordance with s.130 Financial Services (Banking Reform) Act 2013 which amends s.2H FSMA and which comes into effect from 1 March 2014, when discharging its general functions in a way that advances its objectives (see section 2F FSMA), the PRA must so far as is reasonably possible act in a way which, as a secondary objective, facilitates effective competition in the markets for services provided by PRA-authorised persons in carrying on regulated activities.

Draft supervisory statement on Solvency II: recognition of deferred tax

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 PRA's expectations of firms in relation to the recognition of deferred tax in SII. The PRA intends to ensure a consistent and clear communication of its expectations to enable firms and the PRA to make judgements which advance the PRA objectives.

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 stipulated, this relates to the SCR calculation.

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),[1] 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 timing differences against a deferred tax liability (DTL) arising from timing differences, to the extent that the timing 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 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 the twelve months prior to the loss scenario.

2.4 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 DTAs.

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

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 DTAs.

Double counting of deferred tax liabilities

3.2 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

3.3 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

3.4 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.

3.5 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.

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

3.6 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

3.7 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.

3.8 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.

3.9 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.

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 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

4.4 While income from surplus assets in the post-shock 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

4.5 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:

- 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.

4.6 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.