Policy Statement | PS4/19

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

February 2019

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback on responses to Consultation Paper (CP) 27/18 'Solvency II: Adjusting for the reduction of loss absorbency where own fund instruments are taxed on write down'.[1] It also contains the PRA's final policy on updating Supervisory Statement (SS) 3/15 'Solvency II: The quality of capital instruments', see Appendix 1.

1.2 The PRA has also issued a reporting clarification on how such adjustments should be reflected in the Solvency II reporting templates (Appendix 2).

1.3 This PS 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.

1.4 The rationale for the expectation was to address the prudential implications of tax changes introduced by HMRC in the Budget on Monday 29 October 2018 pertaining to hybrid instruments.

Summary of responses

1.5 The PRA received six responses to the CP. Respondents made a number of observations and requests for clarification which, together with the PRA's feedback, are set out in Chapter2.

Changes to draft policy

1.6 Following consideration of responses to the CP, the PRA has added additional material to SS3/15 to clarify points raised by respondents. This, and the content consulted on (originally to be added to Chapter 4), has been inserted as a new chapter 5. The original Chapter 5 (Instruments intended to count towards group own funds) has been renumbered as Chapter 6. The PRA does not consider these additions to the draft policy to be significant, or that the impact is significant, or significantly different, for mutuals. These revisions are aimed at providing readers with greater clarity on the:

- impact of the PRA policy on internal models; and
- treatment of instruments that would normally convert to equity, but may write down instead in some defined circumstances.

1.7 Further details on these changes are set out in Chapter 2.

1.8 In CP27/18 the PRA proposals related to items listed in Article 69 (a)(iii) and (b), and certain items approved under Article 79, of the Solvency II Regulation (the 'Solvency II Regulation').[2]

1.9 As a result of the clarification of details of the tax changes, the scope of this PS has changed compared to that of CP27/18; the PRA has now established that mutual member accounts are not impacted, so reference to Article 69(a)(iii) of the Solvency II Regulation has been removed from scope. This does not result in any adjustment being needed to the

1 October 2018, see page 2 of 2: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-adjusting-for-reduction-loss-absorbency-where-own-fund-instruments-taxed-on-write-down.

2 https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2015:012:TOC.

proposal consulted upon; the consultation proposal refers to restricted Tier 1 own funds (rT1) instruments, and mutual member accounts are not instruments.

Implementation

1.10 The new policy will come into effect for all instruments issued on or after Thursday 21 February 2019.

1.11 The policy contained in this PS has 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 changes arising once any new arrangements with the EU take effect.

2 Feedback on responses

2.1 The PRA must consider representations that are made to it in accordance with its duty to consult on its general policies and practice, and must publish in such manner as it thinks fit responses to the representations.[3]

2.2 The PRA received six responses to the CP, which addressed the following areas:

- the interplay of the proposal with tax, deferred tax, and the Solvency Capital Requirement (SCR) calculation;
- general impacts and costs that the proposal might have on the capital structure of insurance firms;
- European Commission proposals to address the loss of own funds on taxable write down, issued November 2018 following advice from the European Insurance and Occupational Pensions Authority (EIOPA);
- entities that cannot issue share capital due to their structure;
- treatment of instruments that would normally convert, but may write down instead in some defined circumstances; and
- future development of a resolution and recovery regime for insurers.

The interplay of the proposal with tax, deferred tax and the SCR calculation

Set-off against other losses

2.3 Three respondents asked the PRA to take into account the off-setting tax consequences if the write down of rT1 is caused by a loss making event. They said that credit should be given for this set-off when assessing the going concern loss absorbency of rT1 instruments.

2.4 The PRA agrees that there may well be partial or complete offset of the tax liability that arises on write down with other taxable losses that may have occurred. This scenario was covered in paragraph 2.3 of CP27/18, where credit for off-setting the taxable profit against deferred tax assets (DTA) already held, was explicitly contemplated.

2.5 Setting off the gain that arises on write down against tax losses will prevent those losses from offsetting other future profits. The potential future tax benefit of those losses could not

3 Sections 2L and 2N of FSMA.

then be recognised as a DTA on the Solvency II balance sheet. A reduction in DTA would most likely reduce the firm's own funds.

2.6 The CP also recognised that there are two situations where setting off the gain on write down against losses incurred would not result in a loss of own funds (paragraph 2.4 of CP27/18). In both cases there would be DTA which was not recognised as own funds. As noted in the CP, the situations outlined are uncommon and would not normally be possible to anticipate at the time the rT1 was issued.

Deferred tax liability on the Solvency II balance sheet

2.7 The PRA received informal inquiries, which were based on the assumption that the adjustment to the value of the own funds would be reflected as a DTL on the Solvency II balance sheet.

2.8 The adjustment proposed by CP27/18 will not create any changes to the Solvency II balance sheet, and as such, no DTL will arise. To help make this clear, the PRA is also issuing a reporting clarification (see Appendix 2) to provide guidance as to how the adjustment should be reported.

Impact for firms calculating their SCR using an internal model

2.9 The CP proposed that basic own funds are adjusted to reflect the tax charge on rT1 write down, so firms that calculate their SCR using an approved internal model should not capture this loss of own funds in their modelling, as otherwise it would be double counted.

2.10 The PRA has updated SS3/15 to reflect this expectation.

Tax rate used to calculate the adjustment

2.11 One respondent noted that CP27/18 proposed that the tax rate at the point at which own funds were calculated should be used to calculate the adjustment to reflect loss of own funds as a result of tax. They said that this may overstate the tax effects since tax rates may be lower at the point of trigger.

2.12 The PRA recognises that the tax rate at the point of trigger might be either higher or lower than that applicable at the date the adjustment is calculated. So, the amount of the instrument ultimately available to absorb losses could be either greater or less than the recognised amount. However, even if tax rates had been formally announced for some years into the future, it would not be possible to select a more appropriate rate unless the point at which the rT1 instrument will write down could be accurately predicted. The PRA considers that such predictions would introduce spurious accuracy. It therefore confirms that it expects the tax rate at the point that own funds are calculated to be used to determine the adjustment.

General impacts and costs on the capital structure of insurance firms

2.13 Several respondents asked whether the PRA had considered the adverse impacts that the new provisions might have on insurance capital markets. In particular, they mentioned that:

- firms may prefer to issue rT1 that writes down to avoid diluting equity interests; but
- the fiscal changes meant that it was more expensive to obtain a set amount of going concern loss absorbency by issuance of write down rT1 instruments than it was by issuing rT1 instruments which convert into equity.

2.14 Respondents also noted that these extra costs would fall particularly upon firms which are unable to issue ordinary shares, particularly companies limited by guarantee and other mutuals. They asked whether the PRA had considered this when performing the cost benefit analysis on the proposal.

2.15 The PRA agrees that the tax changes will make rT1 that writes down more expensive than that which converts, because the loss absorbing capacity of the rT1 instrument is reduced by the tax effect on write down. Therefore it offers proportionately less loss absorbency than rT1 that converts on trigger. This change and any wider market impacts associated with it are the direct result of fiscal changes. It is the situation that will exist once the tax changes come into effect, and that firms will need to take into consideration when deciding their future capital issuance strategy.

2.16 Given the fiscal changes and resulting economic effects, the PRA needed to consider whether it would:

- expect firms to recognise this new reality when calculating their own funds; or
- have a scenario where firms continue to recognise such instruments for an amount greater than their loss absorbing capacity, when calculating own funds.

In the PRA's view, the former contributes to advancing the PRA's primary objectives of policyholder protection, and safety and soundness, whereas the latter option would overstate the prudential strength of firms that issue write-down rT1 instruments.

European Commission proposals to address the loss of own funds

2.17 Three respondents noted that the proposed treatment appeared to be applied more widely than the European Commission's current proposal, consulted on in November 2018, for addressing the issue of loss of own funds due to tax at the point of trigger.[4]

2.18 The European Commission's proposal would, provided that the contractual terms of the instrument allowed for it, permit regulatory authorities, on an exceptional basis, to waive the rT1 write-down on trigger, and thus avoid a reduction of own funds which would otherwise arise if:

- in the absence of the waiver it were likely that the firm would need to pay tax as a result of the write down and that this would have a significant adverse effect on its solvency position;
- the 75% SCR trigger has not been breached; and
- the Minimum Capital Requirement (MCR) had not been breached.

Loss of own funds when tax is not payable

2.19 The advice provided by EIOPA upon which the European Commission proposal follows, considers only the situation where tax is payable by the issuer on write down. As explained in CP27/18, own funds losses can occur on trigger via a reduction in DTA even if tax is not payable. The Commission proposal does not address loss of own funds in this situation. By applying an adjustment at the point of issuance, the PRA proposal ensures avoidance of losses

4 https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-5720906_en.

of basic own funds due to tax effects when the principal loss-absorbing mechanism is triggered.

Loss of own funds when the 75% SCR or MCR trigger has been breached but the issuer is still paying tax

2.20 The European Commission's proposal to permit a waiver does not extend to such cases, so provides no mitigation for losses of own funds due to tax effects in this situation. In contrast the proposal in CP27/18, which has been adopted in the final policy, provides such a mitigant: by applying an adjustment at the point of issuance the PRA's proposal again ensures that losses of basic own funds due to tax effects when the principal loss-absorbing mechanism is triggered are avoided.

Partial write down of rT1

2.21 One respondent noted that the European Commission's consultation proposed that rT1 instruments might be permitted partial write down in cases where the three month SCR trigger had been breached but neither the 75% SCR trigger nor the MCR trigger are breached.

2.22 The PRA notes this, and the fact that the European Commission's proposal suggests the SCR coverage be revisited every three months and further partial write downs undertaken if the solvency position of the undertaking had deteriorated. This would continue until either SCR coverage was restored or the solvency position deteriorated such that either the 75% SCR trigger or the MCR trigger was breached. At that point the rT1 instrument would write down in full.

2.23 The PRA accepts that, if the European Commission ultimately decides to adopt this change, the tax liability (and loss of own funds) generated at the first point of write down would be less than the principal amount multiplied by the prevailing tax rate. If for example the instrument were written down to 80% of face value, the tax liability arising at the point of write down would only relate to the 20% written down. Following the partial write down, the tax adjustment for the purposes of the own funds calculation would be reduced to reflect the residual value of the instrument (in this case 80% of the adjustment prior to partial write down).

2.24 Since the proposal in CP27/18 already fully catered for the scenario of partial write down, the PRA does not consider this matter to be relevant to its policy proposal.

Entities that cannot issue share capital due to their structure

2.25 Three respondents observed that entities that cannot issue share capital because of their legal form would be particularly impacted by the proposal, since they could not choose to issue rT1 that converts, as an alternative to rT1 that writes down. The PRA agrees that this is a logical conclusion to draw from the tax changes introduced in the Budget.

2.26 One respondent expanded on this, and asked whether this inability to issue ordinary shares was sufficient to exempt such entities from the proposed adjustment because they were not able to issue rT1 instruments that convert on trigger.

2.27 The PRA recognises that companies limited by guarantee, friendly societies, and those with other types of mutual structure cannot issue ordinary share capital and therefore the only type of rT1 instruments they can issue are those which write down on trigger and give rise to a taxable gain. However, that means that (except in the very limited circumstances set out in paragraph 2.4 of CP27/18) the proposed tax changes will always cause a loss of own funds on

rT1 write down; the face value of such an rT1 instrument will always be greater than the going concern loss absorbency that it actually provides.

2.28 The PRA considers that it does not advance its primary objectives of safety and soundness and policyholder protection to permit such entities to overstate their prudential strength by recognising as regulatory capital amounts which do not in fact provide any prudential benefit or policyholder protection. Further, as noted in paragraph 3.10 of CP27/18, the number of mutuals affected by the PRA's proposal is very small. That being the case, the PRA has not changed its proposal in the light of this feedback.

Treatment of instruments that would normally convert, but may write down instead in some defined circumstances

2.29 One respondent pointed out that certain rT1 instruments have been issued with features requiring that they convert on trigger, but with provisions that they would revert to write down in the event of a takeover after issuance. The respondent asked for clarification as regards the PRA's expectations regarding any further issuance of instruments with similar terms.

2.30 The PRA considers that having such a term is a sensible provision to 'future proof' rT1 instruments that convert on trigger. It would not expect firms that have issued (or that issue in future) such instruments to adjust the amount of rT1 recognised as basic own funds, unless there is a reasonable possibility that the change to write down on trigger will occur in the foreseeable future. If a firm has an rT1 instrument in issuance which converts on trigger, but it is reasonably possible that the terms of the instrument will change to write down in the foreseeable future, it should discuss the matter with the relevant supervisory team and include the possibility and the tax consequences in its capital management planning.

2.31 If the principal loss absorbency mechanism of such an rT1 instrument were to change so that the instrument wrote down on trigger, then the PRA would expect the issuer to recognise that the instrument provided less regulatory capital at least from that point onward and apply the adjustment.

2.32 The PRA would not expect the firm to restate its regulatory returns pertaining to periods before the change in rT1 instrument's principal loss absorbency mechanism.

2.33 The PRA has updated SS3/15 to reflect the expectation in paragraph 2.31.

Future changes to the tax treatment of rT1 instruments

2.34 One respondent suggested that the future development of a resolution and recovery regime for insurers could result in a change in tax treatment for rT1 instruments as they might be exempt tax by virtue of Condition D under section 322 of the Corporation Taxes Act 2009.

2.35 If Condition D of section 322 of the Corporation Taxes Act 2009 were to become applicable to some or all rT1 instruments that write down on trigger, then it may be that the tax effect of write down for such instruments would no longer apply. The PRA will review current policy in the light of any such development.

Appendix

1	**SS3/15 'Solvency II: The quality of capital instruments', available at: https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-the-quality-of-capital-instruments-ss**
2	**'Reporting the reduction in loss-absorbing capacity of own fund instruments that are taxed on write down' available at https://www.bankofengland.co.uk/prudential-regulation/regulatory-reporting/regulatory-reporting-insurance-sector**