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Supervisory Statement | SS2/14

Solvency II: recognition of deferred tax

November 2016

(Updating February 2015)

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PRUDENTIAL REGULATION AUTHORITY

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1 Introduction

1.1 This supervisory statement[1] is addressed to all UK firms that fall within the scope of the Solvency II Directive ('the Directive'),[2] and to Lloyd's. It sets out the Prudential Regulation Authority's (PRA's) expectations of firms in relation to the recognition of deferred tax under Solvency II.

1.2 This statement should be read in conjunction with the PRA's rules in the Solvency II Sector of the PRA Rulebook, and the PRA's insurance approach document.[3]

1.3 This supervisory statement expands on the PRA's general approach as set out in its insurance approach document. 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.

1.4 The three key principles for firms addressed by this statement, whether life or general, standard formula or internal model, can be summarised as:

(i) projections and assumptions should be credible;

(ii) there should be no double counting of future tax payable; and

(iii) any set-off should be appropriate, for example as regards the type of tax and jurisdiction.

1.5 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 deferred tax assets (DTA) or the tax effects of a 1-in-200 shock; and

- sets out the PRA's expectations in relation to the credibility of profit projections. Unless otherwise stipulated, these relate to the SCR calculation.

1.6 The expectations set out in this supervisory statement apply equally to firms using the standard formula or an internal model to calculate their SCR, except in regard to the ability to apply group relief where the expectations are different depending on the means of calculation.

2 Requirements for 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 International Accounting Standard (IAS) 12),[4] they can:

- recognise DTA on the Solvency II balance sheet, thus increasing own funds; and

1 On 21 November 2016, this SS was updated – see appendix for full details.
2 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast).
3 Available at www.bankofengland.co.uk/publications/Pages/other/pra/supervisoryapproach.aspx.
4 http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias12_en.pdf.

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- 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 Solvency II 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.

Relevant technical provisions

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

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 Solvency II balance sheet; or

- if an internal model is used, the relevant technical provisions are those of the biting scenario.[1]

Further means of recognition for SCR calculations

2.6 As well as the means of recognition mentioned above, 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 Solvency II balance sheet. Firms with internal

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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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models are expected to consider the extent to which the timing of the loss will influence their ability to use carry-back.

IAS 12 'more likely than not' recognition test

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. The IAS 12 'more likely than not' recognition test applicable to the statutory balance sheet applies equally to the Solvency II balance sheet and the 1-in-200 shock scenario. However the PRA expects that the evidential requirement to demonstrate what is 'more likely than not' would differ depending upon the degree of uncertainty associated with the balance sheet and the shock scenario respectively.

2.9 The PRA expects the evidence required to support 'more likely than not' in relation to the Solvency II balance sheet to be similar to that for the statutory balance sheet. However, it expects the increased uncertainty associated with the 1-in-200 shock scenario will mean that more evidence would be needed.

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;
- ability to offset that type of tax; and
- 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.

2.11 To meet the recognition test, the PRA expects that the capital resources needed to support the assumed level of trading in the post-shock environment will be consistent with a firm's own risk and solvency assessment (ORSA). Further, the PRA expects the assumptions and projections supporting availability and timing of any capital replenishment in the post-shock environment to be credible. This will give the PRA confidence in accepting the expert judgements taken by the firm.

2.12 The PRA expects the same standard of documentation to support the tax effects of the shock, regardless of whether the SCR is calculated using an internal model or the standard formula. The PRA expects an internal model to be capable of calculating the tax effect of the shock across the whole probability distribution, but would not expect that calculation necessarily to be undertaken across the whole population as a matter of course: any pre-tax loss data points which are sufficiently far from the pre-tax biting scenario that they could not provide the post-tax biting scenario will be of less interest. However, where a firm does not calculate the tax effects across the whole population, the PRA expects the firm to document how it identifies which data points are relevant and which are not included.

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 offsetting would

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include, but is not restricted to, the offset of different types of tax which are 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 Solvency II 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.

Solvency II contract boundary assumptions

3.4 Differences in contract boundaries between statutory accounting and Solvency II may be a credible source of future taxable profits. However, double counting would occur if firms were to recognise taxable profit arising from differences in contract boundaries, and include the same taxable profits within projections of taxable profits arising from new business. If firms calculate this impact separately from projections of new business, they are reminded to take care to prevent double counting. The PRA expects that the need to ensure consistency of assumptions for the two figures will be particularly acute if they are not being calculated by the same person or team.

Risk margin

3.5 Technical Provisions 2 to 4 of the PRA Rulebook make it 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 Solvency II 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 a PRA consultation some firms 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.

3.8 The PRA expects that including the current risk margin as a source of future taxable profit would create double counting of the risk margin on business already written, as illustrated by the example in Box 1 below.

Box 1: Example of double counting

Consider a Solvency II balance sheet before setting up a risk margin (ie liabilities valued on a best estimate basis). For simplicity, assume that this balance sheet has a net DTL.

When a risk margin is added to the best estimate, so as to obtain the Solvency II compliant technical provisions on the Solvency II balance sheet, the associated deferred tax effect would also be recognised: DTA would be created that would reduce the net DTL position.

As the risk margin reduces over time so too would the related DTA, increasing the net DTL position as the Solvency II balance sheet and tax base converge. This DTL is a way to demonstrate probable utilisation of potential loss absorbing capacity of deferred tax (LACDT).

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Over time it would therefore be double counting to recognise as a source of utilisation both the DTL increase that occurs as the risk margin unwinds and the unwinding of the risk margin.

3.9 The PRA does not expect that the inclusion of an allowance for risk margin in projections of future new business profits would be an effective mitigant to this. Since the expected tax payable on future new business is not calculated based on amounts valued using Solvency II valuation principles, the inclusion or not of a risk margin in the projections has no impact on the expected tax payable on such business.

3.10 While different considerations might apply to firms which are completely closed to new business, the PRA still expects firms to be able to demonstrate how such double counting could be avoided. These firms would also be expected to have regard to the:

- time the firm has 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

3.11 The deferred tax effects of revaluing items from a statutory balance sheet basis to a Solvency II 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 Solvency II balance sheet.

3.12 The PRA does not expect a firm to reflect any tax effects of the 1-in-200 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 them which might be utilised.

3.13 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 Solvency II 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 firms to 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.

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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.

4.3A The PRA expects firms to consider carefully the use of generalised assumptions that some asset classes will earn above the risk-free rate of return after the SCR stress either as a result of an assumed market recovery ('mean reversion') or the emergence of risk premiums. The inherent complexity and significant judgements required in modelling such returns post-stress pose significant challenges to firms demonstrating the credibility of that assumption.

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.

Projection methodology

4.5 In order to support likely utilisation of LACDT from expected tax on new business, firms would need to project new business and the resulting tax payments. As these tax payments are calculated based on the accounting data, and the stress is calculated based on a Solvency II balance sheet, two means of calculating that tax appear possible:

- firms could develop future projections based on future Solvency II positions. These projections would then need to be adjusted to reflect the tax base positions in order to calculate the tax implications of those projections; and
- firms could develop future projections based on the statutory base. While this approach would likely give rise to simpler tax calculations, it would necessitate the preparation of a post-shock statutory balance sheet as a starting point, when projecting forward beyond the 1-in-200 event.

4.6 As both approaches should result in the same tax figures being projected, either approach, or both with reconciliation of any differences, would appear to be reasonable. The PRA has no expectation that one method should be used in preference to the other.

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Income from surplus assets

4.7 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

4.8 The PRA expects firms applying the standard formula to comply with Guideline 9 of EIOPA's 'Guidelines on the loss-absorbing capacity of technical provisions and deferred tax'.[1] This makes clear that firms using the standard formula to calculate their SCR should only recognise the payment or benefit receivable to the extent that the deferred tax adjustment could be recognised (under Guideline 10) by the firm if not transferred.

4.9 Firms using an internal model to calculate the SCR 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 Solvency II);
- 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-Solvency II group members.

4.10 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 any underlying concerns.

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1 https://eiopa.europa.eu/publications/eiopa-guidelines/guidelines-on-the-loss-absorbing-capacity-of-technical-provisions-and-deferred-taxes.

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Appendix – SS2/14 updates

SS2/14[1] was originally published following CP3/14, 'Solvency II: recognition of deferred tax'.[2]

This appendix details the changes that were made to this supervisory statement (SS) following its initial publication.

21 November 2016

Following CP20/16,[3] SS4/14 was further updated to include information contained in the PRA Directors' letter of 13 March 2015.

To include the PRA's expectations as expressed in this letter and to make other minor drafting changes (which do not change the PRA's expectations), the following amendments were made:

- paragraph 1.1: sets out the firms to which this statement is addressed. The rest of the information previously included in this paragraph is now contained in paragraph 1.4;
- paragraph 1.2: provides information on the legislation and other documents that should be considered in conjunction with the information contained in this statement;
- paragraph 1.3: sets out the general purpose of this type of statement and how this enables the PRA to meet its statutory objectives. Text in the previous paragraph 1.3, which related to the pre-Solvency II environment, is no longer relevant and has been deleted;
- paragraph 1.4: sets out the information previously included in paragraph 1.1 regarding the three key principles of this statement;
- paragraph 1.5: emphasises the areas and PRA expectations within the key messages that firms should note;
- paragraph 1.6: provides a new paragraph which clarifies that the expectations in this supervisory statement apply equally to standard formula or internal model firms, except in regard to the ability to apply group relief. The text in the previous paragraph 1.6 has been updated with the text in the new paragraph 1.3, and so has been deleted;
- paragraph 2.11: has been added and covers the PRA's expectations of firms with regard to their capital resources in a post-shock environment (Directors' letter dated 13 March 2015);
- paragraph 2.12: has been added and sets out the expectation that where a firm calculates its Solvency Capital Requirements (SCR) using an internal model, and does not routinely calculate the tax effect of the shock loss across the whole probability distribution, it will document clearly how it identifies which data points to exclude (Directors' letter dated 13 March 2015);

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1 'Solvency II: recognition of deferred tax', April 2014; www.bankofengland.co.uk/pra/Pages/publications/solvency2recognitionss.aspx.
2 February 2014; www.bankofengland.co.uk/pra/Pages/publications/solvency2recognitioncon.aspx.
3 'Solvency II: consolidation of Directors' letters', May 2016; www.bankofengland.co.uk/pra/Pages/publications/cp/2016/cp2016.aspx.

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- paragraph 3.8: has updated wording to clarify that the "margin" that would lead to double counting if included as a source of taxable profit, is "the risk margin";
- paragraph 4.3A: sets out the importance of demonstrating the credibility of assumptions for asset returns after the SCR stress (Directors' letter dated 13 March 2015); and
- throughout the document: references to the Directive have been updated with references to the PRA Rulebook, where appropriate.

2015

On 20 February 2015 SS2/14 was updated to:

- reflect the subsequent publication in November 2014 of EIOPA guidelines on loss absorbing capacity of deferred tax; and
- respond to feedback received after publication of SS2/14 requesting more detail regarding the rationale behind PRA expectations set out in SS2/14.

As a result of this first update, the 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.

This update did not change the PRA's expectation of firms set out in the original statement.

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