LAC DT in Solvency II – progress report from the work

Lauri Saraste / AAE annual meeting on 20-21th September 2017, Copenhagen

The background

- In solvency II framework the loss absorbing capacity of deferred taxes is allowed to take into account in the calculation.
- According to EIOPA's SCR review first set consultation this '*is the phenomenon that undertakings are able to transfer a part of a shock loss to their tax authority and that the impact of the loss on own funds is therefore lower than the original gross loss itself '*.
- As every EU member state has its own specialties in their taxation framework and also as the LAC DT has been interpreted in quite various ways by different FSA's and insurance companies there seems to be a unawareness amongst insurers of the different features and principles of LAC DT.
- This draft paper tries to point out some of the issues considering LAC DT mainly just from actuarial point of view, leaving out the more member country or company specific issues.

The background

- AAE cross-sectoral working group accompanied with few IC members (Tony, Ana & Kirsten) drafted a short paper trying to to point out some of the issues considering LAC DT mainly just from actuarial point of view, leaving out the more member country or company specific issues.
- This draft paper and its main topics were used when AAE gave comments in end August to the first set of the SCR review to EIOPA → the idea was to bring some principles based thinking into the discussion which seemed to be still quite vague as there's a lot of views across insurers and regions
- The aim is to further the draft to be better prepared to have the discussion towards EIOPA and other stakeholders

Level playing field:

- **As every EU member state has its own specialties in their taxation framework and also as the LAC-DT has been interpreted in quite various ways by different FSA's and insurance companies there seems to be a unawareness amongst insurers of the different features and principles of LAC DT. And this brings the need of the better clarification on the level playing field. We find several reasons for the current situation which could be investigated more:**
  - Due to seemingly different member country interests; there is a large variety of tax rules in EU, different levels of corporate tax, different tax rules for P&L etc.
  - There is different (more or less) pressure from certain jurisdictions to prove management actions that may lead to future profits in the shocked situation. Also there is a lot of subjectivity as to which management actions are applicable
  - Depending whether a country or company is in a DTA position or DTL position seems to matter a lot
  - Having adequate DTL for maximum LAC DT tends to lead to less pressure on LAC DT from future profits (relatively obvious), and only required to show the SII ratio will be back above 100% within 3 to 6 months and recoverability of loss can be shown. Not for LAC DT level as such;
  - Different loss carry forward rules (some countries have only 5 future years they can take into account, others have indefinite years they can take into account)
  - Also the term "level playing field" itself might need to be opened to better understand the issue. When Solvency II is a post-tax system and local tax rules have to be applied as they are under IFRS. As this holds true for the valuation (i.e. own funds) as well as for the stressed case (LAC DT), there will be different starting positions for companies, which might or might nort be an level playing field issue. Furthermore being a post-tax supervision framework means that all fiscal differences must be fairly reflected which is quite a burden. It may create a welcome stimulus to align tax differences, but this would not be the appropriate way to do that. An alternative approach would be to implement taxes in SII using 'minimal tax assumptions'. If insurers are solvent pre-tax, they should also be solvent post-tax.
  - There is a broad consensus that LAC DT up to the amount of net DTL (t=0) is acceptable (as long as netting DTL and DTA is admissible of course)
  - What are (if any) the potential sources of future profits to support DTA (essentially the same in base case as in stressed case)

Complexity

- The open questions relating to LAC DT keep this issue complex. In the future work and analysis EIOPA should aim at a clarification of the principles behind LAC DT, taking into consideration the unchangeable national frame conditions. A harmonization of the calculation could help to reduce the complexity and take away uncertainty. Complexity is a serious cost-issue, requiring significant key resources, for both regulators and insurers.

The underlying causes of the LAC DT:

- The underlying causes of the LAC DT and their subsequent allocation towards the stressed balance sheet results in additional differences between the fiscal valuation and the economic valuation. This change in netDTA can be caused by :
- temporary differences which will recycle back as long as the balance sheet exposure is maintained on the Economic Balance Sheet,
- actual losses due to effect of the underlying scenarios (for example defaults or lapses) and
- results which are mandatory recognised into the period in which they materialise.
- The various causes will require a different approach in the recoverability assessment based on the going concern assumption. Whether an insurer recognised all three causes depends on the actual fiscal legislation and treatment of changes in valuation, which differ per Member State.

Use common language:

- EIOPA have already started their work by opening up many of the different features. Anyway any misleading approaches to describe the phenomenon need to be corrected. Thiswould also help stakeholders to be better placed to discuss and understand the issues around LAC DT:
- It could be avoided to use “LAC DT from future profits” as also LAC DT supported only by DTL is supported by future profits, but essentially future profits existing in the SII metric already at t=0. The crucial point with DTA is, that one has to prove that it is probable that future taxable profit will be available against which the deferred tax asset can be utilized. It could rather write as “LAC DT from DTA” (or something similar).
- Losses. As LAC DT is not about the tax authority physically transferring money to the insurer, it seems fairer to describe these losses as opportunity losses. They are relative ‘losses’, compared to a fictive ‘gross shock’ situation in which the insurer would pay more taxes.

Technicalities behind the calculation of future profits:

- Already highlighted by EIOPA but should be recognized : The overall principles behind the valuation of future profits and also the rationale when, how and in which circumstances this calculation should be explained in insurers solvency report.