Loss Absorbing Capacity of Deferred Tax in Ireland

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Introduction

The loss absorbing capacity of deferred tax ("**LACDT**") is one of the key elements of a company's Solvency Capital Requirement ("**SCR**"). It is also, potentially, one of the more complex components of the SCR, with the European Commission stating: "*The calculation for reduction in capital requirements due to a deferred tax adjustment is complex, and requires a high level of supervisory judgement, resulting in possibly divergent practices in Member States.*[1]"

LACDT allows companies to reflect that a future loss in profits may also result in a reduction in associated tax liabilities, thus reducing the impact on companies' own funds. Therefore, it can help to reduce capital requirements.

We have carried out an analysis of LACDT in the Irish (re)insurance market at year-end 2016 in order to understand the extent to which LACDT is used and to compare and contrast it with other EU countries. The analysis was based on 50 (re)insurance companies, giving coverage of 72% of the Irish (re)insurance market, as measured using total SCR.

We would note that LACDT is an area of potentially immense complexity, impacted by taxation of branches, tax groups, historic changes to taxation (for example, domestic life insurance taxation changed from an Income minus Expenditure approach to Gross Roll-up in 2001 but the relevant companies still have business taxed under the old structure) and practical challenges in modelling. Therefore, it is impossible to make definitive statements about individual companies without very detailed analysis of the individual situation. LACDT is also very dependent upon the company's opening tax position, that is whether there is a net[2] deferred tax asset ("**DTA**") or deferred tax liability ("**DTL**") on the opening balance sheet.

Aggregate Position

The following table summarises the DTA, DTL, LACDT, own funds and SCR figures for the companies included in our analysis:

Item	€million	% of SCR
LACDT	1,472	10%
Own Funds	25,949	169%
SCR	15,367	100%
DTL	1,503	10%
DTA	154	1%

It is noteworthy that the amount of LACDT is very similar in scale to the net DTL position, indicating that the Irish industry does not have a very large dependency upon other sources to justify the LACDT. The scale of the LACDT expressed as a percentage of the SCR, 10% in the above table, can also be compared to the Irish corporation tax rate of 12.5%[3]. If the Irish industry was able to gain the maximum potential benefit from LACDT then we would expect to see this ratio equal to 12.5%.

The aggregate industry position somewhat obscures the position of the individual companies. We have therefore subdivided the industry into a number of groupings:

1) LACDT less than Net DTL
2) LACDT exceeds Net DTL
3) LACDT equal to Net DTL

LACDT less than Net DTL

If the LACDT is less than the Net DTL then it is possible that the company can support the LACDT with the tax liability that sits on the opening balance sheet, on the basis that if the SCR loss were to occur then future tax payments would be reduced. This assumption is not always accurate as companies can have liabilities that arise in different countries or different entities, meaning that it is not always possible to offset one tax loss against an existing tax liability.

There were 15 companies in this position and the following table summarises the statistics for this group:

[1] EIOPA's first set of advice to the European Commission on specific items in the Solvency II Delegated Regulation - consultation paper
[2] It is possible for a company to have both a DTL and a DTA on the opening balance sheet, so it is necessary to examine the net position.
[3] It is also important to bear in mind that some companies have branches in other countries and that profits from the branches will be taxed in those other countries, so that the aggregate tax rate for the company might be different to 12.5%.

Item	€million	% of SCR
LACDT	645	13%
Own Funds	9,969	198%
SCR	5,034	100%
DTL	879	17%
DTA	6	0%

Many of the companies in this grouping appear to be receiving the maximum potential benefit of the LACDT. Maximum potential benefit can be estimated by applying the relevant tax rate to the sum of the Basic SCR plus operational risk capital, noting again that the relevant tax rate is not always the Irish rate.

Some companies in this grouping don't appear to be receiving the maximum potential benefit of the LACDT and appear to have limited the extent of benefit claimed, presumably because of some of the reasons mentioned above.

LACDT exceeds Net DTL

If a company has a LACDT in excess of the Net DTL then it must be able to justify that tax liabilities will arise from other sources and that those tax liabilities are probable. Normally the most significant source of future tax liabilities is the tax liability arising from writing profitable new business. Other potential sources include: reclaiming past tax payments where possible[4], investment income on surplus assets or group relief.[5] Contract boundaries can also have a significant impact because if a company has a short contract boundary then this results in renewals being classed as new business and there might be relatively little uncertainty attaching to the renewal. Therefore, there can be significant future profitability associated with the business that is outside of the contract boundary, and not reflected on the Solvency II balance sheet (other than where it contributes to LACDT).

There were 20 companies in this position and the following table summarises the statistics for this group:

Item	€million	% of SCR
LACDT	675	9%
Own Funds	11,466	148%
SCR	7,740	100%
DTL	471	6%
DTA	147	2%

The LACDT exceeds the net DTL by €351 million[6], so this is the minimum amount of aggregate tax liability arising from the other sources. The aggregate LACDT for this group equals 9% of SCR, which is below the Irish corporation tax rate of 12.5%, so that the group in aggregate is not receiving the maximum potential benefit from LACDT.

Seven of the companies in this grouping appear to be receiving the maximum potential benefit but 13 don't appear to be receiving the maximum level. Therefore, it would appear that many companies are applying some limit on the extent of profits arising from other sources, possibly because they are not in a position to justify these other sources of profits.

LACDT equals Net DTL

The final group includes those companies where the LACDT equals the Net DTL. There were 15 companies in this position and the following table summarises the statistics for this group:

Item	€million	% of SCR
LACDT	152	6%
Own Funds	4,515	174%
SCR	2,593	100%
DTL	152	6%
DTA	0	0%

[4] Possible in Ireland, UK and the Netherlands.
[5] This is not a definitive list of potential recovery sources.

[6] This figure is derived on an individual company basis and can't be calculated with aggregate figures.

The LACDT for this group is only equal to 6% of the SCR, indicating that the group is receiving less than half the maximum potential benefit of the LACDT. It would appear that this group of companies has decided that it cannot justify loss absorbing capacity from sources other than the net DTL and have therefore chosen not to include any additional benefit in relation to LACDT. Some of the companies in this group are closed to new business and will not write any future new business, some are coming from a recent history of losses, while others will have other specific reasons for this decision. It is also possible that some of the companies in this group could potentially justify some additional LACDT but might have decided to limit the benefit claimed because of the extent of work required to justify the future tax liability or the complexity in modelling or other reasons.

LACDT in Europe

EIOPA released a consultation paper on July 4th, 2017 on a number of items, including an analysis of LACDT. The paper includes an analysis of the total amount of LACDT as a percentage of the bSCR* (defined by EIOPA as basic SCR plus operational risk and the loss absorbing capacity of technical provisions) throughout the EEA.

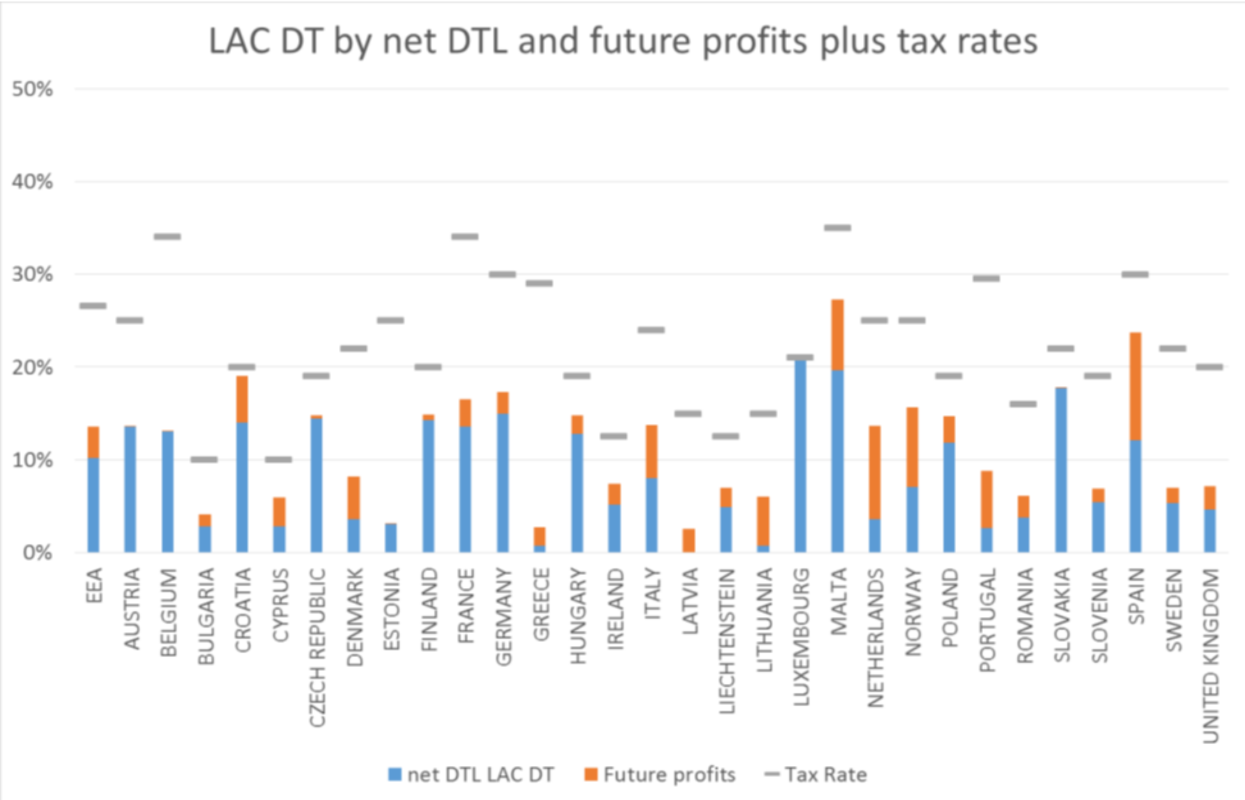
In the chart below EIOPA has split the LACDT between the part attributable to the loss absorbency from Net DTL (the blue bars), and the remaining part consisting of the recovery of tax from some other source, including future new business (the orange bars).

This analysis mostly shows the extent of reliance on future profits to justify the LACDT. A number of countries have a significant reliance on future profits, including those in countries such as Spain, the Netherlands, Malta and Norway, as is indicated by the orange bars in the chart.

It also shows the absolute rate of LACDT in different countries (blue plus orange bars), with significant variation from country to country. Malta has the highest level of LACDT but it also has one of the highest tax rates. It is important to note that the comparison to the local tax rate does not give the full picture because of the possibility of tax on local branches as discussed previously.

In contrast, some countries don't appear to have any significant reliance on future profits, including those in Austria, Belgium and Luxembourg. The Luxembourg insurance industry is able to achieve full LACDT without having to include any reliance on future profits, whereas most countries have a significant gap between the extent of LACDT and the applicable tax rate. Luxembourg appears to be the only country that achieves full LACDT recovery, but those in some other countries such as Croatia are close to full LACDT.

Ireland appears to have a relatively low reliance on future profits to justify the LACDT, and also to have a relatively low LACDT rate. This is consistent with the analysis we have undertaken on a subset of the Irish industry, which also provides a similar picture.



Conclusion

The Irish insurance industry in aggregate doesn't appear to be relying heavily upon sources other than the net DTL to justify the LACDT, with some countries making much greater use of other sources. The EIOPA consultation note acknowledges that National Supervisory Authorities have different approaches in relation to the portion of LACDT that is not justified by the net DTL position or by reclaiming past payments. It is also important to acknowledge taxation differences in different countries, as an important source of difference, as is the different types of business written in different countries.

When we look at the Irish (re)insurance industry in detail we see three groupings; those companies who can mostly rely on the existing net DTL to justify the maximum potential LACDT, those who use additional sources to justify LACDT to some extent and those who have limited the LACDT to the extent of the net DTL position.

The second group of companies that are relying on other sources only contains a small number of companies where the LACDT is substantially in excess of the net DTL position. Therefore, it would appear that there aren't many companies in the Irish industry heavily relying upon sources other than the net DTL position to justify the use of LACDT.

Modelling future tax payments is a complex issue requiring consideration of a number of factors, especially in the context of the extreme scenarios considered when calculating SCR. It would appear that some companies could potentially gain additional capital efficiency by undertaking some work to justify greater use of LACDT.

How Milliman can help

Our consultants have been involved in advising our clients on Solvency II issues since its conception. We undertake a range of work for clients across all three pillars of Solvency II. In relation to Pillar I in particular, this includes:

- Assistance in modelling and justification of LACDT
- Extensive experience of modelling projected balance sheets, technical provisions and SCR calculations
- ORSA modelling and independent review
- Independent Review of Solvency II balance sheet, technical provisions and SCR
- Assessment of standard formula SCR appropriateness
- Operational risk modelling
- Solvency II capital management
- Assessing the impact of USPs and drafting applications for regulatory approval of USPs
- Assessing the impact of Long Term Guarantee Measures (LTGM) such as the matching adjustment or the volatility adjustment and drafting applications for regulatory approval of LTGMs

Milliman also has a range of software available to support companies in the ongoing Solvency II requirements including:

- Solvency II Compliance Assessment Tool (link)
- Milliman Star Solutions - Vega®: An automated Pillar 3 reporting and standard formula aggregation system (link)
- Milliman Star Solutions - Navi®: A liability proxy modelling tool (link)

As a result, we have a wide range of experience that can be brought to bear to benefit your business.

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