Society of Actuaries in Ireland

Treatment of Italian Tax Asset under Solvency II

25.01.16

Committee

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Disclaimer: The material, content and views in the following presentation are those of the presenter.

Purpose of the Survey

Historically an Area of Concern for the CBI

- Liquidity Considerations
- Appropriate valuation of recoveries
- Concentration risk / Significant Portion of Balance Sheet
- Use of Asset to back Technical Provisions and Solvency Margin
- Lack of Consistency across the industry

Guidance issued periodically since 2009

- Focussed on treatment under Solvency I
- Later guidance considered risk and liquidity elements of Solvency II

CBI Survey Issued in Q3 2015 Focussing on Liquidity and Governance

Not clear what future CBI guidance would look like – should the Society form a view?

Overview of Substitute Tax System

Payment Mechanism

- Annual payment of 0.45% of 31 December Mathematical Reserves
- Payable following June

Tax Cap

- Provision for a cap or upper limit on the Italian tax asset introduced in 2013.
- For 2013, if the full tax asset at the start of the year plus the initial calculation of the mathematical reserve tax due for the current year, exceeds the 2.50% of the mathematical reserves, the tax on mathematical reserves due in the current year is capped.
- For years following 2013, the 2.50% threshold will be decreased by 0.1% each year up to 2024, and will be equal to 1.25% as from 2025.

Overview of Substitute Tax System

Recovery Mechanisms

- Against future policyholder exit tax:
  - On chargeable gains on death (excluding sum assured over underlying unit value), maturity or surrender;
  - Policyholder tax is payable at a rate of 12.5% primarily on Italian government bonds.
  - Tax rate payable for all other securities is 12.5% where gains incepted before 31 December 2011, 20% where gains incepted between 1 January 2012 and 30 June 2014, and 26% thereafter.
- By offsetting against future prepayments if the prepayment tranche has not been recovered after five years;
  - Offset limited to prepayment from 5 years ago less recoveries made during the year
- By offsetting against Italian taxes payable (within the Group) including payroll taxes, corporation tax and capital gains tax.
- Directly from Italian Revenue if no other means exist.

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CBI Considerations

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CBI Guidance 2009/2014

Overview

In June 2009 CBI issued a letter to the CEO's of affected companies setting out some concerns about the creation of a tax asset.

In November/December 2009 CBI issued a follow-up letter

- Included guidance on Maximum Values to be taken on Expected Recoveries

In 2014 CBI issued a survey requesting various pieces of information and asking for a number of stresses to be tested.

Later in 2014 having reviewed the survey responses CBI issued further guidance

- Included restrictions on use of asset

CBI Survey/Guidance 2015

Survey sent to Italian companies in 2015 with focus on liquidity

Questionnaire covering

- Risk Appetite (risk limits, risk monitoring)
- Sources of liquidity risk
- Liquidity Risk Management
- Liquidity Position

Quantitative Template

- Cashflows
- Balance Sheet
- Debt position
- Breakdown of assets
- Solvency II

We are not aware of any companies receiving specific feedback from this survey

Guidance Note issued in late 2015 relating to treatment of Italian Tax under Solvency II

- No explicit mention of valuation methods for assets or liabilities for future payments

Comparison of CBI requirements

	2009 Guidance	2014 Guidance	2015 (Solvency II) Guidance
Prescriptive asset valuation rules covering discount rates and timing of recoveries for various recovery methods	✓	✓	✗
Liability valuation rules for future payments	✓	✓	✗
Disclosure requirements - payments and recoveries split by year, valuation of asset and valuation of liability	✓	✓ Some additional requirements also e.g. amount of recoveries from immediate lapse	✓ Reporting of certain items expected in SFCR, RSR and ORSA as appropriate
Restriction on use of asset - can't cover liabilities (other than liability for future prepayments (excluding liability for prepayments due within 12 months) and first 100% of required solvency margin	✗	✓	✗

Comparison of CBI requirements

	2009 Guidance	2014 Guidance	2015 (Solvency II) Guidance
Requirement for Liquidity Policy covering concentration risk, timing of recoveries, recovery in times of stress	✗	✓	✓ Requirement to document liquidity needs in short and medium term including appropriate liquidity buffer
Guidance/statements relating to liquidity considerations when using asset to cover liabilities	✓	✓ Covered in liquidity policy requirements	✓ **"Undertakings should expect rigorous supervisory engagement where the tax asset is used to cover the capital requirements and the technical provisions"**
Requirement for Risk Appetite Statement considering illiquid nature of asset and concentration risk with risk limits informed by the FLAOR/ORSA	✗	✓	✓

Comparison of CBI requirements

	2009 Guidance	2014 Guidance	2015 (Solvency II) Guidance
Minimum stresses to be considered as part of FLAOR/ORSA: - future investment conditions - levels of new business - expenses - exercising of options by policyholders - persistency - taxation. Also consider liquidity and concentration risk.	✗	✓	✓
Consideration of liquidity and concentration risks associated with tax asset as part of Prudent Person Principle	✗	✗	✓
Consideration of tax asset in various Risk Management Policies - ALM, investment risk , liquidity & concentration risk	✗	✗	✓

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Italian Tax Survey Results

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Overview of the Survey

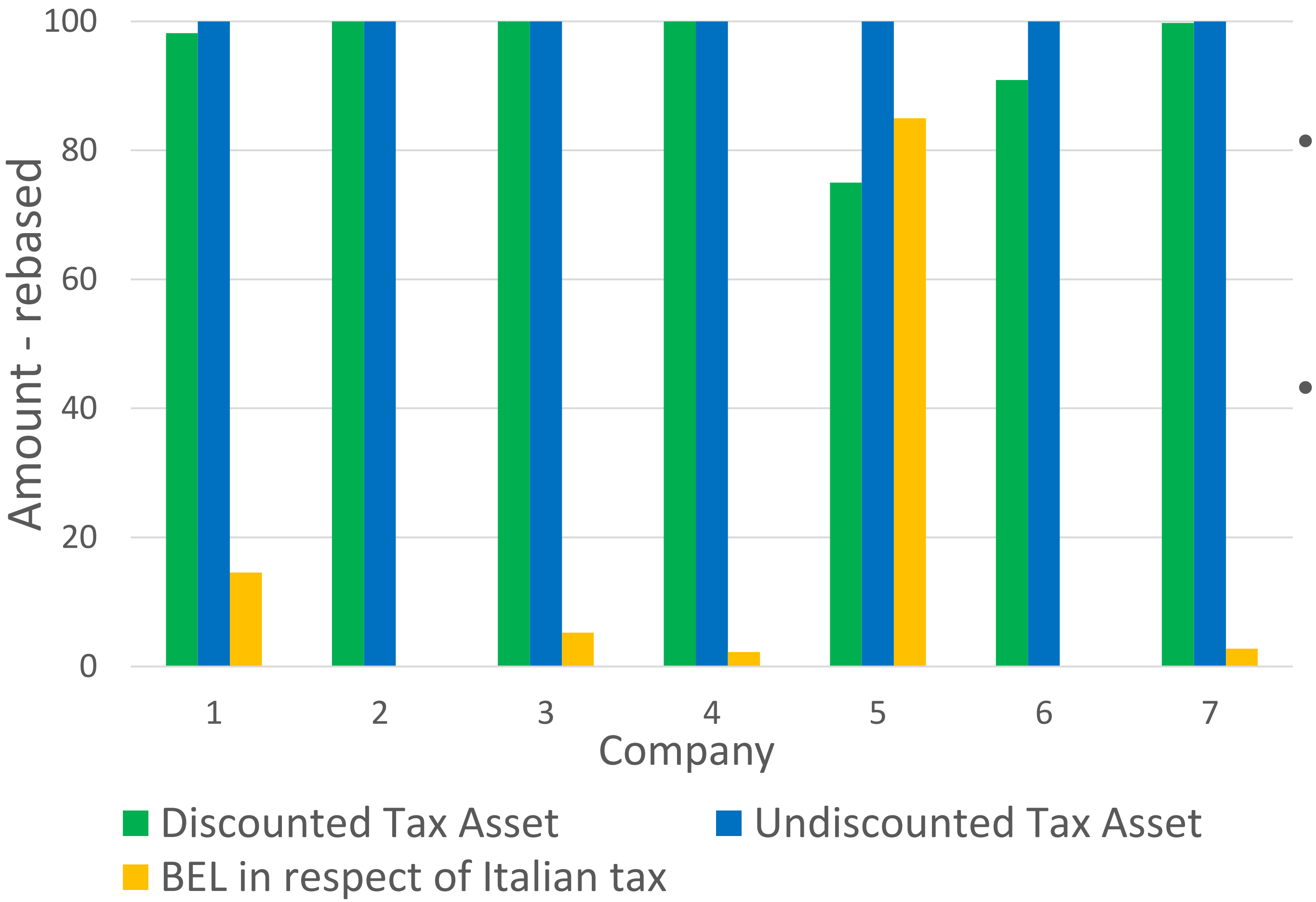
Designed to identify differences in the treatment of the 'Italian withholding tax asset' under Solvency II:

- 18 questions
- 11 respondents

Questions covered the following areas:

- Method of valuation
    - Historic taxes prepaid on business in force
    - Future taxes due for prepayment on business in force
    - Timeline for recovery of prepaid taxes, both historic and future, on business in force
- Allowance within the standard formula SCR in respect of withholding tax prepayments & recoveries
- Sensitivity and scenario testing methods used in the ORSA process to allow for risks not captured by standard formula

Summary of the Solvency II balance sheet at 31 December 2014



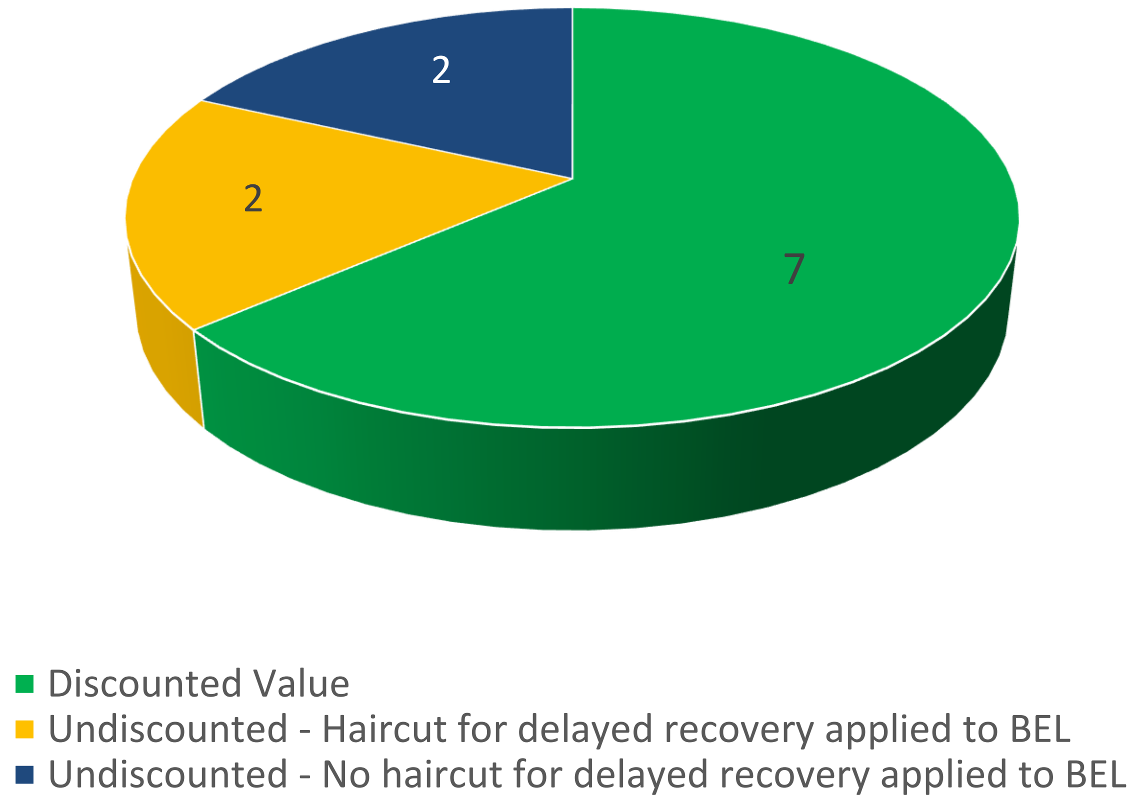
- Company 2,3 & 4 - tax asset valued using undiscounted value
- Company 3 & 4 - BEL increased to allow for delayed recovery

For Solvency II purposes, how is the tax asset valued on the balance sheet?

Is it appropriate that there should be no haircut for delayed recovery?

Under Solvency II, should adjustment for delayed recovery be made to the tax asset or to the BEL?

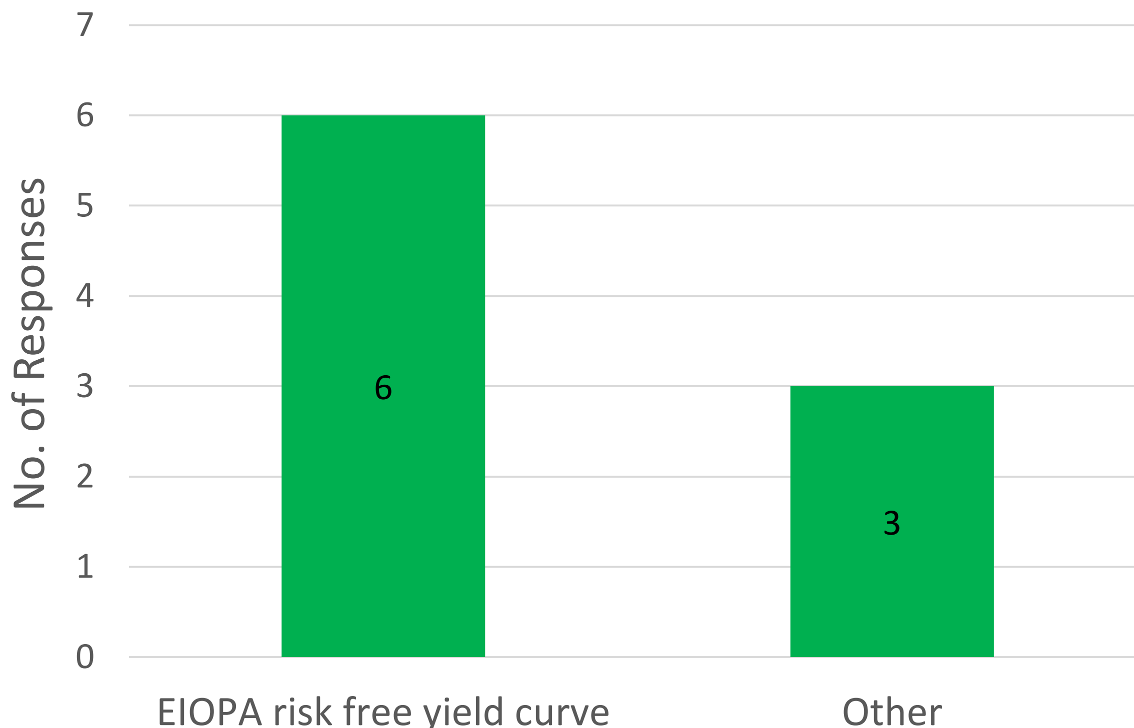
Where adjustment is made to tax asset, who is responsible for its calculation?



What discount rate is applied to the tax asset and/or adjusted BEL?

What discount rate should be used for delayed recovery?

Is the same discount rate being used for adjustments being made to tax asset and any adjustments being applied to BEL for future prepayments and associated recoveries?



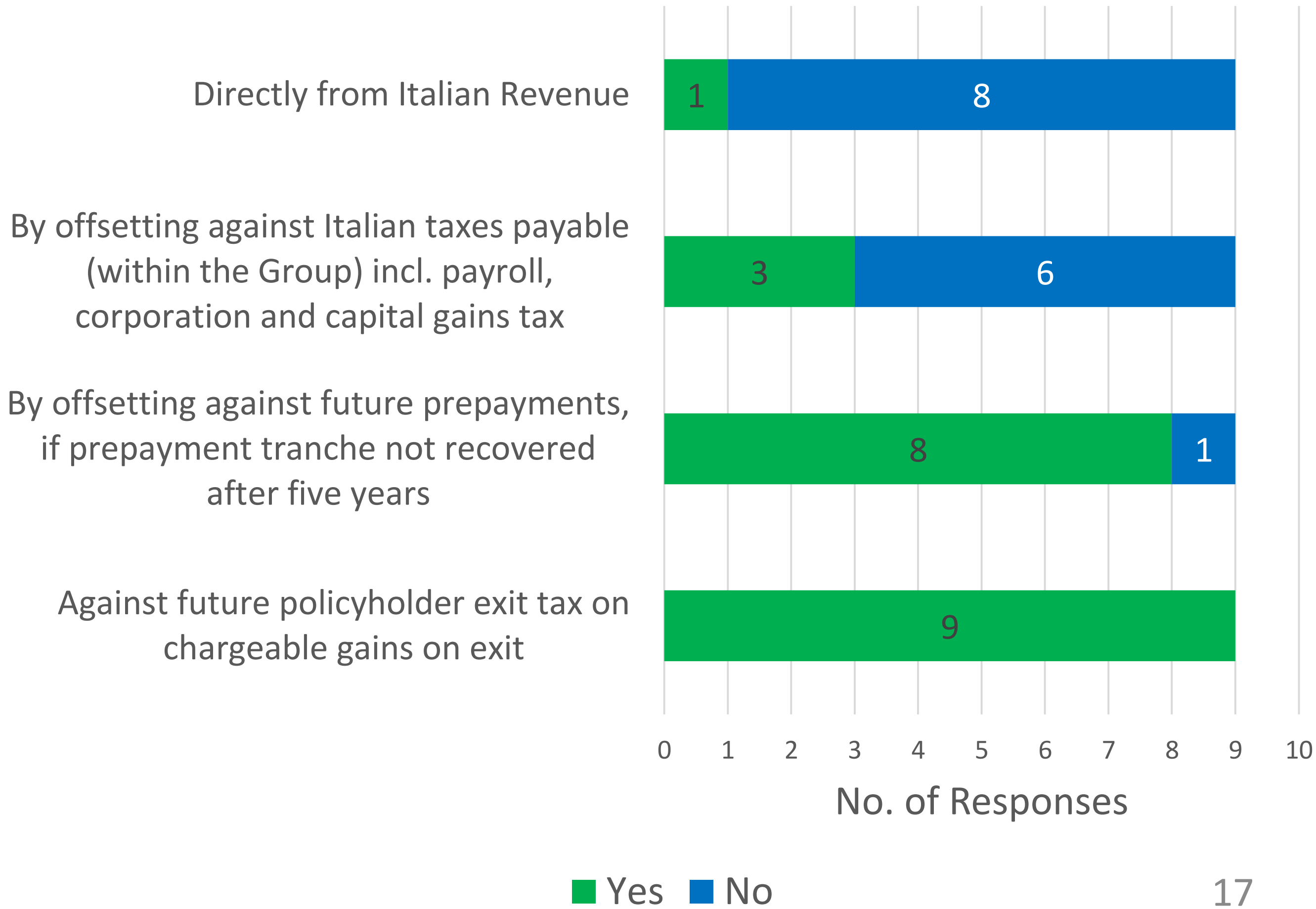
Other:

1. Risk free adjusted for credit risk
2. Group lending rate
3. Yields on Corporate bonds equivalent to Group rating

Where a discounted value of the tax asset and/or BEL has been adjusted, what method of recovery is assumed?

Very few assume direct recovery from Revenue

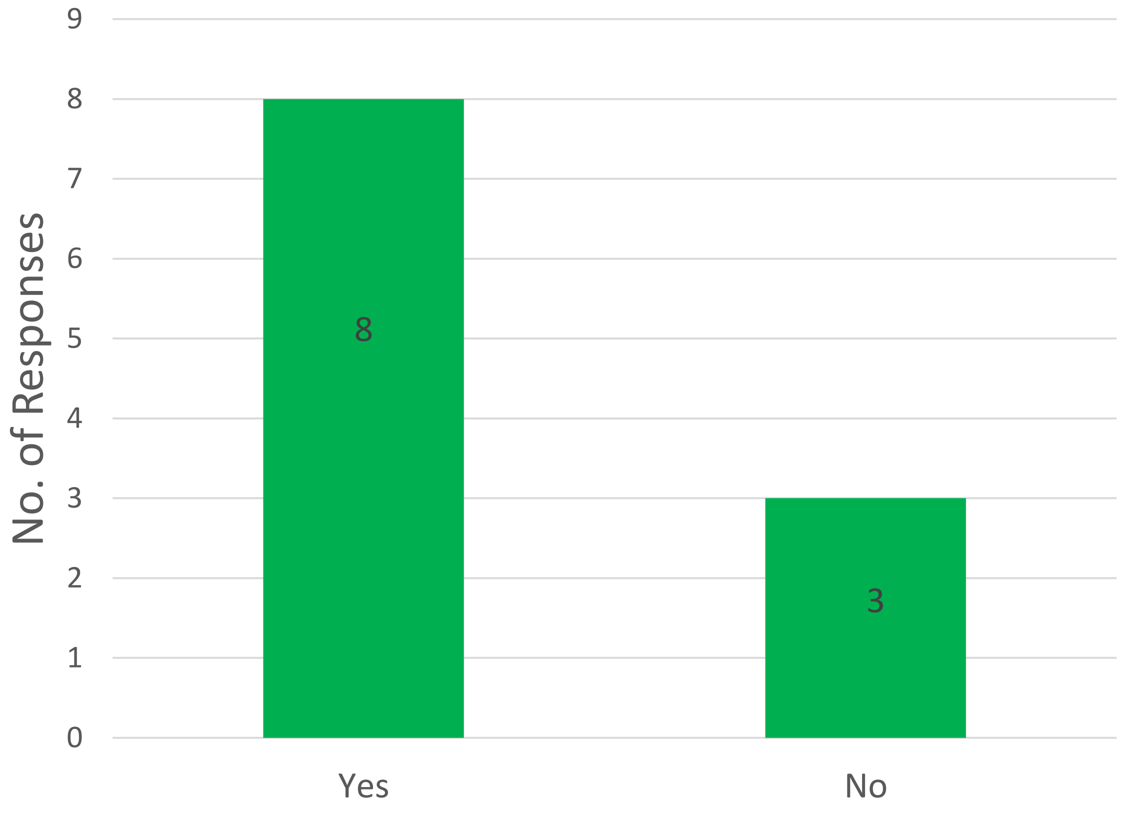
Where recovery against group taxes is used, companies have checked that it is legally enforceable



Is a Best Estimate Liability held in respect of future prepayments and subsequent recoveries?

3 companies specified that they don't allow for future prepayments and subsequent recoveries in their BEL

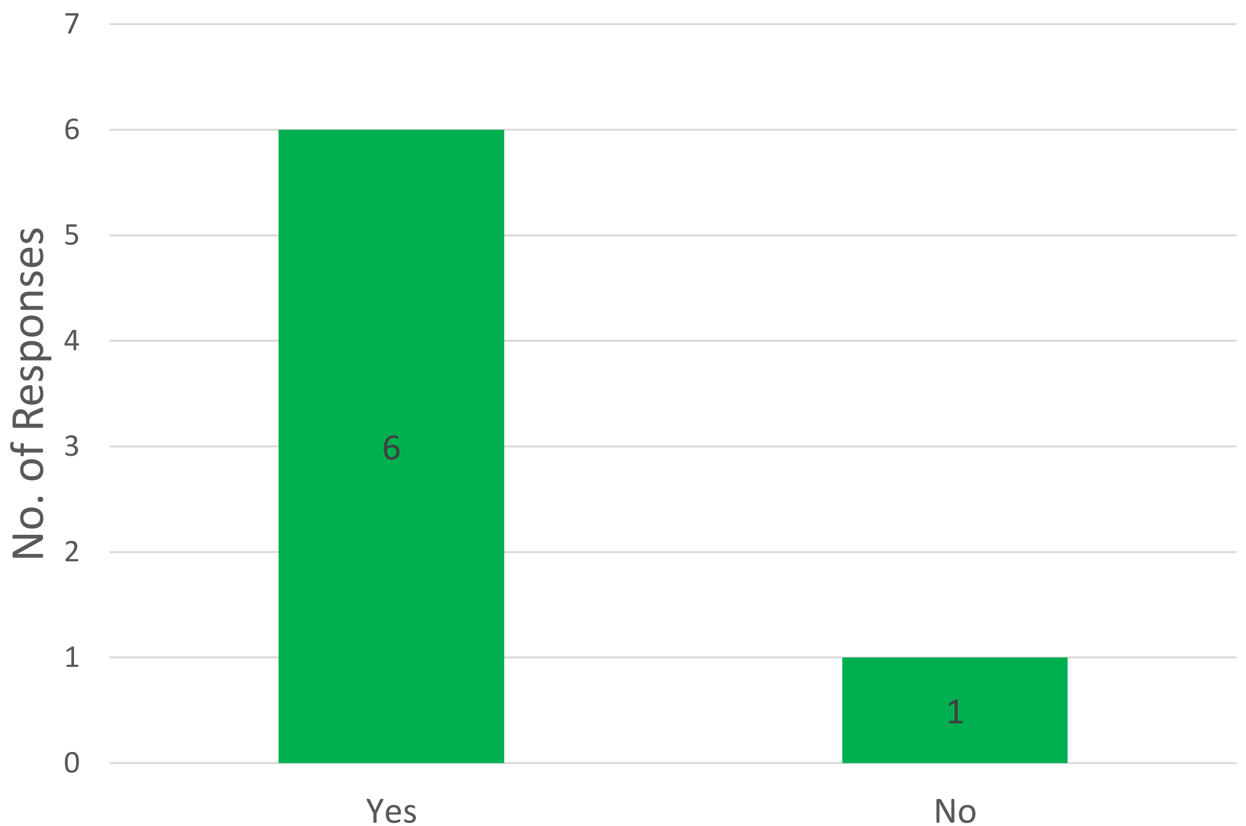
Of those 3, 2 had no allowance for an economic adjustment to tax asset / BEL and 1 had an allowance



Does the BEL calculation exclude cashflows already used for the purposes of valuing the recoverability of the historic tax asset that is held on the balance sheet?

4 of the 11 companies surveyed did not provide a response

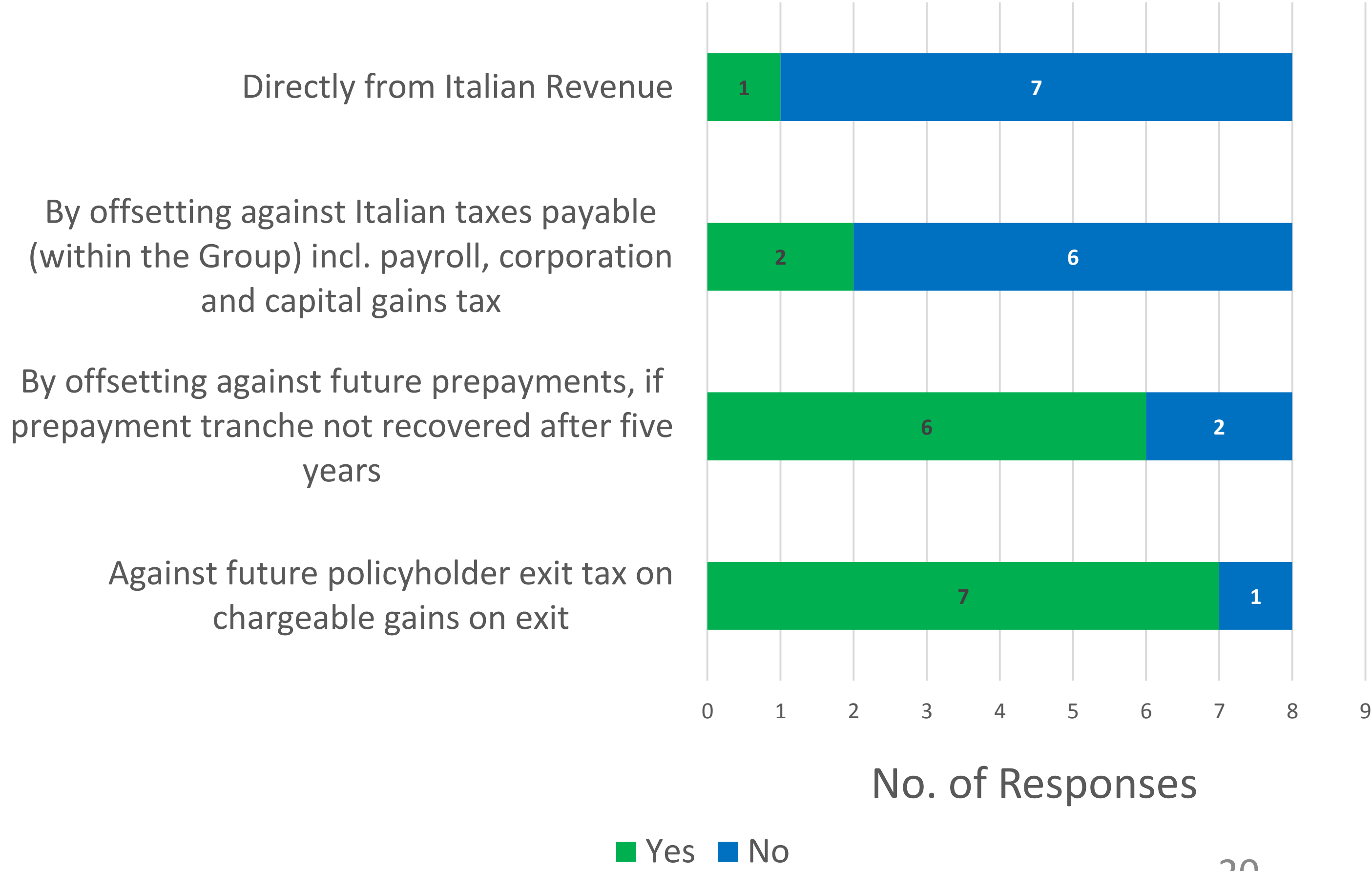
1 company appears to be double counting



What method of recovery is assumed in the BEL calculation in respect of future prepayments of tax due?

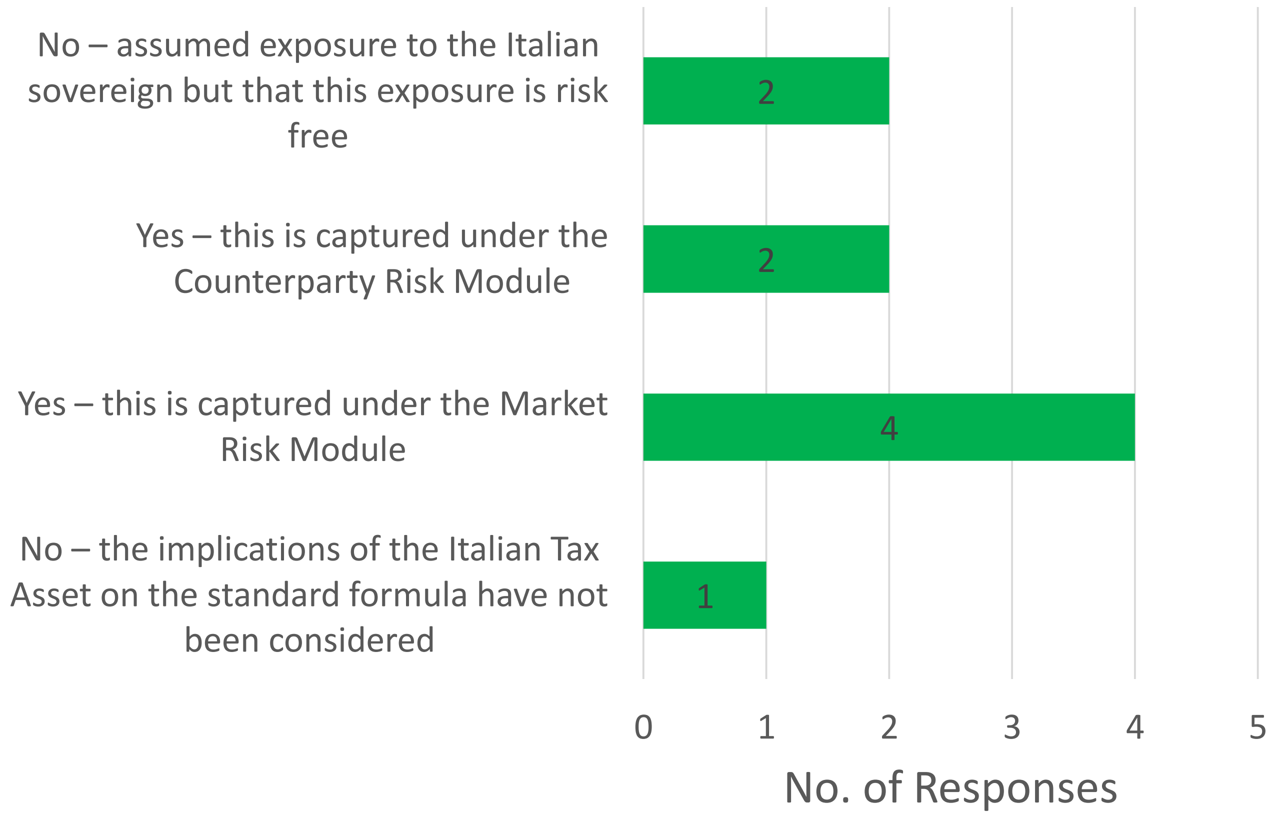
Some differences noted in methods of recovery assumed for the existing tax asset and future prepayments of taxes on inforce

Should methods of recovery be the same?



Under the standard formula, is capital held in respect of the risk associated with the Italian tax asset?

- 2 respondents provided no response
- No consistency of approach in SF
- Which sub-modules under Market Risk would we expect capital to be held?
- Counterparties considered were Italian Revenue / Group and, in one case, policyholders?

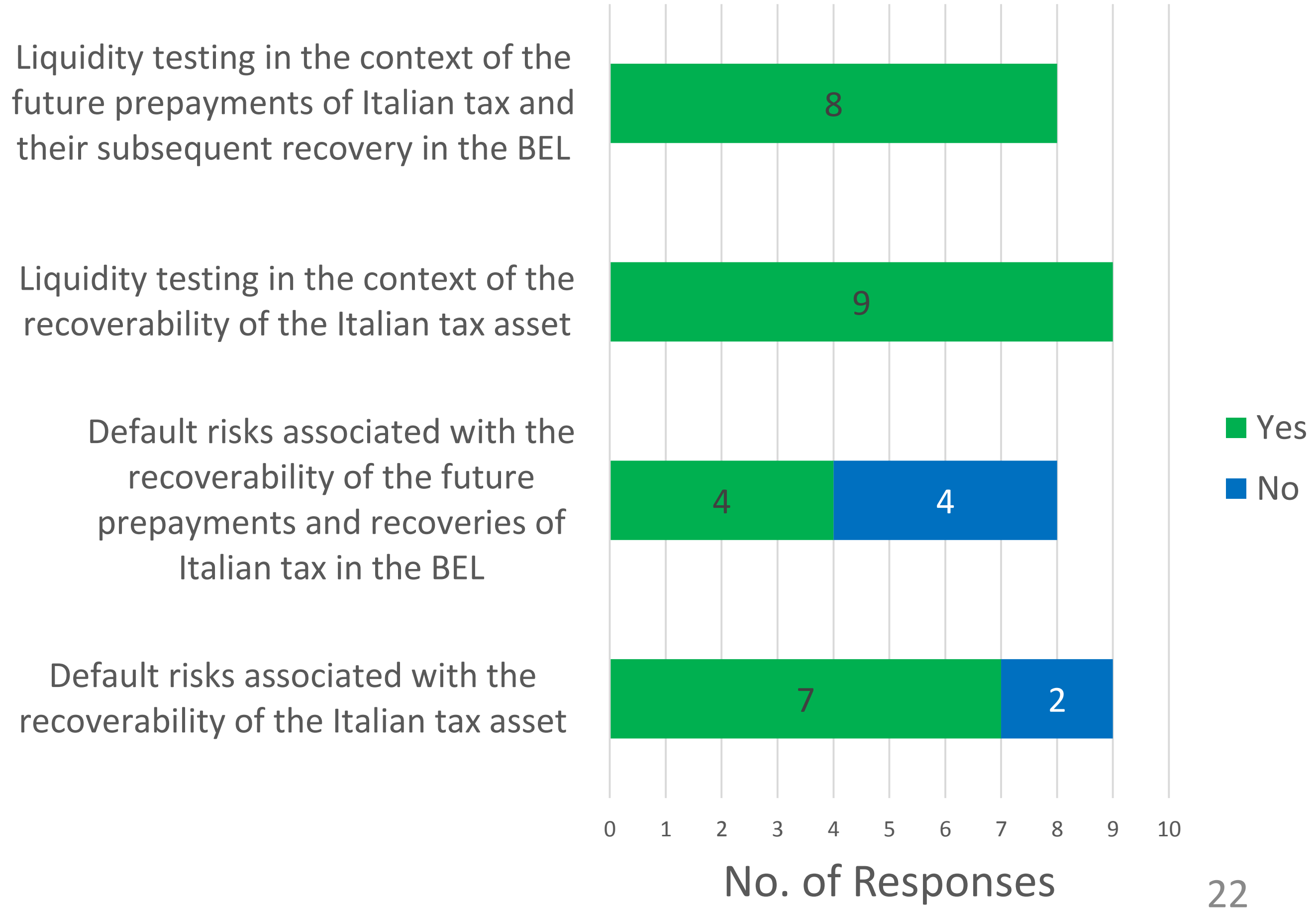


Are each of the following items assessed through sensitivity and scenario testing in the FLAOR?

Under what circumstances are there risks of default?

Answers indicated respondents allowing for risks of default where recovery against exit tax and/or future prepayments?

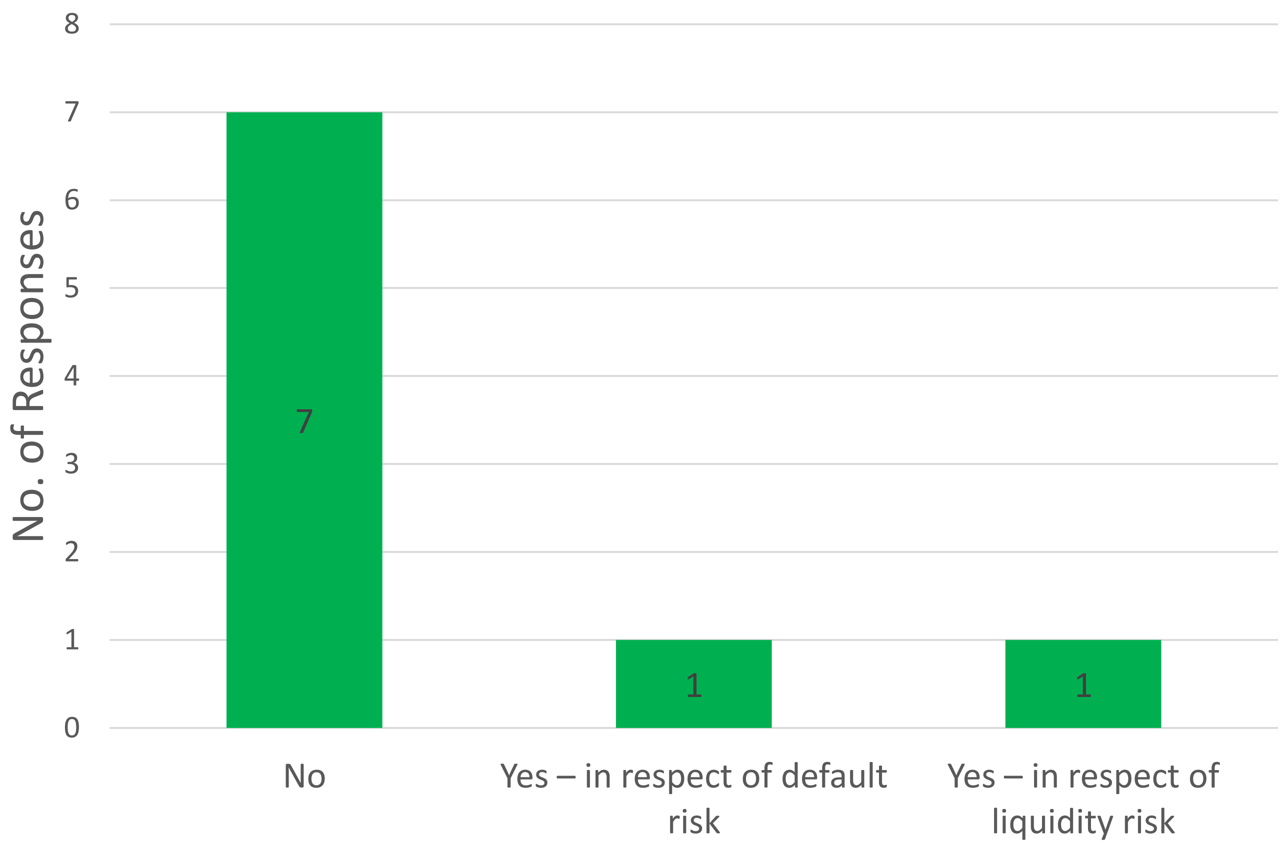
One company allowing for risk of default in SF and allowing for additional stresses in FLAOR



Is additional capital held in respect of this risk which is not captured by the standard formula?

8 respondents

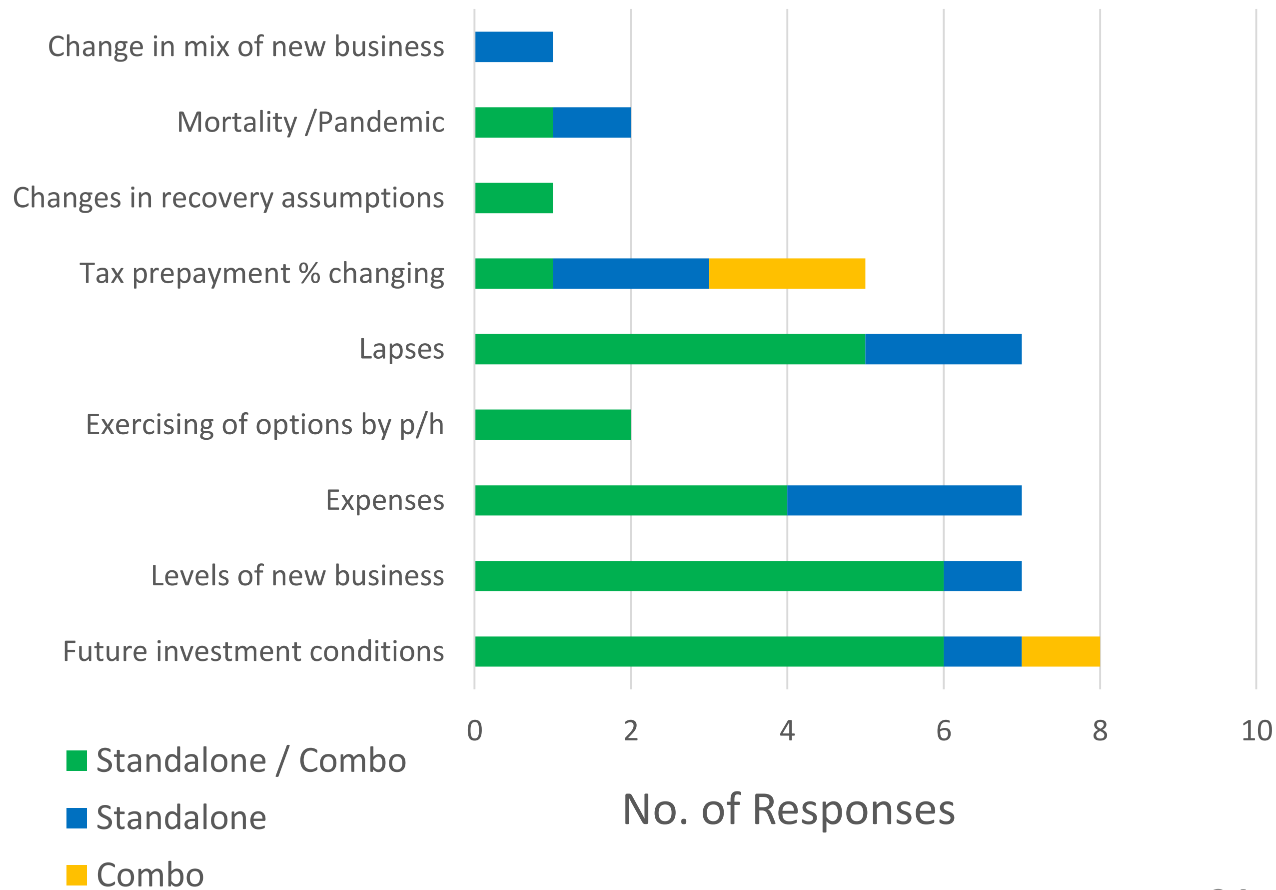
Only 1 company indicated that it was holding additional capital in respect of liquidity and default risk



Which of the following stresses are included in the ORSA?

Some companies appear not to be following the CBI's minimum testing requirements which requires testing of the following assumptions, individually and combined:

- **I. Future investment conditions;**
- **II. Levels of new business;**
- **III. Expenses;**
- **IV. Exercising of options by policyholders;**
- **V. Persistency; and**
- **VI. Taxation.**



Summary of Key Observations

- Some lack of consistency with respect to method of valuation and recognition on balance sheet
- Significant lack of consistency of treatment by companies within Standard Formula
- Indications that CBI's minimum testing requirements are not being followed

Closing Considerations

- Given the different corporate structures and recovery mechanisms available, is a lack of consistency really an issue?

- Are the latest CBI guidelines sufficiently clear?

- Would companies welcome further guidance from the Society?
  - On asset valuation?
  - Liability calculation?
  - Capital requirements?

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