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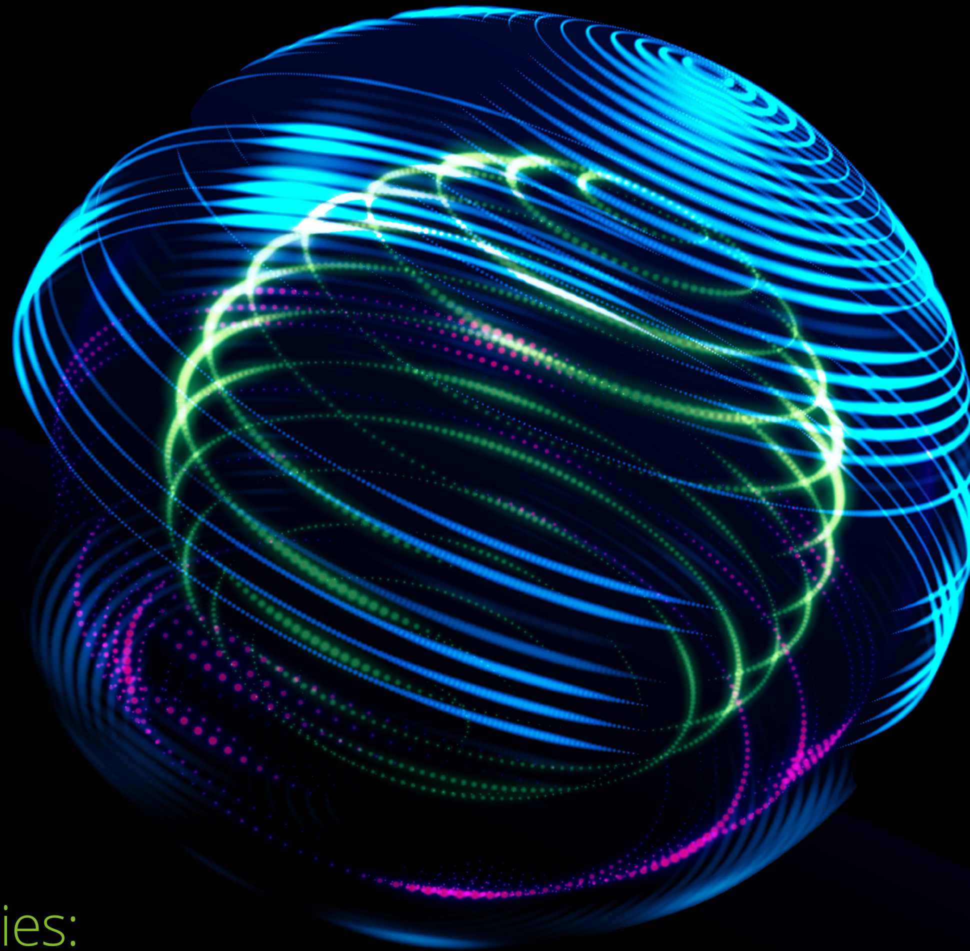

SAM Interpretation Series: Loss Absorbing Capacity of Deferred Taxes (LACDT)

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The recent change to corporate tax rates makes it an opportune time to delve deeper into the Loss Absorbing Capacity of Deferred Taxes (LACDT).

SAM Interpretation Series – LACDT

Introduction

With just over 4 years into insurers reporting under the Solvency Assessment and Management (SAM) framework, many insurers have changed gear from implementation to capital optimisation. This naturally results in different interpretations of the Financial Soundness Standards for Insurers (FSIs) emerging. The recent change to corporate tax rates, makes it an appropriate time to delve a bit deeper into the Loss Absorbing Capacity of Deferred Taxes (LACDT).

The basics

The total Solvency Capital Requirement (SCR) for an insurer must be calculated as:
$SCR = BSCR + SCR_{OP} + SCRPart + AdjDT$

Where

BSCR – Basic Solvency Capital Requirement

SCR_{OP} – Operational Risk Capital Requirement

SCR_{Part} – Participation Risk Capital Requirement for insurance-related participations in the same sector

AdjDT – An adjustment factor for the loss absorbing capacity of deferred taxes

The standard makes reference to two deferred tax asset calculations. The first is with reference to the economic balance sheet where deferred taxes need to be calculated based on the difference between the values ascribed to assets and liabilities in accordance with the principles of the FSIs, and the value ascribed to the same assets and liabilities reported for tax purposes[1].

The second is with reference to AdjDT which should be calculated as the change in the value of the insurer's deferred taxes that would result from an instantaneous loss of an amount that is equal to:
$SCR_{Shock} = BSCR + SCR_{OP} + SCR_{Part}$

The calculation above "change in the value of the insurer's deferred taxes" should be calculated in accordance with FSI 2.1 and subject to a few other criteria mentioned in the standard.[2]

The standard further goes on to require that the capital requirement for a risk component be calculated by applying a stress scenario and measured by its impact on the level of an insurer's basic own funds.[3]

Interpretations

We have seen a specific area of interpretation emerge in how deferred taxes are treated within the SCR calculations when estimating AdjDT.

Interpretation 1

Attachment 5 of FSI 4 requires that AdjDT should be calculated as the change in the value of an insurer's deferred taxes. This could imply that all changes to the insurer's deferred taxes should be captured in this risk module.

Interpretation 2

Paragraph 5.2 of FSI 4 and many of the market risk sub-modules, life underwriting risk sub-modules as well as the participation risk module require that the capital charge for these modules be calculated as the change in an insurer's basic own funds.

This could imply that within these modules, changes in deferred taxes (which form part of basic own funds) should be captured in the relevant market risk module (where change in basic own funds is mentioned) and not within the calculation of AdjDT.

In this case AdjDT would therefore only capture changes in the value of an insurer's deferred taxes arising from risk modules that do not explicitly specify that the capital charge should be calculated as the change in an insurer's basic own funds.

References

1. Paragraph 4.4 of FSI 2.1
2. Attachment 5 of FSI 4
3. Paragraph 5.2 of FSI 4

Illustrative example

To illustrate the impact of the different interpretations, we present the SCR results for a hypothetical short-term insurer with the characteristics as contained in the table below.

Corporate tax rate	27%
Capital gains tax rate	21.6%
Equity symmetric adjustment	1%
SA equity exposure	100 000
CGT liability on SA equity for tax reporting	20 000
Additional deferred taxes as per FSI 2.1	0
Ensuing 3 years profit attracting CGT	0
Ensuing 3 years profit from underwriting	80 000
Other market risk charges	0
Non-Life underwriting risk charge	200 000
Operational risk charge	10 000
Participation risk charge	0

Interpretation 1

Equity risk charge (A)	44 000
Market risk charge (B)	44 000
Non-Life underwriting risk charge (NLUR)	200 000
BSCR (C)	215 258
Operational risk charge	10 000
Participation risk charge	0
SCR Shock for LACDT (D)	225 258
Market risk portion of BSCR (E)	38 817
NLUR portion of BSCR (F)	176 441
LACDT from Capital Gains Tax (G)	(8 384)
LACDT from Income Tax (H)	(21 600)
LACDT (I)	(29 984)
SCR (J)	195 274

Where

A = (43% + 1%) * 100 000
B = **A** (no other market risk charges)
C = sqrt (**B** ^ 2 + NLUR ^2 + 2 * 0.25 * **B** * NLUR)
D = **C** + Operational risk charge + Participation risk charge
E = **B** / (**B** +NLUR) * **C**
F = NLUR / (**B** +NLUR) * **C**
G = - min [**E** * 21.6% - 20 000 (CGT liability), 21.6% * 0 (Ensuing 3 years profit attracting CGT)] - 20 000 (CGT liability)
H = - min [(**F** + Operational risk charge) * 27% , 27% * 80 000 (Ensuing 3 years profit from underwriting)]
I = **G** + **H**
J = **D** + **I**

Interpretation 2

Equity risk charge (A)	38 896
Market risk charge (B)	38 896
Non-life underwriting risk charge (NLUR)	200 000
BSCR (C)	213 079
Operational risk charge	10 000
Participation risk charge	0
SCR Shock for LACDT (D)	223 079
Market risk portion of BSCR (E)	34 693
NLUR portion of BSCR (F)	178 386
LACDT from Capital Gains Tax (G)	0
LACDT from Income Tax (H)	(21 600)
LACDT (I)	(21 600)
SCR (J)	201 479

Where

A = (43% + 1%) * 100 000 * (1 – 21.6%)
B = **A** (no other market risk charges)
C = sqrt (**B** ^ 2 + NLUR ^2 + 2 * 0.25 * **B** * NLUR)
D = **C** + Operational risk charge + Participation risk charge
E = **B** / (**B** +NLUR) * **C**
F = NLUR / (**B** +NLUR) * **C**
G = 0 (benefit fully accounted for in the Equity risk sub-module)
H = - min [(**F** + Operational risk charge) * 27% , 27% * 80 000 (Ensuing 3 years profit from underwriting)]
I = **G** + **H**
J = **D** + **I**

The SCR under each interpretation is as follows:

- Interpretation 1 – 195 274
- Interpretation 2 – 201 479

It is worth noting that in the above calculation it was assumed that the equity holdings of the insurer meet the requirements to be accounted for under the CGT calculation.

Additional considerations

'Tax' is a broad term with many nuances that can materially affect the resulting SCR and solvency of an insurer. Life insurers, for example, have the additional complexity of needing to understand CGT profits and losses, the 'I – E' result, underwriting profits and the direction and storing of historic movements at a tax fund level (as well as offsetting impacts when certain conditions are met).

There will be another wave of complexity as insurers move to IFRS 17, where the emergence of the underwriting and finance results will change as transitional arrangements are introduced. We recommend a combined view of the principle decisions when moving from IFRS to SAM as well as the movement from IFRS 4 to IFRS 17. This combined view will lead to the most correct tax and commercial outcome for insurers.

Conclusion

As Benjamin Franklin put it, nothing is certain except death and taxes. True to the quote taxes are certain, however where to account for them may not be. Following a 1 in 200 year event, it is expected that insurers would raise a deferred tax asset. However, we have seen an interpretation emerge in how deferred taxes are treated within the SCR calculations.

Through the illustrative example, we have observed that each interpretation has an impact on the SCR estimate with results being dependent on insurer specific balance sheets and ensuing 3 year profits.

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