BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Consultation Paper | CP26/19

Solvency II: Adjusting for the reduction of loss absorbency where own fund instruments are taxed on conversion

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Responses are requested by Monday 13 January 2020.

Please address any comments or enquiries to:
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1 Overview

1.1 In this consultation paper (CP), the Prudential Regulation Authority (PRA) proposes to amend its expectation on the treatment of restricted Tier 1 own funds (rT1) instruments in the light of recent information from HMRC. The proposals would make amendments to Supervisory Statement (SS) 3/15 'Solvency II: the quality of capital instruments' (see Appendix).

1.2 The SS currently sets out the PRA's expectation that insurers will deduct the maximum tax charge generated on write down, when including externally issued rT1 instruments in their own funds. This consultation proposes expanding this expectation to reflect the maximum tax charge that could be generated on conversion of such items into ordinary shares. To reflect any changes to SS3/15 following this consultation the PRA would also update the reporting clarification published as Appendix 2 to Policy Statement (PS) 4/19 'Solvency II: Adjusting for the reduction of loss absorbency where own fund instruments are taxed on write down'.[1]

1.3 The CP is relevant to UK insurance firms within the scope of Solvency II, the Society of Lloyd's, and firms that are part of a Solvency II group that will determine and classify capital instruments under the Solvency II own funds regime, together with their advisors.

Background

1.4 On Monday 29 October 2018 the Government announced new rules for the taxation of hybrid capital instruments.[2] Any credit arising on writing down or conversion of externally issued hybrid capital instruments is subject to corporation tax unless it falls in one of the exceptions in section 322 of the Corporation Tax Act 2009.[3] The PRA considers Condition B in section 322 to be most relevant to the status of hybrid capital instruments issued by insurance firms.

1.5 Condition B applies if the hybrid capital instrument is released in consideration of shares forming part of the ordinary share capital of the issuer. That being the case, the PRA understood that rT1 instruments that convert on trigger would not normally be taxed on that conversion.

1.6 On this basis, on Thursday 21 February 2019 the PRA introduced an expectation in Chapter 5 of (SS) 3/15 that firms issuing external rT1 instruments that write down on trigger should reflect the maximum tax charge generated on write down when calculating its own funds. It did not introduce any expectation for hybrid capital instruments that converted to ordinary shares on trigger.

1.7 HMRC has recently drawn the PRA's attention to its conclusion that where the instrument has a conversion share offer (CSO), and this is drafted in such a manner that there is an option for the issuer to compel the noteholder to sell the shares issued, the exercise of this option may result in Condition B not being satisfied. They explain that this is because a realistic view of the facts is that the release of debt is not in consideration for shares but in consideration for cash.

1 February 2019: www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-adjusting-for-reduction-loss-absorbency-where-own-fund-instruments-taxed-on-write-down.

2 Chapter 3 of assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752083/Hybrid_and_Mismatch_Technical_Note_FINAL_2510118_UC_291018.

3 In this CP 'external' is used to mean that the investors in the rT1 instrument are not in the group of the issuer.

1.8 If this type of option is exercised the credit on conversion[4] would be taxable in the same manner as hybrid instruments which write down on trigger.

1.9 Except in rare cases, this tax will be reflected on the Solvency II balance sheet as either a separate liability, or as a reduction in deferred tax assets (DTA). As explained in more detail in paragraphs 2.3 to 2.6 of PS4/19, this Solvency II balance sheet impact would usually result in a reduction in own funds, although there may be situations where the loss-absorbing capacity of the write-down feature would not be limited by this tax effect.

Purpose

1.10 The purpose of the proposals in this consultation is to maintain the existing regulatory policy of only recognising rT1 items to the extent that they provide loss absorbency on trigger, and to prevent the amount of loss-absorbency provided by rT1 instruments that convert into ordinary shares on trigger from being overstated.

Implementation

1.11 The intended implementation date for the final policy following this CP is the date of publication of the final policy.

Responses and next steps

1.12 This consultation closes on Monday 13 January 2020. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP26_19@bankofengland.co.uk .

1.13 The proposals set out in this CP have been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including those arising once any new arrangements with the European Union take effect.

1.14 In the event that the UK leaves the EU with no implementation period in place, the PRA has assessed that the proposals would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA).

4 That is, the credit entry in the issuer's accounting records which results from the conversion of the rT1 into equity.

2 Proposals

2.1 The PRA proposes to update SS3/15 (see Appendix) to add an expectation that insurers would deduct the maximum tax charge generated on conversion when:

- they include in their own funds external rT1 capital instruments that convert to ordinary shares on trigger; and
- that instrument has a CSO mechanism in its terms.

2.2 An exception to this proposed expectation would be if the insurer has provided the PRA with a properly reasoned independent tax opinion from an appropriately qualified individual, taking into account HMRC precedent, statements and guidance, that no tax will be payable on trigger. The PRA would generally expect such opinion to be provided at least 30 days before issuance.

2.3 The PRA proposes that the maximum tax charge generated on conversion would be calculated as: the instrument's face value (less any minimum CSO price per share specified in the terms of the instrument at issuance multiplied by the number of ordinary shares created on trigger) multiplied by the prevailing corporate tax rate.

2.4 The PRA proposes to introduce the above expectations for all new issuances of rT1 instruments that convert on trigger and have CSO features after the date of publication of the final policy. Where firms have already issued external rT1 instruments that convert to ordinary shares on trigger and have a CSO mechanism, their supervisory team would discuss appropriate arrangements with each firm on a case-by-case basis.

Regulatory requirements supporting the proposals

2.5 The PRA considers that the contribution of the instrument to own funds should reflect the extent to which it is able to provide policyholder protection through its ability to absorb losses. This is supported by the Solvency II requirement to assess quality by considering whether an own funds item 'is available, or can be called up on demand, to fully absorb losses on a going-concern basis, as well as in the case of winding up'.[5] The PRA considers that, where a CSO included in a basic own funds item that converts on trigger means that it could generate a tax charge if the firm chose to exercise it, the capacity of that item to provide policyholder protection through loss absorbency is reduced. This should be reflected in the own funds calculation.

5 Article 93(1)(a) of the Solvency II Directive.

3 The PRA's duty to consult

3.1 The PRA has a statutory duty to consult when introducing new rules and, when not making rules, has a public law duty to consult widely where it would be fair to do so. When doing so, the PRA provides the following in relation to the proposed policy:

- a cost benefit analysis;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with the PRA's duty to act in a way that advances its general objective, insurance objective (if applicable), and secondary competition objective;
- an explanation of the PRA's reasons for believing that making the proposed policy is compatible with the regulatory principles; and
- a statement as to whether the impact of the proposed rules will be significantly different to mutuals than to other persons.

3.2 The Prudential Regulation Committee (PRC) should have regard to aspects of the Government's economic policy as recommended by HM Treasury.[6]

3.3 The PRA is also required by the Equality Act 2010 to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.[7]

Cost benefit analysis

3.4 HMRC's clarification that some rT1 instruments that convert on trigger and have a CSO will be subject to tax if the CSO is exercised, means that affected rT1 instruments will be less loss absorbing. Any additional costs that affected firms may incur result from the HMRC's clarification.

3.5 The proposals in this CP help to ensure firms continue meeting the existing regulatory requirement of only recognising rT1 items to the extent that they provide loss absorbency on trigger. The CP does not introduce any additional regulatory requirements, therefore there are no additional costs associated with the proposals in the CP.

Compatibility with the PRA's objectives

3.6 The PRA considers that the proposals in this CP are compatible with the PRA's statutory objectives to promote the safety and soundness of PRA-authorised firms and to contribute to policyholder protection. The PRA is seeking to ensure the delivery of the main objective of the Solvency II Directive as described in Article 27 of the Solvency II Directive (ie the protection of policyholders and beneficiaries). By providing guidance to firms, the PRA helps to ensure firms continuing meeting existing regulatory requirements and having sufficient loss absorbency in order to promote the safety and soundness of PRA-authorised firms and to contribute to ensuring that policyholders are appropriately protected.

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6 Section 30B of the Bank of England Act 1998.
7 Section 149.

3.7 The PRA also has a duty to facilitate effective competition as a secondary objective, subordinate to its safety and soundness and policyholder protection objectives. The proposals facilitate effective competition as they will prevent firms from overstating their capital position with respect to future issuances. In addition, the proposals also seek to minimise the impact of the proposed policy to instruments already in issuance, which were issued on the basis of law and PRA expectations applicable at that time.

Regulatory principles

3.8 In developing the proposals in this CP, the PRA has had regard to the regulatory principles. Three of the principles are of particular relevance.

(i) The principle that a burden or restriction which is imposed on a person, should be proportionate to the benefits that are expected to result from the imposition of that burden:

- The proposals are only targeted at instruments for which action is needed, ie instruments which convert but either do not have CSO are not impacted by the proposals.
- The PRA considered whether it would be appropriate to ask for tax advice on all rT1 instruments that convert on trigger, regardless of whether they had a CSO. However, it concluded this would be disproportionate and ineffective, as it would impose costs on firms who were not impacted and because a tax opinion would be unlikely to identify any further issues before HMRC has flagged them.

(ii) The principle that the PRA should use its resources in the most efficient and economical way:

- Asking firms to provide the tax advice, rather than increasing PRA resource to provide the required tax specialisation, helps limit demands of overall PRA budget.

(iii) The principle of transparency:

- The PRA has chosen to consult on expanding the tax haircut, rather than introduce the change by bilateral discussions with individual firms as they planned to issue new rT1 instruments.

Impact on mutuals

3.9 Insurance mutuals are unable to issue hybrid capital instruments that convert into ordinary share capital on trigger. That being the case, the PRA does not believe that any mutuals will be impacted by the PRA proposals in this consultation paper.

HM Treasury recommendation letter

3.10 HM Treasury has made recommendations to the PRC about aspects of the Government's economic policy to which the PRC should have regard when considering how to advance the PRA's objectives and apply the regulatory principles.[8]

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8 Information about the PRC and the recommendations from HM Treasury are available on the Bank's website at https://www.bankofengland.co.uk/about/people/prudential-regulation-committee.

3.11 The PRA considers that better outcomes for consumers is particularly relevant to these proposals since they will help to ensure that policyholders are afforded an appropriate degree of protection, and that firms do not overstate the amount of loss absorbing capital that they hold.

Equality and diversity

3.12 The PRA does not consider that the proposals give rise to equality and diversity implications.

Appendix: Draft amendments to Supervisory Statement 3/15 'Solvency II: The quality of capital instruments

In this appendix deleted text is struck through and new text is underlined.

…

External rT1 instruments which write down on trigger or which convert on trigger and contain a conversion share offer

…

<u>5.1A The PRA expects external rT1 instruments which convert on trigger and have a conversion share offer (CSO), issued on or after [TBA: date of publication of the final policy] to deduct an amount to reflect the maximum tax charge generated in the same manner, unless the issuing firm can provide the PRA with a properly reasoned independent tax opinion from an appropriately qualified individual, taking into account HMRC precedent, statements and guidance, that no tax will be payable on trigger. The PRA would generally expect such opinion to be provided at least 30 days before issuance.</u>

<u>5.1B HMRC has confirmed that the tax charge will be raised on the basis of the face value of the rT1 instrument less the value of cash transferred to the rT1 noteholders by the ordinary shareholders through the CSO mechanism. However, the CSO price will not be known until after the instrument has been triggered and a CSO offer made.</u>

<u>5.1C Since the trigger event only occurs on significant breach of SCR, it is realistic to assume that the market price of shares are impacted and therefore that the CSO price will be very low and potentially negligible. For the purposes of the calculation of the maximum tax charge generated, the PRA therefore expects firms to calculate the tax adjustment on the assumption that the CSO price is negligible unless, at the point of issuance, the terms and conditions of the instrument state a minimum price, on or above which any CSO will be offered.</u>

<u>5.1D Where such a minimum CSO price is included in the terms and conditions, the PRA will expect the deduction to be calculated based on the difference between the face value of the rT1 instrument and the minimum CSO price.</u>

…

Instruments that convert on trigger unless the issuer has been taken over, in which case they write down

5.4 Certain rT1 instruments have been issued with features requiring that an instrument converts on trigger, but with provisions that if a takeover occurred then the instrument would revert to write down instead. The PRA does not expect firms that have issued (or that issue in future) such instruments to adjust the amount of rT1 recognised as basic own funds <u>(so long as they have obtained the independent tax opinion noted above if the instrument has a CSO)</u> unless and until the principal loss absorbency mechanism has changed. At that point, the PRA does not expect the firm to restate its regulatory returns pertaining to periods before the change in rT1 instrument's principal loss absorbency mechanism.