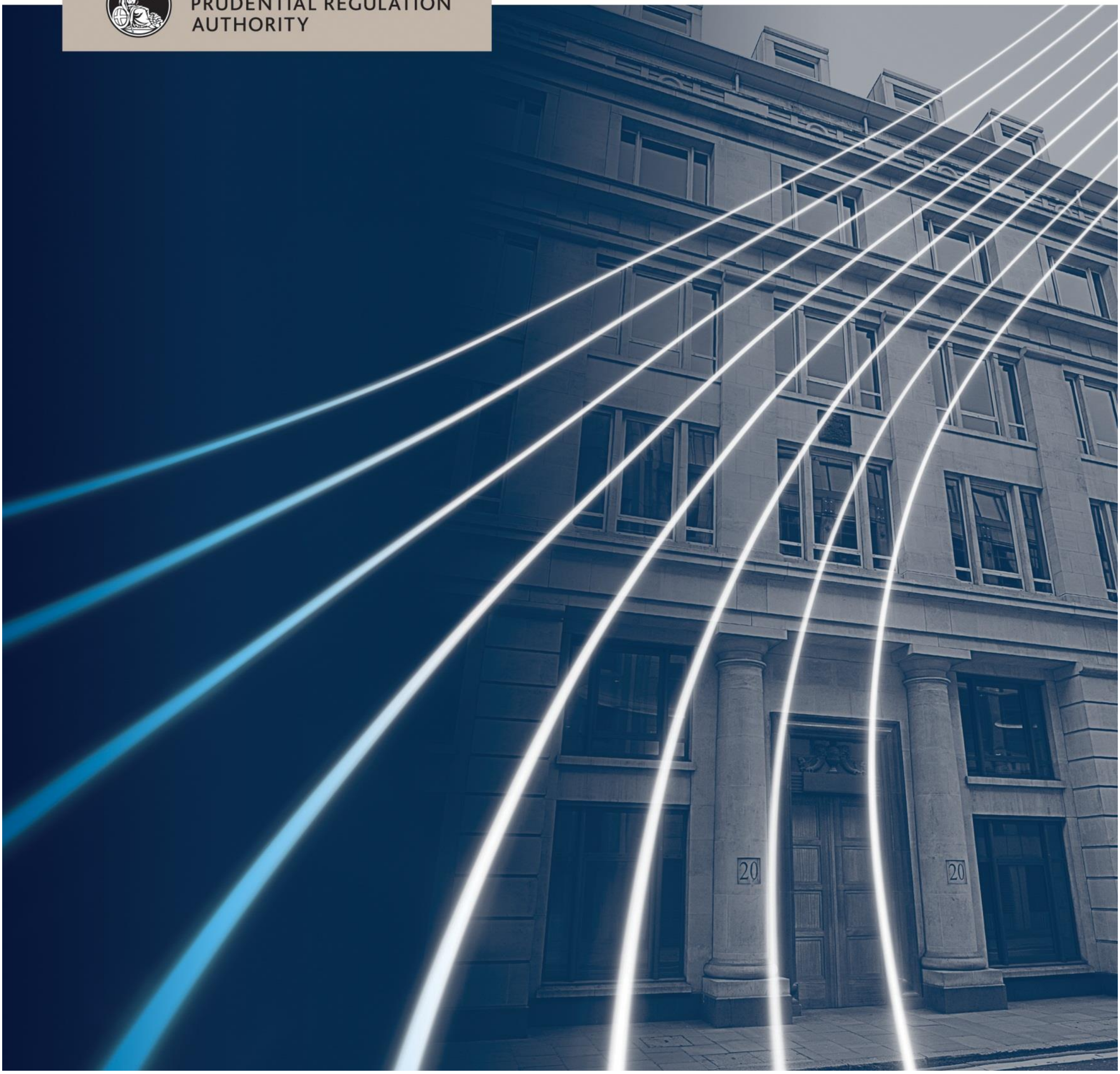
Policy Statement | PS7/20

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

March 2020

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 26/19 'Solvency II: Adjusting for the reduction of loss absorbency where own fund instruments are taxed on conversion'.[1] It also contains the PRA's final policy in an updated Supervisory Statement (SS) 3/15 'Solvency II: The quality of capital instruments' (Appendix 1).

1.2 This PS 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

1.3 In CP26/19 the PRA proposed to update SS3/15 to add an expectation that insurers would deduct from their own funds the maximum tax charge before set off of any prior year losses (the tax charge) generated on conversion of a restricted Tier 1 (rT1) capital instrument when:

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

1.4 An exception to this proposed expectation would be in the event that the insurer had 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 charge will arise on trigger. The PRA would generally expect such an opinion to be provided at least 30 days before issuance.

1.5 The PRA proposed in the CP that the maximum tax charge generated on conversion would be calculated as: the instrument's face value multiplied by the prevailing corporate tax rate. The only time this would not be the case would be if the terms of the instrument had a minimum CSO price, in which case the maximum tax would be calculated as the instrument's face value less this guaranteed CSO price multiplied by the tax rate.

Summary of responses

1.6 The PRA received six responses to the CP. Five of these respondents made a number of observations and requests for clarification of what the PRA expected from the tax opinion process. Two made technical observations regarding the way that any maximum tax impact was to be calculated. Three suggested alternative means by which they thought that the PRA could achieve its policy objective and asked for this to be considered. The PRA provides feedback to these responses, clarifications and suggestions together with its final policy decision, in Chapter 2.

Changes to draft policy

1.7 After considering the responses, the PRA has made the following changes to the draft policy and will reflect these in the updated SS:

- as an addition to the expectations proposed in CP26/19: where any CSO mechanism is included within the terms and conditions (T&Cs) of an instrument, a firm may calculate its own funds without making an adjustment for tax and still be consistent with our expectations despite the

[1] October 2019: https://www.bankofengland.co.uk/prudential-regulation/publication/2019/sii-adjusting-for-reduction-of-loss-absorbency-where-own-fund-instruments-are-taxed-on-conversion.

absence of a tax opinion at the point of issuance, provided that a certain condition is included in the T&Cs of that instrument. Namely, that it is prevented from exercising the CSO unless, at least 10 days prior to exercise it has obtained a properly reasoned, independent tax opinion from an appropriately qualified individual that confirms that the action will not cause a tax charge to arise.

- Notwithstanding the change above, where a firm chooses to obtain a tax opinion at the point of issuance, the PRA expects the firm to provide the opinion to the PRA at least 10 days before issuance.

- The PRA's expectation as to how to calculate the maximum tax charge has been amended to reflect the fact that the cash paid on exercise of a CSO will never be below the face value of the ordinary shares into which the instrument converts.

- The PRA has clarified that a tax opinion obtained at issuance may be used for more than one issuance provided the T&Cs pertaining to the CSO are identical and the provider of the tax opinion remains independent and confirms to the PRA in writing that, taking into account any subsequent HMRC precedent, statements and guidance, their tax opinion remains valid.

- The PRA has amended the expectation to refer to the tax opinion being provided by a 'properly qualified person' to make clear that the opinion can be signed in the name of an incorporated or unincorporated body, notwithstanding that the qualification will pertain to one of the employees of that body.

1.8 The PRA has considered the impact of the above changes, and concluded that they provide benefit by reducing compliance costs, providing greater flexibility and clarifying the PRA's expectations. The impact of each change proposed is considered in more detail in Chapter 2.

1.9 The expectations introduced by this PS only relate to firms that have ordinary share capital. That being the case, the PRA is of the opinion that no mutuals will be impacted by the policy in this PS. The impact of the PS is the same for all firms that have ordinary shares, regardless of the form of their ultimate holding company.

Implementation

1.10 The changes outlined in this PS will take effect on publication of this PS on Monday 16 March 2020.

1.11 The policy set out in this PS has been designed in the context of the UK's withdrawal from the European Union and entry into the transition period, during which time the UK remains subject to European law. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework at the end of the transition period, including those arising once any new arrangements with the European Union take effect.

1.12 The PRA has assessed that the proposals would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA) at the end of the transition period. Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018'[2] for further details.

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[2] April 2019: https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.

2 Feedback to responses

2.1 The PRA must consider representations that are made to it in accordance with its duty to consult on its general policies and practises, and must publish in such manner as it thinks fit feedback to the representations.

2.2 The responses have been grouped as follows:

- alternative proposal suggested by responses;
- calculating the maximum tax charge;
- clarification as to which instruments the expectation applies;
- the mechanics of providing the tax opinion; and
- comments received regarding cost benefit analysis (CBA).

Alternative proposal suggested by responses

2.3 The PRA proposed 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.

2.4 An exception to this proposal was if the insurer has provided the PRA with a properly reasoned independent tax opinion from an appropriately qualified individual that no tax charge will arise on trigger, taking into account HMRC precedent, statements and guidance. The PRA proposed that such an opinion is to be provided at least 30 days before issuance.

2.5 Three respondents pointed out that a CSO mechanism only provides an option, but not a requirement for the issuing firm to compel noteholders to sell shares issued on trigger of the rT1 instrument. The issuer could therefore avoid a tax charge arising by not exercising that CSO option. They argued that to impose a tax adjustment on all instruments with CSO terms which could not provide a properly reasoned tax opinion was therefore over-prudent, as the firm may not exercise the CSO.

2.6 Three respondents questioned HMRC’s conclusions, explained in more detail in paragraph 1.7 of CP26/19, that if a CSO which compelled the noteholder to sell the shares was exercised, this would be taxable in the same manner as hybrid instruments which write down on trigger. They observed that the final arbiter as to tax law was the courts, not HMRC, and noted that HMRC’s rationale for its conclusions might be subject to challenge during the lifetime of any rT1 instrument. We agree with this comment.

2.7 Based on these two arguments these respondents suggested an alternative to the PRA’s proposal. They argued that firms issuing an rT1 instrument with a CSO in its T&Cs should not be expected to make an amendment to reflect any reduction of loss absorbency when calculating its own funds, despite not having provided a tax opinion before issuance, provided the T&Cs forbid the firm from exercising the CSO unless:

- at the point at which the CSO was to be exercised the firm could provide the PRA with a properly reasoned independent tax opinion that no tax charge would arise from that exercise; and

- the firm had obtained a written non-objection from the PRA.

2.8 One respondent also observed that an rT1 instrument with similar T&Cs had already been issued in 2019.

2.9 The PRA has considered these arguments and has decided to amend the final policy to include the provision of a tax opinion at the point at which the CSO was being exercised as an alternative way of addressing the uncertainty regarding loss of own funds. The PRA has decided not to include an expectation that the firm seeks a non-objection in addition to obtaining the tax opinion.

2.10 The PRA considers that the addition of this option offers significant cost advantages because firms who issue rT1 instruments that do not trigger during their lifetime will incur no costs. It will also result in a more reliable tax opinion on which to make decisions as to whether to exercise the CSO if the instrument triggers. This is because an opinion drafted close to the point at which the option might be exercised is able to reflect the tax regime at that point, whilst an opinion drafted at issuance may well be overtaken by subsequent changes.

2.11 However, since some firms may prefer certainty at the point of issuance as to whether they will be able to exercise a CSO, the PRA has decided to keep both options rather than withdraw the policy proposal consulted upon. This provides flexibility for firms.

Calculating the maximum tax charge

2.12 The PRA proposed that the maximum tax charge generated on conversion would normally be calculated as: the instrument's face value multiplied by the prevailing corporate tax rate. The only time this would not be the case would be if the terms of the instrument had a minimum CSO price, in which case the maximum tax would be calculated as the instrument's face value less this guaranteed CSO price multiplied by the tax rate.

2.13 One respondent pointed out that calculating the tax using the instrument's face value would overstate the tax due and was therefore overly prudent because there would always be some residual value in the ordinary shares. Another respondent pointed out that shares cannot be issued at a discount to face value. Since the CSO price is unlikely to impose further losses on the noteholders by being set below this nominal amount, it acts as a limit to the maximum amount of the tax impact in cases where the instrument terms do not set a minimum CSO price per share.

2.14 The PRA agrees with this argument. The cash payment may exceed this, leading to a lower tax charge, but the extent of this will not be known until shortly before the CSO is exercised.

2.15 The PRA has amended the tax charge calculation to be the difference between the rT1 instrument's face value and the nominal value of the shares into which it converts. This benefits firms by lowering the size of the adjustment that the PRA expects firms to make if they cannot provide a tax opinion at issuance and do not want to follow the alternative route explained in paragraphs 2.3 to 2.9 above.

2.16 It is likely that the amended calculation will still overstate the tax charge that would arise. To mitigate this, firms could include a minimum CSO price per share (greater than the nominal value of the shares) in the terms of the instrument. This would lower the maximum amount of the tax impact, and so the adjustment to own funds. This was reflected in the consultation proposal, and the PRA has decided to implement that unchanged in the final policy.

2.17 No respondent suggested any alternative means by which this uncertainty of cash paid could be mitigated. In the absence of certainty regarding the cash paid to noteholders on exercise of the CSO, and having considered the feedback received, the PRA has decided it is prudent not to amend the proposed changes to SS3/15 to reflect this uncertainty.

Interaction with any tax losses

2.18 Three respondents stated that substantial tax losses are likely to be contemporaneously available to the relevant issuer which could be offset against any taxable profit which is deemed to arise on release of an rT1 debt. The PRA agrees with this, but had already explained in paragraph 1.9 of CP26/19, and referenced a longer explanation to this already contained in paragraphs 2.3 to 2.6 of PS4/19,[3] that if the tax is not reflected on the Solvency II balance sheet as a liability then it will reduce deferred tax assets. In either case, the amount of own funds will almost always be reduced.

Interaction with the firms' own risk appetite

2.19 The same three respondents suggested that it would be more proportionate for any adjustment to be made to the amount above the solvency capital requirement (SCR) that the firm has identified would be prudent to hold given its risk profile, and that the firm has notified to the PRA as part of its own risk and solvency assessment (ORSA).[4]

2.20 Holding more own funds in excess of the SCR can make it less likely that a firm breaches its SCR. However rT1 will only trigger once the firm is in significant breach of its SCR, at which point any such excess amount will already have been lost. Increasing this excess would therefore not mitigate any loss of own funds at the point a firm is deciding whether or not to exercise a CSO.

Interaction with loss absorbing capacity of deferred tax (LACDT).

2.21 Two respondents asked the PRA to clarify what impact the tax payable on exercise of an option would have on the SCR, via LACDT. These responses acknowledged that an impact could only occur in cases where a firm had not previously been able to demonstrate that all potential LACDT could already be utilised.

2.22 The PRA acknowledges that in some situations tax payable could be used to demonstrate likely utilisation where the rT1 was issued out of the same insurance entity which suffered loss in the SCR loss scenario. However, most hybrid capital is issued out of a holding company, and is intended to provide group capital. In that case, the taxable amount would not be in the same legal entity as the tax losses, the taxable amount could not be used to demonstrate utilisation of LACDT without assuming group relief. The PRA has already expressed its expectations regarding group relief in SS2/14[5] paragraphs 4.8 to 4.10. That being the case, the PRA concludes it would not be helpful to expand further, since any situations not already addressed would be case-specific. If a firm believed that it had a situation which was not already covered, and was contemplating issuing an rT1 instrument with a CSO, it should discuss this with its supervisory contacts as early as possible.

3 February 2019: Solvency II: 'Adjusting for the reduction of loss absorbency where own fund instruments are taxed on write down'; https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-adjusting-for-reduction-loss-absorbency-where-own-fund-instruments-taxed-on-write-down.
4 As required by Commission Delegated Regulation (EU) 2015/35 Article 304 (1)(c).
5 November 2016; 'Solvency II: recognition of deferred tax'; https://www.bankofengland.co.uk/prudential-regulation/publication/2014/solvency2-recognition-of-deferred-tax-ss.

Clarification as to which instruments the expectation applies

2.23 Two respondents asked for clarification as to whether the policy proposal only applied to rT1 instruments which compel holders of relevant instruments to sell the shares they receive pursuant to a CSO, or to all instruments which contain a mechanism which simply provides optionality for such holders.

2.24 HMRC's conclusion that the tax on conversion would be taxable in the same manner as hybrid instruments applies only to those instruments with a CSO drafted in such a manner that there is an option for the issuer to compel the noteholder to sell the shares issued. However, the drafting of CSO terms to date has been diverse, and it is not always immediately clear to the non-expert whether a particular instrument can be considered to compel the noteholders or not.

2.25 The CP therefore proposed firms would provide a tax opinion at issuance for all rT1 instruments which contain CSO terms unless the firm chooses to confirm that it will immediately accept that an adjustment shall be made or the firm chooses to draft the instrument in the way suggested in paragraphs 2.4 to 2.11 above. The PRA has reconsidered that expectation in the light of the responses received, and concluded it would be extremely difficult to define exactly what terms might constitute ability to compel. Attempting any such hard definition risked instruments not being included that subsequently proved to fall within the tax regime, which could cause an overstatement of loss absorbing capacity. In contrast, in those cases where the lack of ability to compel is clear in the T&Cs the cost of obtaining a tax opinion would be low. That being the case the PRA has decided to implement the policy as proposed.

The mechanics of providing the tax opinion

Who can provide the opinion?

2.26 One respondent asked whether the PRA intended to provide advanced approval or agreement that an individual is independent and appropriately qualified. The PRA does not intend to do this, but if a firm is worried that the person or entity it has identified may be challenged by the PRA regarding this it should discuss this with its supervisory contact.

2.27 Three respondents asked whether 'an appropriately qualified individual' would be a person or could be a Limited Liability Partnership. We accept the common understanding that an appropriate qualification will usually only pertain to a natural person and that this terminology could therefore be read restrictively. However, the PRA understands that the costs of providing a tax opinion could be exacerbated if the PRA were to restrict this to mean a natural person. In its final policy, the PRA has therefore clarified its expectation by changing the word 'individual' to 'person', which is defined in the PRA Rulebook[6] to include both incorporated and unincorporated bodies.

2.28 Two respondents questioned whether the independence of an accounting firm's tax opinion might be called into question if that accounting firm subsequently became auditor of the insurance firm. Whilst the PRA does not consider that a current or potential future audit assignment would of itself be a barrier to an accounting firm providing an independent tax opinion, it would be for the person providing such tax opinion to determine such independence. If it felt this could be an issue, given the specificities of a particular case, it would be able to decline the assignment.

2.29 One respondent asked whether, if the person giving the tax opinion ceased to be independent, a further tax opinion would be required. The PRA can see no reason why the independent opinion of an appropriately qualified person should cease to be reliable if that person subsequently ceased to be independent. It therefore sees no merit in requiring a further tax opinion to be provided.

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6 http://www.prarulebook.co.uk/

2.30 Another respondent asked whether the third party or firm drafting the terms of the instrument could be viewed as independent. Whilst ultimately it is a matter for the person providing the tax opinion to take a view about its own independence, the PRA confirms that this would be the case so long as it was not the issuer drafting the terms, and that they could therefore provide the tax opinion if they were appropriately qualified.

The confidence with which the opinion is given

2.31 One respondent asked whether a 'more likely than not' tax opinion would be necessary to comply with the expectation.

2.32 'More likely than not' is generally considered to be anything greater than 50% likelihood that an event will occur, but may only be marginally greater than 50%. The PRA does not consider it prudent that firms should rely on capital that may have close to a 50% likelihood of not being available to protect policyholders when needed. It therefore would not accept a 'more likely than not' tax opinion as being sufficient to rebut the expectation that an adjustment should be made when calculating own funds in such cases. As such, any tax opinion that carried a level of confidence less than 'more likely than not' would also not be appropriate.

When the tax opinion needs to be provided by

2.33 Two respondents noted that firms may not be able to provide a tax opinion at least 30 days before issuance because the T&Cs might still be fluid, because a short window of opportunity to issue rT1 arises unexpectedly or because there is a material change in the law or published precedent, statements, or guidance that might necessitate an opinion being updated.

2.34 The PRA considers that in most situations the issuance of rT1 capital will be as part of a planned capital management process and that the T&Cs will be relatively stable in order to allow the tax opinion to be provided at least 30 days before issuance. This is supported by the relatively stable state of the T&Cs of most instruments submitted 30 days before issuance in compliance with the Pre-Issuance Notification rules.[7] However, the PRA recognises that there may be occasions where an opportunity to issue an instrument opens up unexpectedly and that a 30 day notice period cannot be met. It has therefore amended the proposal to be at least 10 days' notice.

2.35 Amending the notice period benefits firms by allowing them to access a short issuance window should one arise.

Reusing tax opinions for multiple issuances

2.36 One respondent asked whether a tax opinion can be used multiple times where similar terms and circumstances apply. Having considered the argument, the PRA has decided that it would be reasonable for a firm to use the same tax opinion obtained at issuance of an rT1 instrument to meet PRA expectations, in the following circumstances:

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7 https://www.bankofengland.co.uk/prudential-regulation/supervision/capital-instruments-pre-issuance-notification

- the T&Cs regarding the CSO mechanism were identical to that of a previous issuance;
- the provider of the original tax opinion continues to be independent; and
- the firm has obtained from that person a confirmation, taking into account any HMRC precedent, statements and guidance from time to time, that the original tax opinion applies equally to the terms of the new rT1 instrument.

2.37 However, since the decisions regarding the tax implications of drafting are dependent on small differences in drafting, the PRA considers that it is not appropriate to use the same tax opinion if changes have been made to the section of the T&Cs which addresses the CSO.

2.38 If, when the firm asks the provider of the original tax opinion to do this, that provider indicates that the opinion is no longer applicable then the PRA expects the firm to apply an adjustment to its own funds calculation in respect of that earlier issuance and to notify their supervisory contact immediately.

2.39 The option to re-use an existing tax opinion benefits firms because the cost to re-use a pre-existing tax opinion will be lower than the cost of obtaining a new opinion.

2.40 The PRA has decided that it would not be reasonable for a firm to re-use the same tax opinion that was obtained at the point a CSO was being contemplated to meet PRA expectations because of the likely long delay between:

- initial rT1 triggering and a CSO being contemplated; and
- the firm's subsequent rT1 issuances also triggering so that a second CSO is contemplated.

Comments received regarding CBA

2.41 One respondent noted that, should a firm choose to obtain a tax opinion in order to avoid reflecting a reduction in loss absorbency on exercise of a CSO, this could cost in the region of £100,000. The respondent also noted that this was a comparatively small cost to bear compared with the alternative of reflecting the potential tax impact of the CSO in own funds. It argued that a cost-benefit analysis should be undertaken.

2.42 The PRA is committed to providing a qualitative cost benefit analysis for changes to supervisory statements when it is judged appropriate to do so, notwithstanding that the Financial Services and Markets Act (FSMA) s138 does not apply.

2.43 The additional costs associated with reduced loss absorbency arise directly from HMRC's clarification regarding rT1 instruments with CSO. To ignore such reduced loss absorbency when calculating own funds would not be consistent with the PRA's statutory objectives.

2.44 By introducing the possibility for firms to choose to obtain a tax opinion in order to avoid making an adjustment to their own funds calculation, the PRA is introducing a potential benefit for firms at a cost which is likely to be much lower than the benefit. Also, by making it voluntary, firms may choose not to obtain a tax opinion if the costs of obtaining it would outweigh the benefits.

2.45 As a result of consultation responses, the PRA has amended its policy expectation to allow firms, in some circumstances, to delay incurring costs associated with procuring the tax opinion until shortly before the CSO is exercised. This further lowers the cost of providing the benefit by removing them altogether for firms whose rT1 does not trigger (so that the possibility of exercising the CSO never arises).

Other matters raised by respondents

2.46 Two respondents asked for clarification that no retrospective action would be taken to apply an adjustment to instruments that have already been issued. One respondent argued the opposite – that not to apply an adjustment to instruments already in issuance would be to provide firms who had already issued rT1 instruments with an unfair competitive advantage.

2.47 The PRA confirms the view stated in paragraph 2.4 of CP26/19, that it will discuss appropriate arrangements with each such firm on a case-by-case basis.

Appendices

Reporting restricted Tier 1 instruments available at:
https://www.bankofengland.co.uk/prudential-regulation/regulatory-reporting/regulatory-reporting-insurance-sector

SS3/15 'Solvency II: the quality of capital instruments' available at:
https://www.bankofengland.co.uk/prudential-regulation/publication/2015/solvency2-the-quality-of-capital-instruments-ss