



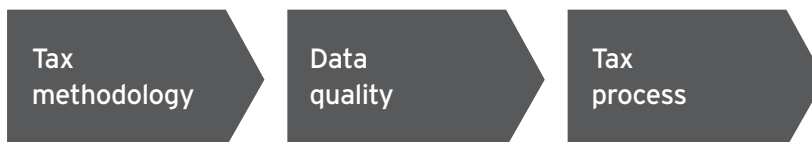
# Solvency II - Tax in Pillar I

## Executive summary

Insurers face many issues in interpreting the key principles of Solvency II, and Pillar I deals with the quantitative aspects of the regime. Tax can constitute a major component in the Pillar I calculations in relation to both the capital availability and capital requirements.

- ▶ In the economic balance sheet, which determines the available capital, deferred tax can be a significant balance sheet item. In QIS 5, the last full-scale quantitative impact study to be published, deferred tax assets comprised over 50% of Tier 3 capital.
- ▶ In the calculations of solvency capital requirements, both under the standard formulae and in the internal models, the adjustment for loss absorbency of deferred tax can be as much as 20% of required capital.

This paper reviews some of the challenges that insurers are now experiencing in dealing with the quantification of tax under Pillar I. These fall into three broad categories: tax methodology, data quality and the need for a fully integrated tax process.



### Methodology for tax in the Solvency II balance sheet

Currently in the market there are significant variations in methodology and approach in taking tax into account. There are complex issues on which detailed guidance or industry standards have yet to be established. As a result, insurance companies and groups have had to formulate their own approach.

### Availability and quality of information

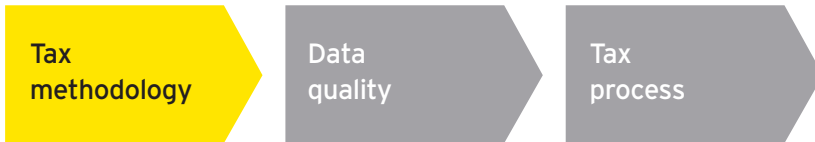
The timely provision of high-quality data will be critical to the accuracy of the Pillar I tax calculations.

The deferred tax numbers in the economic balance sheet need to be derived from the tax basis balance sheet. Typically, the IFRS balance sheet may be used as an interim step. Where IFRS balance sheets do not exist, this exercise presents a greater challenge.

Deferred tax recognition assumptions will need to be supported by profit forecasts which may not be produced as part of the Solvency II process.

### The process and structuring of the tax function

Tax departments are increasingly being drawn into Solvency II programs. The additional pressures on the function in terms of internal staffing and resource optimization for Solvency II could be significant.



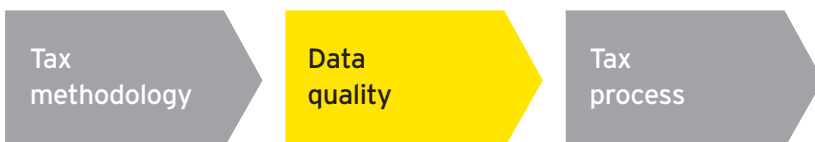
## Tax methodology

It is essential that the tax methodology is clearly thought out and documented, so that consistency and clarity is obtained across a group and appropriate principles can be incorporated into internal models and processes as they are developed. In many cases, the challenge is to attain a balance between technical accuracy and practical achievability. Companies and groups need to understand where any simplification of methodology could lead to actual misstatement of capital.

The tax methodology will need to address:

Item	Considerations	Issues
(1) Deferred tax asset (DTA) recognition	Use of IFRS principles Evidence of taxable profits emerging in a reasonable time frame	Use of judgment-based accounting principles (IAS 12) in a statistical formula or model Offsetting of DTAs and deferred tax liabilities where they are of the same nature and for the same fiscal authority What constitutes a reasonable time frame? What profit forecasts should be used to recognize DTAs? Avoidance of double counting when using profit margins to support DTA recognition
(2) Risk margin	Use of risk margin to support recognition of deferred taxes	Can the risk margin be used to support recognition of deferred taxes?
(3) Tax in best estimate liabilities	Consideration of taxes deducted from policyholders	Use of forecast cash tax cost due to fiscal authorities from the future or policyholder recharges?
(4) Loss absorbency of deferred tax	Computation of loss absorbency of deferred taxes	Recognition of DTAs in stressed scenario Availability of profit forecasts and new business models support recognition of DTA under stress Assumptions regarding effect of shocks on existing profit projections
(5) Diversification benefits	Allocation of diversification benefit in group solvency tests	Attribution of the diversification benefits calculated at group level to the solo entity level to determine applicable tax rate
(6) Group considerations	Group relief and tax integration	Integration of deferred taxes calculated at a solo entity level in different jurisdictions to produce a group solvency calculation

Our experience is that the tax methodology forms the basis of the code written by the model architect. The challenge here is accurately reflecting the methodology in the technical model build and making certain that the results obtained are in line with expectations.



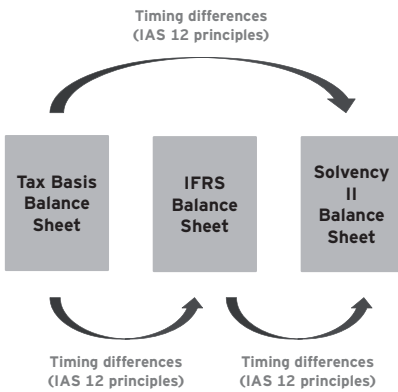
## Data quality

In order to calculate deferred tax within the Solvency II balance sheet, it is necessary to be able to accurately compute and calculate the differences between the tax value and economic value of assets and liabilities.

### Identification of tax basis balance sheet

The preparation of a tax basis balance sheet in each jurisdiction is the most reliable way of systematically quantifying these differences. This should not be a new requirement for those insurers who are already reporting under IFRS, but the added demands of Solvency II may put more pressure on the provision of high-quality tax balance sheet data.

The tax basis balance sheet may differ widely from the accounts basis, jurisdiction by jurisdiction, where the tax base is not IFRS. It can be difficult applying IFRS principles to a tax basis balance sheet that relies on regulatory or local GAAP. Further complications can arise from translating an IFRS balance sheet into the Solvency II balance sheet and measuring the timing differences between them.



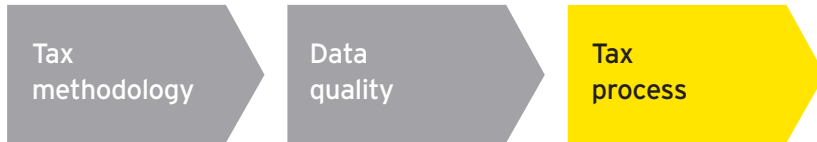
For groups operating in multiple jurisdictions with a mixture of branches and subsidiaries, this can be an even more arduous and complex task.

In practical terms, the accounting and tax systems used to calculate deferred tax should be able to produce results that meet Solvency II's reporting requirements as well as existing reporting requirements.

**Data to support deferred tax asset recognition**

DTAs arise, there is a requirement that insurers demonstrate that these will be recoverable in a reasonable time frame. Therefore, in addition to

the data needed to support calculation of the deferred tax balances, adequate data will be required for the recognition of DTAs. In order to avoid double counting of profits previously recognized on the balance sheet, but eliminated under stress, insurers may need to look to new business forecasts to support recognition of DTAs.



**Tax process**

To date, the level of tax department involvement in the Solvency II Pillar I projects has varied significantly. Often the Solvency II teams have asked tax departments for ad hoc support to develop methodology, tax assumptions in internal models and SCR calculations, and review model outputs. In other cases, fully integrated and staffed tax work streams sit within the Solvency II teams to make certain that tax is properly reflected in all aspects of the program. Either way, the burden on tax departments is increasing.

It seems likely that the process for quarterly and annual reporting under Solvency II will require tax department input on a regular basis, and will create the need for systems and processes which enable tax calculations to be performed and reported.

It will also be necessary to make certain that revisions to systems and processes for financial and regulatory reporting meet the needs of the tax department, and enable tax returns and reporting to be addressed.

A fully integrated tax process must be accepted by all departments involved in the reporting cycle. Furthermore, systems should be fully integrated and available to all departments, e.g., finance and actuarial, so that data flows seamlessly between teams.

**Conclusion**

There are many challenges to insurers in arriving at an accurate tax position under Solvency II. Insurers must determine the most viable method of measurement if they are to produce results to meet Solvency II's complex reporting requirements alongside their business as usual.

The most effective way to achieve results in this area is to make certain that tax teams are fully involved in the development of the Solvency II operating model. Addressing issues such as the quality of tax data now could result in a streamlined process in the future when the business will be under significant reporting pressure. Taking action at this stage to develop an appropriate tax methodology could create significant balance sheet value.

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