



Quantifying Risk, Enabling Opportunity.

SAM Phase II LACDT

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SAM Phase II

Role of LAC SAM Phase II Subcommittee

LACDT

- An overview of LACDT
- Why do we need an Information Note?
- General principles
- Allowance for tax rules
- Recoverability of post-stress DTA

SAM Phase II

SAM Phase II

The Prudential Authority launched a review of prudential regulation, referred to as SAM Phase II Process began late 2019 and is expected to be ongoing for a few years

Life insurance topics that the PA is looking at include:

- Iterative approach to the risk margin
- Stressing Life IBNRs
- LACDT
- Expenses
- Single equivalent scenario for UW risk
- Treatment of linked insurers

So far, the PA has published additional (draft) guidance on the first of these two topics

Role of LAC Subcommittee on SAM Phase II

Engagement with the PA

- Discussions with PA on certain matters
- Formal responses to draft guidance on behalf of profession
- Providing an actuarial view on the matters as opposed to an industry view

Subcommittee prepares additional information on certain SAM related topics

These are typically published as information notes (such as the LACDT note discussed today)

The subcommittee is also looking at SAM related matters not on the PA's list

For example, looking into the calibration of the retrenchment risk stress

LACDT Information Note

Objectives

What is LACDT?

Why do we need an Information Note?

General principles

Allowance for tax rules

Recoverability of post-stress DTA

LACDT without post-stress DTA

Reduce DTL when losses
are made
 $\Delta\text{DTL} = 28\% \text{ of } -500$

Deferred taxes allows
SCR to be “net of tax”

FSI 2.1 Section 4.4

FSI 4 Attachment 5

IFRS Balance Sheet

Investments	9 000
Current assets	1 000
DTA	0
Total assets	10 000
Technical provisions	8 000
Current liabilities	1 000
DTL	0
Total liabilities	9 000
IFRS Excess assets	1 000

SAM Balance Sheet

Investments	9 000
Current assets	1 000
DTA	0
Total assets	10 000
Technical provisions	7 000
Current liabilities	1 000
DTL	280
Total liabilities	8 820
SAM Own Funds	1 720

Stressed SAM Results

Investments	9 000
Current assets	1 000
DTA	0
Total assets	10 000
Technical provisions	7 500
Current liabilities	1 000
DTL	140
Total liabilities	8 640
Stressed Own Funds	1 360

-1 000

+280

+720

+500

-140

-360

LACDT with post-stress DTA

DTA says “future profits will not be taxed”

It implies future post-stress profits of $140 / 28\% = 500$

IFRS Balance Sheet

Investments	9 000
Current assets	1 000
DTA	0
Total assets	10 000
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Current liabilities	1 000
DTL	0
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IFRS Excess assets	1 000

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Stressed SAM Results

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Total liabilities	9 500
Stressed Own Funds	640

+140

+1 500

-280

-1 080

-1 000

+280

+720

Why an Information Note?

LACDT can reduce SCR significantly

- Complexity
- Judgement

IFRS Balance Sheet

Investments	9 000
Current assets	1 000
DTA Complexity	0
Total assets	10 000
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Total liabilities	9 000
IFRS Excess assets	1 000

SAM Balance Sheet

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Stressed SAM Results

Investments	9 000
Current assets	1 000
DTA Judgement	140
Total assets	10 140
Technical provisions	8 500
Current liabilities	1 000
DTL Complexity	0
Total liabilities	9 500
Stressed Own Funds	640

Background

An educational document, not formal guidance

Process followed

- Written by LAC SAM Phase II Subcommittee
- Approved by LAC
- Reviewed by Professional Matters Board
- Also on the PA's SAM Phase II list

Scope

- All members calculating or reviewing LACDT
- Some exclusions, e.g. internal models, foreign jurisdictions and cell captives

General principles

**Principle of
proportionality**



**Follow IFRS
requirements**



**Consistency across SAM
balance sheet, SCR and
projected profits**



**I-E tax in policyholder
funds is captured within
risk modules**

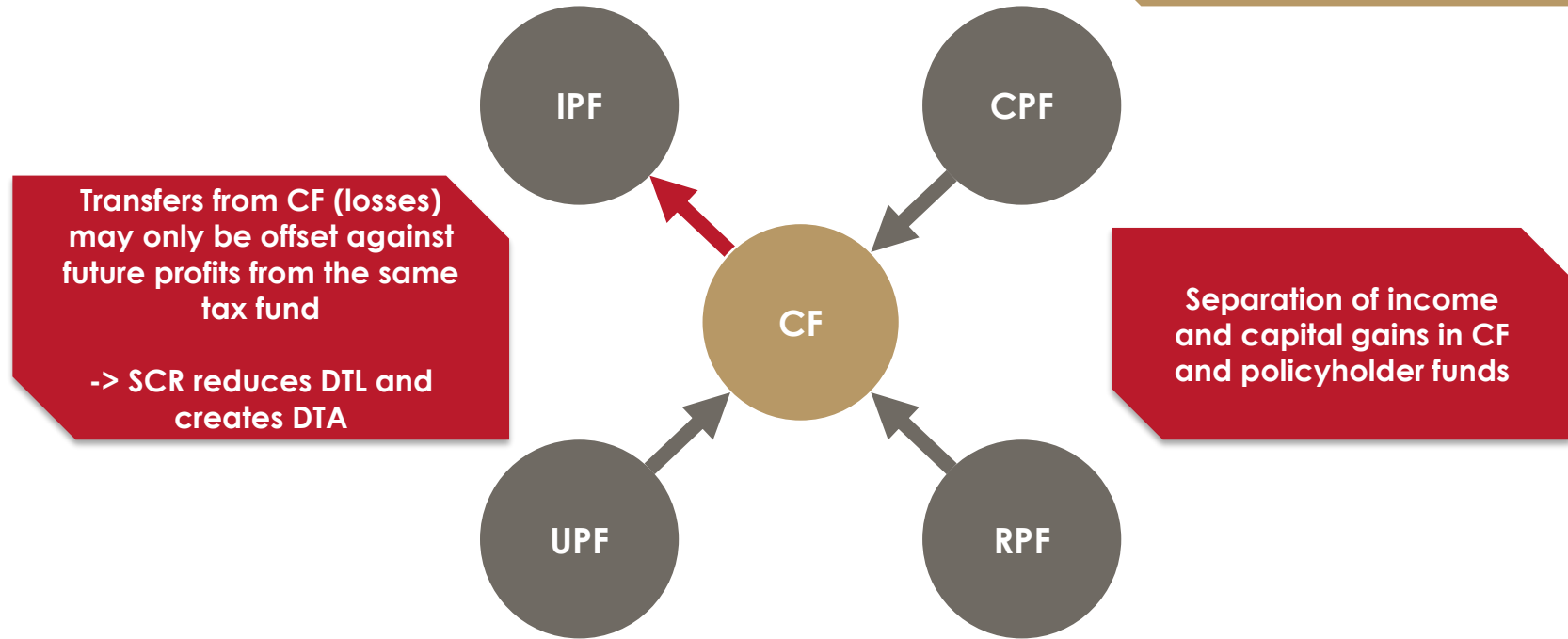
Allowance for tax rules



Complexity

Main tax rules

Information Note includes a summary of key tax rules, as well as illustrative examples



Deferred tax within the SCR (with DTA)

Tax rules affect every instance of DTA and DTL

IFRS Balance Sheet

Investments	9 000
Current assets	1 000
DTA Easy	0
Total assets	10 000
Technical provisions	8 000
Current liabilities	1 000
DTL Easy	0
Total liabilities	9 000
Excess assets	1 000

SAM (after deferred tax)

Investments	9 000
Current assets	1 000
DTA Easy	0
Total assets	10 000
Technical provisions	7 000
Current liabilities	1 000
DTL Easy	280
Total liabilities	8 820
Excess assets	1 720

SAM (after SCR stress)

Investments	9 000
Current assets	1 000
DTA Very complex	140
Total assets	10 140
Technical provisions	8 500
Current liabilities	1 000
DTL Complex	0
Total liabilities	9 500
Excess assets	640

+140

+1 500

-280

-1 080

-1 000

+280

-720

Key considerations relating to tax rules

Separate tax impacts by tax fund and tax type

FSI 4
Attachment 5
Section 4

**More generally,
consider all tax rules
that would apply
practically**

Simplifications and assumptions

- Identify all such items, implicit and explicit
- Documentation including limitations
- Appropriate controls and governance oversight
- Regularly assess appropriateness

Potential methodology for SCR disaggregation

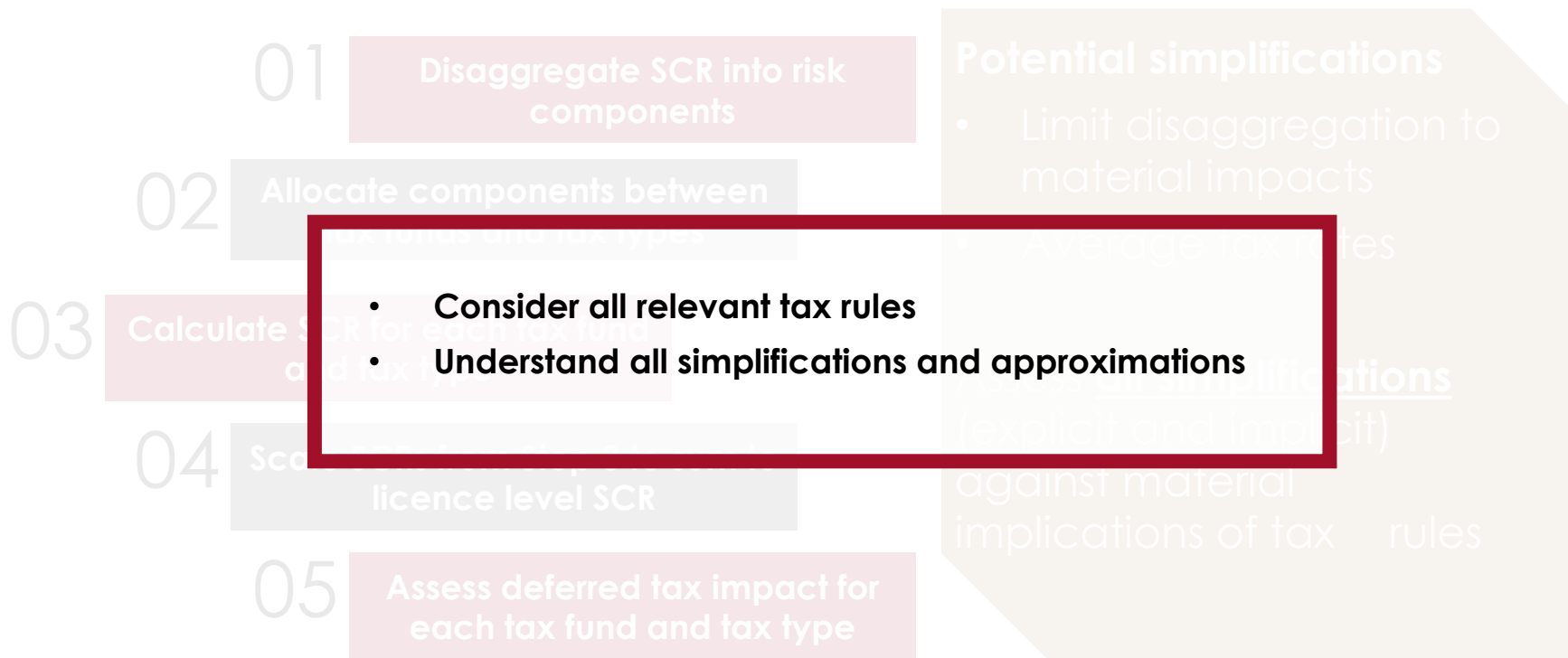
- 01 Disaggregate SCR into risk components
- 02 Allocate components between tax funds and tax types
- 03 Calculate SCR for each tax fund and tax type
- 04 Scale SCRs from Step 3 to sum to licence level SCR
- 05 Assess deferred tax impact for each tax fund and tax type

Potential simplifications

- Limit disaggregation to material impacts
- Average tax rates

Assess all simplifications (explicit and implicit) against material implications of tax rules

Potential methodology for SCR disaggregation



Recoverability of post-stress DTA



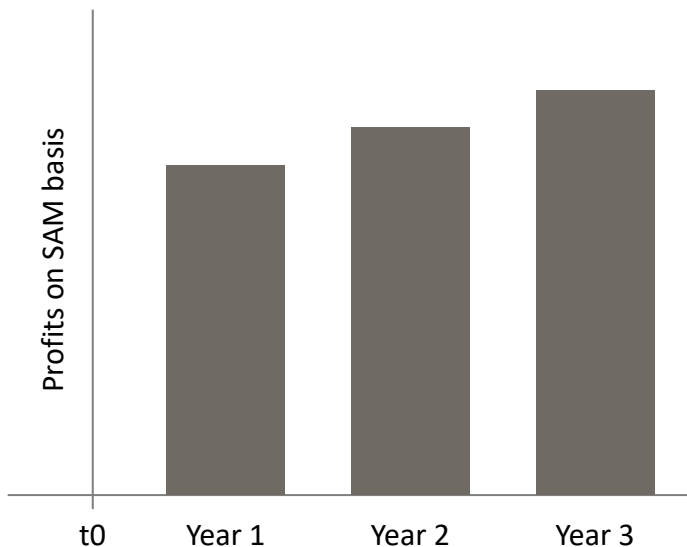
Judgement

Recoverability of post-stress DTA

- Are there sufficient post-stress profits to justify the DTA?
- Limited to three years profits on the SAM basis
- Not optional
- As simple as possible, but no simpler than that

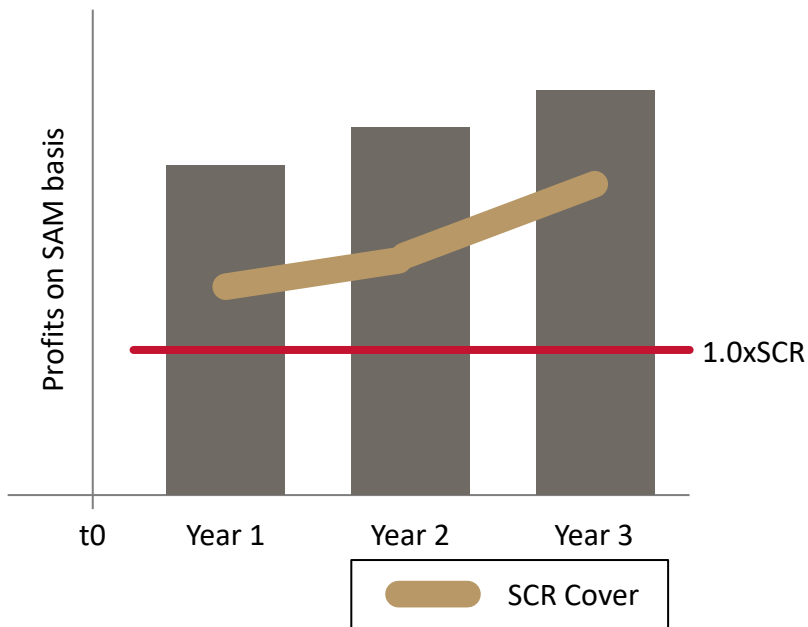
To the extent the calculation of *AdjDT* results in the raising of a deferred tax asset, the maximum amount which should be raised is that which can be recovered from the insurer's ensuing three years' profit (i.e. profits raised in the three years after the stressed event).

Step 1: Project best estimate profits



- Consistency with budget and ORSA
- Projected on **SAM basis**
- Sources of profit:
 - New business
 - Renewals of existing business (short boundaries)
 - Release of risk margin
 - Investment returns in excess of risk free for assets backing TPs
 - Investment return on “excess assets”

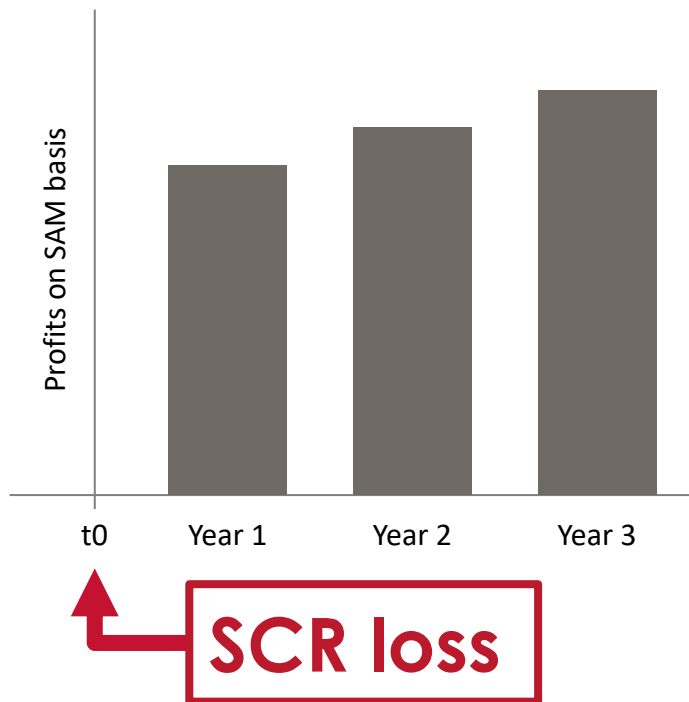
Step 2: Project best estimate balance sheet



Also project the balance sheet including MCR and SCR since it affects:

- Ability to write new business
- Regulatory intervention

Step 3: Calculate standard pre-LACDT SCR



FSIs define only the size of the loss, nothing else

Insurers must set the adjustment factor for the loss-absorbing capacity of deferred taxes ($AdjDT$) equal to 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:

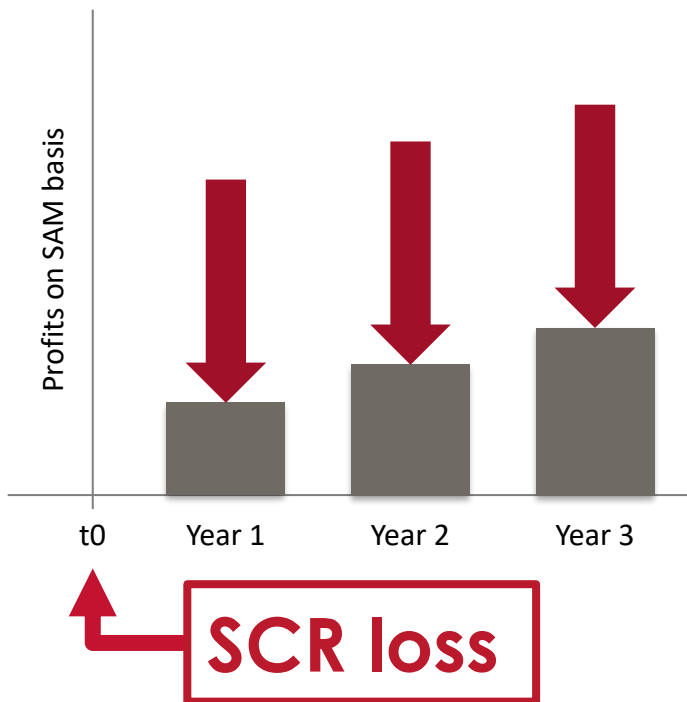
$$SCR_{shock} = BSCR + SCR_{Op} + SCR_{Part}$$

There's work to do: translate the loss into future profit impacts, i.e. **describe the loss**

Various **assumptions** required:

- Disaggregate into risk components
- Persistence of stresses
- Do asset values recover?
- Industry vs company vs economic

Step 5: Stress future profits



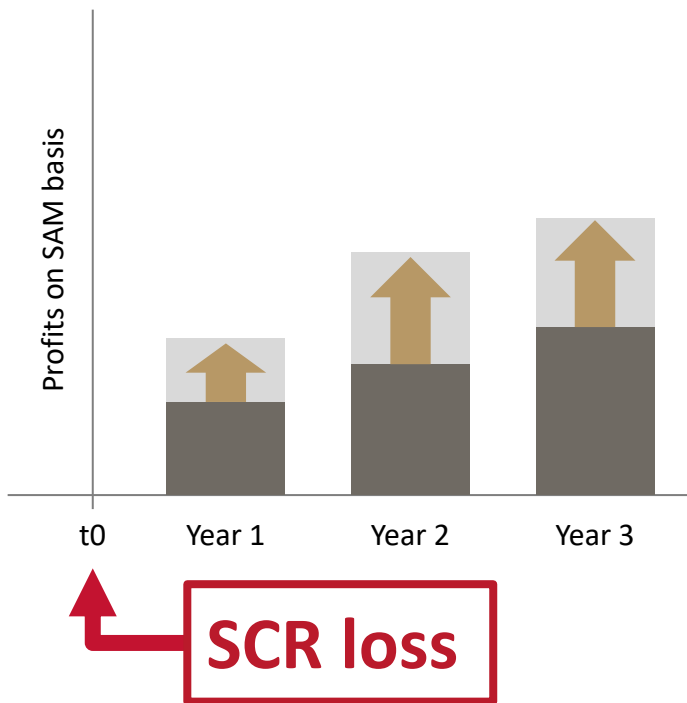
Sources of profit

- New business pricing, volumes and mix
- Renewal of existing business
- Release of risk margin
- Investment return in excess of risk-free
- Investment return on shareholder assets

Also consider:

- Consistency with ORSA stresses
- Could have less post-stress management action to reduce SCR
- Going concern
 - Regulatory intervention
 - Capital injections
- Actions by reinsurers
- Tax rules
- Other changes in operating environment

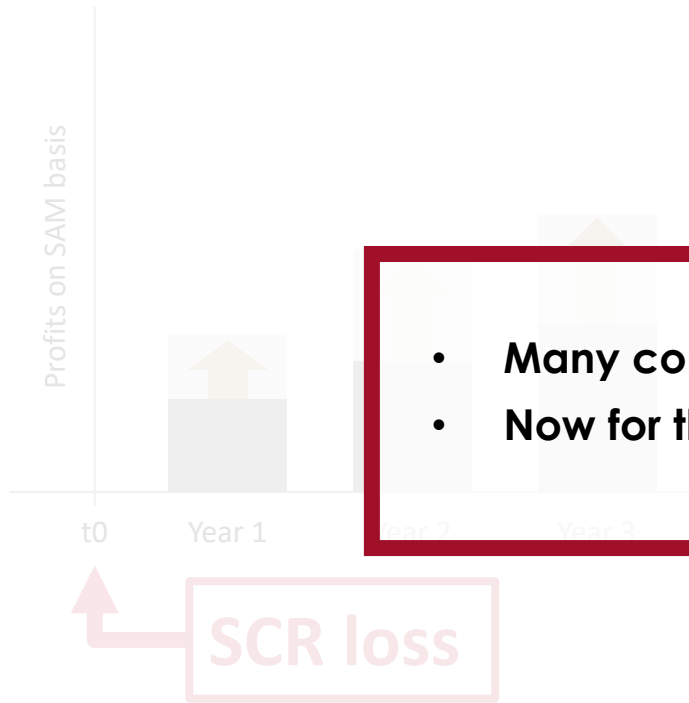
Step 6: Incorporate management actions



Impact of management actions

- Inherited from SCR and additional management actions, e.g. those relating to new business and renewals
- Could be a reliance on third parties, e.g. reinsurers and providers of capital
- All management actions subject to FSI requirements:
 - Governance approval
 - Realistic, objective and verifiable
 - Time and cost to implement

Step 6: Incorporate management actions



Impact of management actions

- Inherited from SCR and additional management actions, e.g. those relating to new business and renewals

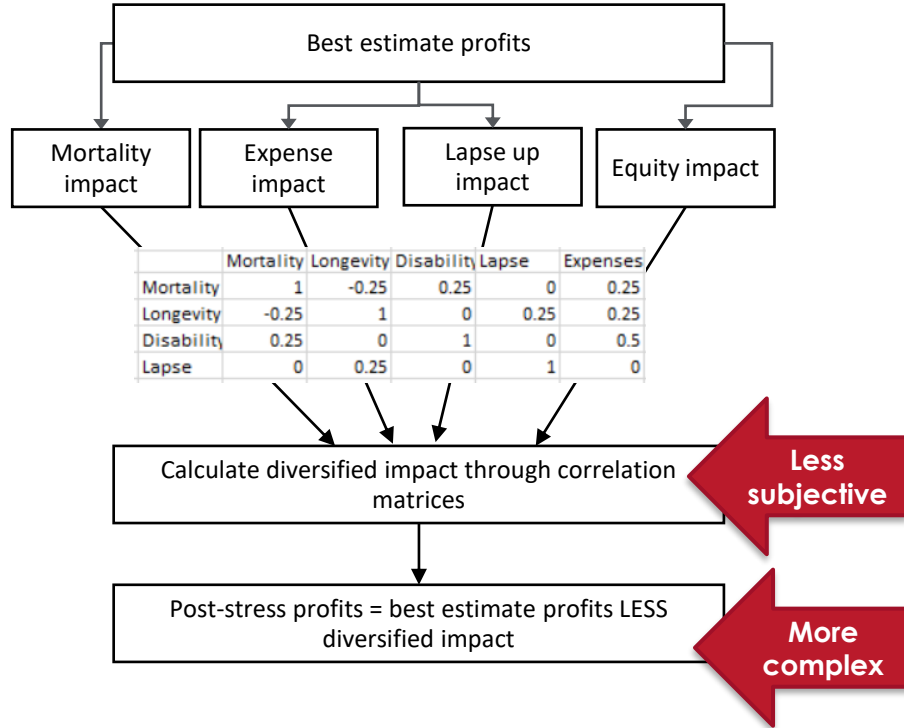
third parties, e.g. reinsurers and providers of capital

• All management actions subject to FSI requirements:

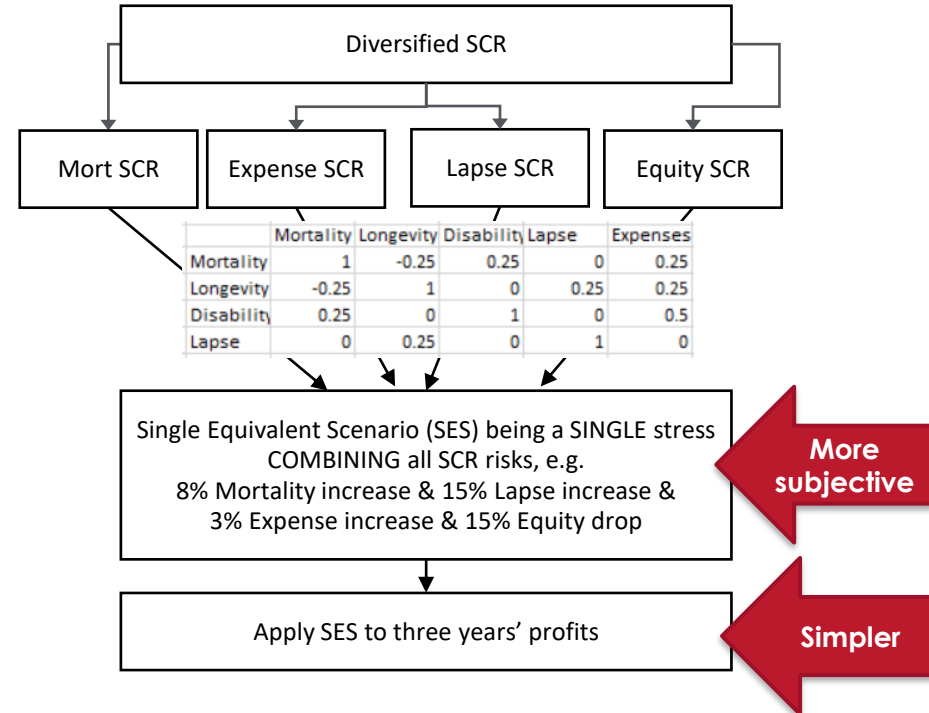
- Governance approval
- Realistic, objective and verifiable
- Time and cost to implement

Three potential modelling options

1. Correlation matrices



2. Single equivalent scenario



3. Judgemental overlay on budget: simplest, but most subjectivity required

The challenge of judgement



The solution to judgement – no silver bullet

Principle of proportionality

- **Identify** all factors <- refer to Information Note
- **Robust consideration** of all factors through research, workshops, extrapolation of past internal and external events
- **Detailed documentation**, especially of qualitative and judgement decisions
- **Robust controls** around changes
- **Approval by appropriate governance forums** (where deemed necessary)

In Summary

Consider general principles

Allowance for tax rules

- **Consider all applicable tax rules**
- **Understand all simplifications**

Recoverability of post-stress DTA

- **Identify, consider and document all factors**
- **Appropriate governance and controls**

Questions
