Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

2014

Withholding Tax – Guidance & Requirements

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1. Introduction

In November 2009 the Central Bank of Ireland ("the Central Bank") issued a letter to all life assurance companies that had opted into the Italian Withholding Tax regime. This set out guidance on the methods and discount rates that could be used to value the tax recoveries available in respect of that regime (the "tax asset"), as well as guidance on liquidity considerations, reserving for future prepayments and disclosures to the Central Bank.

In December 2012 new legislation, Italian Law n. 228 of 24 December 2012 (the so-called Legge di Stabilità or Stability Law), was passed to increase the prepayment rate to 0.45% p.a. (with a one off rate of 0.5% for 2012). A cap on the total amount of the prepayment of 2.5% of the fund value was also introduced with this cap reducing by 0.1% p.a. until it reaches 1.25%.

In April 2013 the Central Bank issued a survey requesting various details and asking for a number of stresses to be tested. The Central Bank has reviewed the responses to the survey as well as the annual disclosures that have been received. The review has highlighted:

- A variety of legal interpretations of how and when recoveries of the tax asset can be made;
- A variety of approaches and justifications to using the asset to back technical reserves; and
- Various considerations with regard to liquidity and the proportion of available assets coming from these tax recoveries.

The Central Bank's main concerns remain that:

- A prudent value is placed on the tax asset recoveries;
- Companies make provision for adequate recognition of the illiquid nature of the tax asset; and
- Companies make provision for adequate recognition of any concentration risk.

The Central Bank also wishes to ensure that companies adopt consistent practices, where appropriate, in relation to the tax asset held with a view to ensuring a level playing field.

2. Current Guidance and Solvency II

In addition to the guidance letter of November 2009, the Central Bank has issued other guidance which relates apply to the assessment of the value, liquidity and concentration risk of any asset, including a tax asset, and to which companies are expected to continue to have regard.

The "Guideline for Insurance Undertakings on Asset Management" notes that "the safekeeping and liquidity of assets are not explicitly addressed in the insurance regulations". In the guideline it is "considered preferable to adopt a broad approach and to provide overarching guidance for undertakings on asset management rather than address specific instances or examples." The guideline acknowledges that different amounts of liquidity and different practices in terms of controls may be appropriate depending on the size and structure of the undertaking and the nature of the business it conducts. It highlights that the current regulations "encourage a prudent spread of assets without imposing undue restraints" but it remains the responsibility of management to satisfy themselves and the Central Bank of the suitability of their assets.

Under Solvency II there will be no explicit limits on what assets can be invested in or on how those assets can be used. However all investments must be subject to the Prudent Person Principle (Article 132 of the Solvency II Directive). The "Central Bank of Ireland Guidelines on Preparing for Solvency II – Systems of Governance" expands on this (Guidelines 22 to 27) and provides that an Investment Risk Management Policy (Guideline 20) and a Liquidity Risk Management Policy (Guideline 21) should form part of a company's Risk Management Policy. Particular points to be considered in those policies include:

- The level of security, quality, liquidity, profitability and availability the undertaking is aiming for with regard to the whole portfolio of assets and how it plans to achieve this;
- Its quantitative limits on assets and exposures, including off-balance sheet exposures, that are to be established to help the undertaking achieve its desired level of security, quality, liquidity, profitability and availability for the portfolio;
- Consideration of total liquidity needs in the short and medium term including an appropriate liquidity buffer to guard against a liquidity shortfall; and
- Consideration of the level and monitoring of liquid assets, including a quantification of potential costs or financial losses arising from an enforced realisation.

3. Changes to Guidance

The Central Bank is imposing the requirements set out in section 4 of this paper for the purpose of introducing:

- Requirements relating to the manner in which the tax asset is valued and how the tax asset can be used to cover the technical reserves and the required minimum solvency margin[1];
- A requirement for companies to establish and maintain a Liquidity Policy;
- A requirement for companies to specifically address the illiquid nature of the tax asset and potential concentration risk in using that asset in the Risk Appetite Statement and the Liquidity Policy; and
- A requirement for companies to report additional information to the Central Bank.

The guidance issued in the November 2009 letter has been incorporated into this paper and companies are now required to comply with the relevant provisions set out herein.

The Central Bank also provides guidance in section 5 of this paper as to how the Central Bank expects companies to take the tax asset into consideration in their preparation for Solvency II. Companies are expected to demonstrate within their Forward Looking Assessment of Own Risks, prepared in accordance with the "Central Bank of Ireland Guidelines on Preparing for Solvency II", that they have sufficient liquidity to cover stressed situations.

3.1 Legal Basis

Companies are required to give an undertaking to the Central Bank under section 24(1) of the Insurance Act 1989 that they will comply with the requirements set out in section 4 of this paper, as a condition of their authorisation.

[1] "Required minimum solvency margin" has the meaning given to that term in Article 2 of the European Communities (Life Assurance) Framework Regulations 1994 - "means the greater of the appropriate required solvency margin and the amount of the appropriate minimum guarantee fund and "required Community minimum solvency margin" and "required Irish minimum solvency margin" shall be construed accordingly.

4. Updated Requirements

4.1 Overall Requirements on Expected Recoveries

For the purpose of meeting technical provisions or their required minimum solvency margin, companies may take account of the value of expected recoveries of the tax asset, subject to the restrictions detailed below, provided it is reasonable for them to expect that value on a prudent basis.

- The value taken must not exceed the maximum value as set out in the requirements below;
- The value taken must not cause breach of the requirements on liquidity as set out below;
- The company must comply with requirements on disclosure as set out below.

4.2 Maximum Values to be taken on Expected Recoveries

The maximum value that can be placed on the expected recoveries should be obtained by discounting at an appropriate rate of interest to the expected date of recovery.

The expected date of recovery is the date on which the company, on prudent assumptions, expects to receive value for the recovery. The method and date of recovery should be consistent with the Liquidity Policy (see section 4.5) and the Risk Appetite Statement.

The appropriate rates of interest and the expected date of recovery may vary according to the expected source of recovery. The requirements set out in subparagraphs A – D must be complied with in respect of those expected sources of recovery:

A. Deductions made from payments to Policyholders

If the expected source of recovery is through deductions made from payments to policyholders:

a. The minimum rate of discount should reflect the expected return on policyholder assets as used in the cash reserve calculations (e.g. the return on the unit linked assets if it is a unit linked policy);

b. The expected date of recovery should be based on the maturity date of the policy and allow for recovery at that date. Lapsation may be taken into account but this must be on a prudent basis.

B. Relief against Other Group Tax

If the expected source of recovery is through relief on other taxation liabilities of the group to which the company belongs, then there must be a binding agreement within the group that there will be a payment to the company for surrender of such relief. Due regard should be given to the size of the total group withholding tax recoveries relative to the group tax payable to the Tax Authority. The value taken must be based on the expected payment and:

a. The minimum rate of discount should reflect the market interest rate that would be required by the market on loans issued by the group of that duration (determined by reference to actual loan stock or by reference to loan stock of similar entities of the same credit rating);

b. The expected date of recovery must reflect the date on which cash is expected to be received.

C. Recovery from the Sovereign Tax Authorities

If the expected source of recovery is through recovery from the sovereign tax authorities then:

a. The rate of discount should reflect the market interest rate on Government stock of appropriate duration;

b. The expected date of recovery should be increased by two years from the date at which recovery would be theoretically possible to reflect administrative delays unless the company has actual experience of achieving such recoveries in which case the date should be based on experience.

D. Recovery from Future Advanced Payments

As recovery from future advanced payments are the replacement of one possible recovery by another, value should not be taken through this route unless the company can demonstrate recovery of cash via this method. If value is taken through this route then full justification for its use should be given as part of the annual disclosure set out below.

4.3 Requirement for a Liability for Future Payments

The impact of future tax payments and their recovery should be taken into account in cash flow projections undertaken by the Appointed Actuary for the purposes of valuation. It is possible to do this in a number of ways and it is not intended to specify the method. However whatever method is used the discount rate and timing of recovery should be consistent with those adopted to value the tax asset. For purposes of completing regulatory returns it should be noted that no new business and no lapses are normally assumed, however, if assuming a lapse rates leads to higher reserves then a prudent lapse should be allowed for.

4.4 Specific Restrictions on How the Asset is Used

Where the asset is relied on extensively to cover a company's technical provisions and solvency margin requirements this raises issues over that company's liquidity profile and concentration risk. Companies are now required (as a minimum):

- To only use the tax asset to cover that part of its technical provisions which provide for future prepayments of the tax (excluding those due within 12 months). The tax asset may not be used to cover technical provisions for individual policies (e.g. mortality and expense reserves), general portfolio level provision reserves (e.g. for closed fund expenses and resilience) or tax prepayments due within twelve months; and

- To restrict the asset to only contribute to available assets in excess of the first 100% of the Required Minimum Solvency Margin.

More prudent approaches must be considered by companies and full justification of the approach adopted should be set out in the Liquidity Policy.

4.5 Requirements for a Liquidity Policy

Companies are required to establish and maintain a liquidity policy ("Liquidity Policy"). Tax recoveries are not a liquid asset therefore companies are required to consider the illiquid nature of the tax asset, and the potential concentration risk that the asset gives rise to, as part of their assessment of the wider liquidity needs of the company. That assessment must be included in the Liquidity Policy. The Liquidity Policy shall also address how and when the company expects to make the tax asset liquid and any measures that may be available to the company to realise that asset in times of stress. If the company assumes that it can transfer the asset within the group or makes use of other lines of credit, it must demonstrate how these liquidity channels will be available in times of stress.

The Liquidity Policy should include an assessment of the extent to which it is appropriate that the tax asset backs technical provisions and the available solvency margin and if further restrictions in addition to the minima set out above are appropriate. This should consider the term of the asset and any liabilities it is used to back, as well as the appropriate term for assets backing the available solvency margin. This assessment should be set out in the Liquidity Policy in the context of the overall liquidity requirements of the company and the nature of the other assets held by the company for these purposes.

4.6 Risk Appetite Statement

Companies are required to address in their Risk Appetite Statement the illiquid nature of the tax asset and potential concentration risk that that asset provides. The Risk Appetite Statement needs to be approved by the board of directors of a company in accordance with the Corporate Governance Code for Credit Institutions and Insurance Undertakings.

Any limits set out in the Risk Appetite Statement should be informed by the Forward Looking Assessment of Own Risks and be reviewed and updated on a regular basis.

4.7 Requirements for Disclosure

Unless no value is being taken for expected recoveries, full disclosure of the treatment and value taken must be made with the annual returns. This does not form part of the formal returns; it does not need to be formally audited (though auditors should be given copies) and does not form part of the

publically disclosed documents. Quarterly disclosure to the Central Bank is only necessary where the treatment has changed since the last disclosure. The disclosure should have multiple parts.

a. A summarised balance sheet identifying: liquid assets; the tax asset; the liability for future tax payments and separately any payments due within twelve months; available assets; the Required Minimum Solvency Margin, and solvency coverage. The available assets and solvency coverage should also be shown excluding the tax asset and the liability for future payments;

b. For each company accounting year since payments commenced a table showing: the amounts paid to the tax authorities in that year; the amounts already recovered (split by method of recovery); amounts remaining to be recovered; and expected value of those recoveries. A separate table summarising the position of all years together should also be shown;

c. The amount of exit tax that would be recoverable from policyholders should all affected policies lapse immediately;

d. Explanation of the method of calculation of expected value of recoveries (i.e. A, B, or C above or a combination of those methods);

e. The interest rate (or rates) used in discounting and the expected date of recovery;

f. If method B is adopted then such information as is relevant to establishing the likelihood that such recovery will be made in practice; the nature of the guarantee and details of any historic payments that might indicate that the guarantee had been called upon. In addition if the guarantee is predicated on there being other group taxes to be set against then details of tax payments by the group that would indicate the likelihood of the tax advance being recoverable; and

g. Descriptions of the approach used to calculate the liability for future tax payments, together with the projected cash flows used in the calculation.

No disclosure is necessary from companies not affected by this issue.

5. Guidance on Forward Looking Assessment of Own Risks

The "Central Bank of Ireland Guidelines on Preparing for Solvency II – Forward Looking Assessment of Own Risks" ("the Guideline") sets out that the first Forward Looking Assessment of Own Risks should be carried out by all insurance undertakings during 2014. Whilst the Guideline refers to an assessment of the overall solvency needs of the undertaking those companies holding a Withholding Tax Asset should consider the impact that this asset has on their liquidity and the potential impact on their solvency needs.

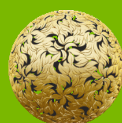
It should be noted that the Guideline sets out the need for material risks to be subject to a sufficiently wide range of stress tests or scenario tests in order to provide an adequate basis for the assessment of the overall solvency needs of a company. These should be sufficiently broad as to ensure that the board of directors of a company is fully informed of all the risks associated with making the prepayments and holding the resulting asset. As a minimum these tests should cover variations in the following assumptions, individually and combined, consistent with a Solvency II standard:

i. Future investment conditions;
ii. Levels of new business, where this is being written;
iii. Expenses;
iv. Exercising of options by policyholders;
v. Persistency; and
vi. Taxation.

The projections should be consistent with recovery methods set out in the Liquidity Policy and highlight situations under which the Risk Appetite Statement limits are breached. Actions to be taken when these limits are breached should be documented.

When Solvency II is fully implemented the Forward Looking Assessment of Own Risks will be superseded by the 'Own Risk and Solvency Assessment' and similar considerations will continue to apply.

T +353 1 224 4000 **F** +353 1 894 4631 www.centralbank.ie insurance@centralbank.ie



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Bosca PO 11517, Duga Spencer, Baile Átha Cliath 1, Éire
PO. Box No 11517, Spencer Dock, Dublin 1, Ireland