Hot Topics

Technical Provisions & Capital Requirements

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Milliman Breakfast Briefing
6 October 2015

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Hot Topics

- Deferred Tax
- Contract boundaries
- Other Issues

Deferred Tax and Solvency II

Arises in a number of ways:

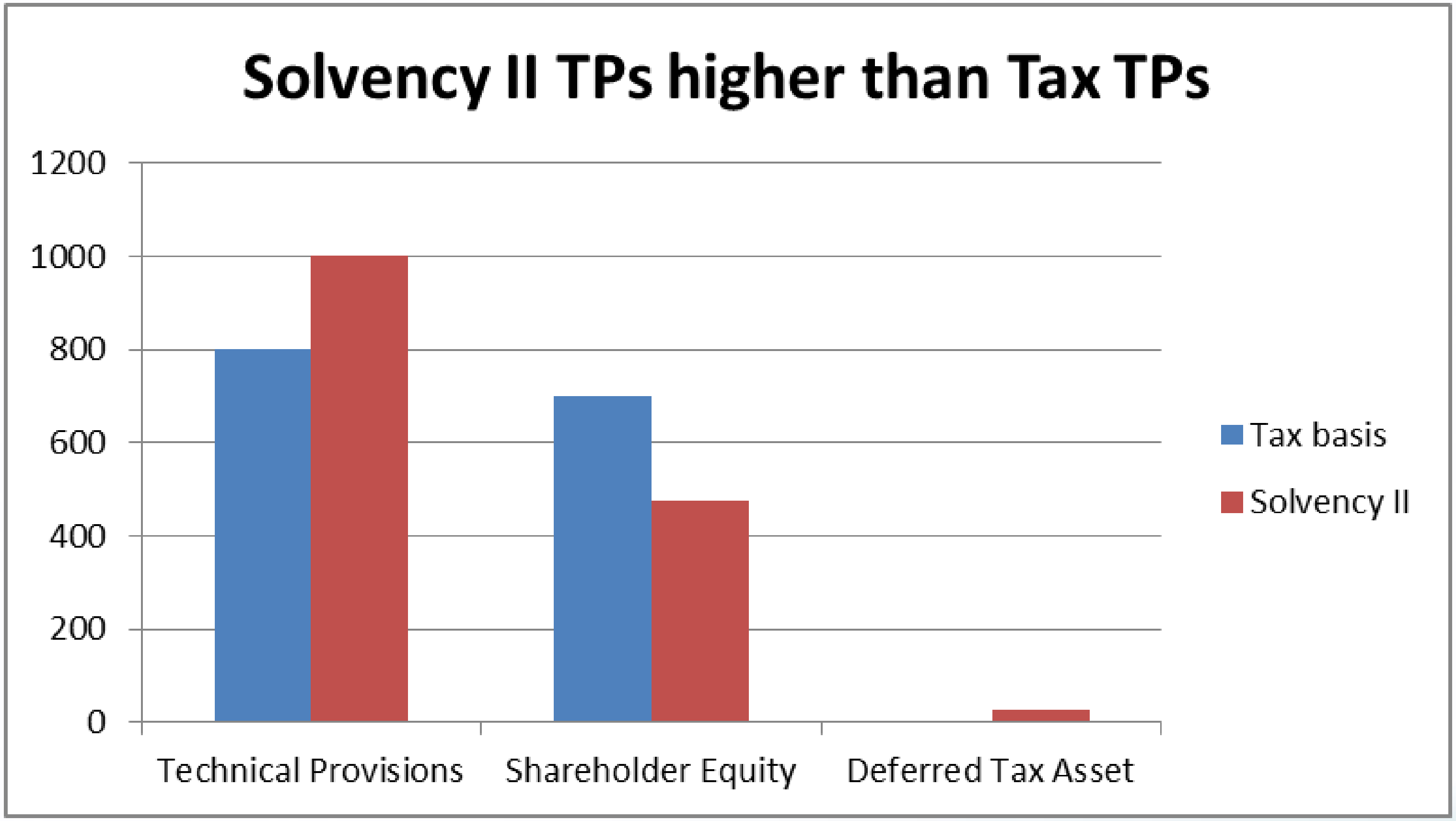
1. Existing DTA or DTL on tax balance sheet
2. Deferred tax arising from move to SII balance sheet
3. Loss absorbing capacity of deferred taxes

Move from tax to SII balance sheet

- SII own funds greater than own funds on tax balance sheet
  - Example of company with strong future profits and negative BEL
  - Tax basis might not allow negative liabilities
  - SII embeds future profits in balance sheet
  - DTL arises associated with future profits

- Converse position also possible
  - Example of tax basis not recognising full value of guarantees
  - SII places a higher value on the liability
  - Corresponding fall in own funds
  - Potential to establish a DTA

Move from tax to SII balance sheet



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Loss absorbing capacity of deferred tax

- 1 in 200 scenario results in lower level of own funds
- This reduction could be partly offset by tax
- Relatively straight-forward if DTL on balance sheet
- If DTA on balance sheet need to consider whether what level can be supported

Regulations

Establish DTA if **probable** future profit will be available

- Uncertainty increases when going beyond normal planning cycle
- Need to consider profit in the 1 in 200 scenario

Potential sources of additional profits

- Where loss absorbing capacity requires creation of DTA
- Solvency II balance sheet already reflects losses on existing business
- Potential sources of profits to justify loss absorbing capacity?
  – New business
  – Income from surplus assets
  – Group relief potentially
  – Solvency II not fully economic – e.g. contract boundaries
  – Run-off of risk margin?

Regulations

- Perform calculation at sufficiently granular level
  - Different countries / tax rates / sources of profits / time periods
- Avoid double counting
  - Can't use same profits to support existing DTA & loss absorbing capacity
- Documentation
  - Sources and assumptions

Contract Boundaries

- The point beyond which future premiums are considered new business

- It is not the projection period

  – projection period should include all cashflows in respect of premiums paid before the contract boundary

Contract Boundaries

- Future premiums are not part of the existing contract if:

  1. unilateral right to terminate the contract or
  2. unilateral right to reject premiums payable or
  3. unilateral right to amend premiums or benefits payable in such a way that the premiums fully reflect the risks

- Also need to consider unbundling

- Debate around discernible impact on economics

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Contract Boundaries

- Including future premiums can result in higher own funds
- Often results in lower solvency coverage ratio
  - Capital requirement also increases
- Focus on solvency coverage ratios
  - Some companies happy to exclude future premiums
- Other companies want to include future premiums
  - making arguments to support position

Other Issues – Ring-Fenced Funds

- Ring-fenced funds
  - E.g. with profits fund
  - excess own-funds within RFF can't be used to meet SCR of other funds

- Situations that share some elements of RFF but not all
  - Funds withheld
  - Assets pledged as collateral
  - Should you get full diversification benefit?

- No definitive answer
  - Case by case consideration
  - ORSA should consider treatment and risks

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Other Issues – DB Pension Schemes

Issues can be somewhat similar to ring-fenced funds

- Calculation of capital requirements
- Claiming full diversification benefit?
- Are management actions assumed realistic?
- ORSA should consider treatment

Other Issues – Risk Margin

Consideration of hedgeable risks

- Shouldn’t just assume all market risk is hedgeable
- What types of market risks is the company exposed to?
- What if not able to fully look-through?
- Counterparty risk sometimes excluded
- Documentation of assumptions

Other Issues – Expense allocations

Lots of issues in relation to expense allocation

- Market value of liabilities versus own expenses
- Especially for companies closed to new business
  – Assumption that companies will write new business
- Can result in need for additional capital in future
  – TPs not sufficient to meet expenses

Other Issues

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Summary

- Numerous issues emerging

- Companies need to consider approach to debatable issues
  - Consider position relative to wider industry
  - Consider alternative treatments and impact on capital
  - Group view

- Sometimes not obvious where a position is being taken
  - Issue for Boards to consider