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Insurers face challenges on management actions

Management actions are currently a hot topic for many insurers across Europe. Many companies are concerned to secure credit in the best estimate and SCR for their proposed management actions, as Elliot Varnell, Jeremy Kent, Russell Ward, Russell Osman and Andrew Gilchrist explain

Key points

THE CURRENT DRAFT Solvency II requirements on management actions are challenging – even for those firms used to taking credit for such actions. Many companies are therefore concerned to ensure they can claim credit in the best estimate and solvency capital requirement for their proposed management actions.

- With-profits firms have to balance the Solvency II requirements with a need to maintain flexibility in their responses in stressed scenarios. UK with-profits firms also need to consider conduct of business constraints in assessing the credit that can be claimed under Solvency II.
- Participating business in the European life sector generally includes fewer explicit management actions but such actions can arise implicitly through the targeting of credited rates.
- Finally, hedging can be seen as a management action, depending on the context, and specific considerations need to be accounted for when looking to take balance sheet credit from

In some countries and sectors, the concept of using management actions to reduce technical provisions and capital charges is a new one; in others, the issue is how credit previously taken for management actions can be carried over into the Solvency II regime.

Management actions can impact the Solvency II balance sheet in two areas: the best estimate liability ("best estimate") element of the technical provisions; and the solvency capital requirement (SCR) and consequently the impact on the risk margin element of the technical provisions. This article focuses mainly on the best estimate, but the final section examines how the management actions can also affect the SCR.

WHAT ARE MANAGEMENT ACTIONS?

Management actions are actions (i.e. decisions) that are available to the management (the board and delegated authorities) of an insurer. These actions would usually serve to reduce, but could sometimes increase, the value of the company's best estimate. The reduction could be effected directly, through reducing direct cash-flows to policyholders (or other cash-flow recipients), or indirectly by lowering cash-flow volatility and, therefore, reducing that element of the best estimate relating to the time value of money.

Examples of direct management actions might include:

- Profit sharing – e.g. adjusting the discretionary benefits to policyholders to reflect experience.
- Charges – e.g. changes in unit-linked expense charges or charges for guarantees.
- Managing expense levels – e.g. closure to new business or future pension promises to staff in stress scenarios.

Examples of indirect management actions might include:

- Investment strategy
  - Reduction in the riskiness of asset mix underlying guaranteed or unit-linked products.
- Risk management/hedging strategy
  - Reduction in the cash-flow volatility through the use of hedging instruments such as futures, swaps and options.
- Reinsurance strategy

– Reduction in the cash-flow volatility by sharing risk with reinsurers (e.g. uncertainty due to longevity).

SOLVENCY II REQUIREMENTS

Regulators might be concerned about the expert judgement embedded in management actions, and whether the modelled actions would actually be taken if the corresponding trigger points are reached.

In order to ensure that the assumptions about future management actions are determined as objectively as possible, Solvency II requires that insurers should "establish a comprehensive future management actions plan" approved by the board [1].

This plan should cover the identification of relevant future management actions, the specific circumstances in which they would be carried out, and those circumstances in which it might not be possible to carry them out.

The plan should also note the order in which the actions would be carried out, any governance requirements applicable, and any work required to ensure that the insurer is in a position to perform these actions.

These requirements constitute a key foundation of the risk management and governance of an insurance company, and are an important link between Pillars I and II of Solvency II.

Solvency II also requires that the management actions be realistic and consistent with an insurer's current business practice and strategy, and take into account the time needed and the expenses incurred in their implementation.

It could be concluded that the effect of such a plan is to remove the amount of discretion available in the management of the insurer, by "codifying" certain triggers and responses. While this may allow credit to be taken in calculations of the best estimate, it may also act to restrict the ability of the insurer's management to act appropriately in stressed market conditions.

Insurers might therefore choose to deviate from a management action plan. Such a deviation is allowed under current draft Solvency II requirements, provided that the reasons are documented and included in the management action plan. Where the insurer acts differently to the plan, it would be appropriate to review the plan to see if it needs updating.

MANAGEMENT ACTIONS IN UK WITH-PROFITS

Allowance for management actions in the calculation of technical provisions has been used in the UK since 2004 for firms with large with-profits (participating) books of business. Typical actions modelled for realistic reporting purposes are: changes to the proportion of assets held in investments where capital is at risk; changes to future bonus rates; and reductions in the degree of smoothing applied to policy payouts.

Under the current UK regime, the board of the insurer is required to sign off that the management actions used in the calculation of the technical provisions are a reasonable set of actions that it might take under the various scenarios.

For management actions to be allowable under Solvency II, they must be consistent with current business practice. Typical management actions in a UK with-profits fund are those highlighted above but, in stressed conditions, could also include increasing guarantee charges, the sale of blocks of business, or putting the insurer into run-off.

One aspect of modelled management actions that needs consideration for UK with-profits business is whether the actions conform to insurers' obligations in respect of treating customers fairly. The UK Conduct of Business regulation for with-profits funds requires that policyholders should not be unfairly affected by management actions.

The board makes the assessment of management actions but will seek the views of the with-profits actuary and the person or body tasked with providing an independent view of the exercising of discretion, such as a with-profits committee [2].

MODELLING MANAGEMENT ACTIONS

In order to take credit for management actions, the actions need to be reflected in the model used to calculate the best estimate. This can be challenging where actions depend on the solvency of the insurer, creating a circular logic in the calculations which need sophisticated techniques to solve or model simplifications to remove the circularity.

There may be a number of actions available and the action, or actions, taken will depend upon the circumstances applying at the time. Some modelled management actions may not be undertaken in circumstances where the model assumes they will be taken. In this case, the board will need to consider whether it remains appropriate to take credit for that action and regulators may well seek justification from firms wishing to continue to take credit for such actions.

There may also be some non-modelled actions which will be available to the insurer in adverse circumstances. For example, a mutual insurer will need to reduce, or remove, discretionary policyholder benefits in significantly adverse circumstances to meet minimum benefits guaranteed to all policyholders. If the mutual is currently well capitalised, then it is unlikely to be modelling such an action, because the consequential reduction in liabilities and capital would be small. That is, the implicit margin included in the reserves by not modelling that action would be small. However, if capital becomes constrained, then the implicit margin would increase and it is likely the model would be enhanced to include that action.

MANAGEMENT ACTIONS IN EUROPEAN PARTICIPATING BUSINESS

In many continental European countries, crediting rates on participating business are determined primarily according to defined formulae based on book value returns. In these cases, there is little or no explicit discretion in setting bonus rates, which might fall under the category of management actions. However, insurers can manage the timing of realisation of gains and losses, in order to control book value returns and therefore target a particular crediting rate.

Such investment strategies constitute a form of management action and some insurers are explicitly including them in their models. In general, investment strategies are important drivers of crediting rates and, where they are modelled, they can affect the calculation of the best estimate.

In the context of continental European participating business, many insurers have not yet developed fully dynamic asset-liability models for Solvency II or other purposes, although significant progress has been made in the last few years. For those insurers that are using dynamic asset-liability models, the future investment strategies (i.e. buying and selling of assets) need to be modelled.

In many cases, modelled investment strategies are quite simplistic. For example, they may not vary according to scenario (e.g. a modelled "buy" strategy which always purchases government bonds of a particular duration, regardless of economic conditions).

However, some insurers are using more sophisticated investment strategies in their models, such as targeting a proportion of "risky" assets (e.g. equities), which can vary according to a projected solvency ratio.

Many insurers writing European participating business therefore face the twin challenges of continuing to develop management actions in their models, together with explaining and justifying these in order to take advantage of them in their liability valuation.

HEDGING TO REDUCE THE SCR

Under the draft Solvency II requirements, management actions can also be used to reduce the SCR in addition to the best estimate.

The current draft Solvency II rules relating to SCR-related management actions are similar in wording to those already considered in relation to the calculation of the best estimate.

These rules set out the requirements that companies must comply with in order to take credit for management actions under both the standard formula SCR calculation and an internal model approach. Below, we consider the potential implications of the requirements for dynamic hedging programmes, a cornerstone of many financial risk mitigation strategies.

The first challenge arises before the rules themselves are even considered: When does a continuing risk mitigation programme, such as a dynamic hedge, constitute a future management action?

We consider two situations:

- Continued execution of an existing formal hedging programme
  - Consider a case where the insurer's management set up a hedging programme. It is up and running at the balance sheet date, addressing defined risks on defined blocks of business and employing a specified set of financial instruments to manage the risks to explicitly defined tolerances. The design and parameterisation of the hedging programme is therefore approved by the board.
  - This could be interpreted as the continuing execution of a past management decision and, hence, the Solvency II rules on future management actions should not apply.

> "In many cases, modelled investment strategies are quite simplistic. For example, they may not vary according to scenario"

- Dynamic adjustment of an existing hedging programme
  - Consider an internal model that has made allowance for actions to extend an existing hedging programme under certain market conditions. Such changes might relate to the risks hedged, instruments used, or the thresholds applied for rebalancing. The design and parameterisation, however, needs to be revisited by the board in the event of changing the hedging programme.
  - This approach embodies management decisions yet to be taken and the Solvency II rules on future management actions could therefore be assumed to apply.

If the draft Solvency II requirements for future management actions do apply, then there are a number of areas to be carefully considered, including:

- Defining the precise circumstances which would trigger the hedge to be amended and being able to justify that the changes proposed could realistically be implemented in those circumstances.
  - This is an area where independent back-testing of the hedging approach through relevant market scenarios can provide support to the documented strategy.
- Validating that any changes to the hedging programme do not raise conflicts with obligations to, or communications with, policyholders - this is especially relevant for UK with-profits business as discussed.
- Leveraging practical experience of implementing a hedge to ensure suitable allowance is made for the lead time and costs required to execute changes.
  - Significant lead times can result in dilution of the capital benefits of the strategy. However, lead times can be significantly reduced by completing preparatory work, such as detailed hedge design and mock testing in advance, enabling changes to a programme be made live quickly, subject to there being a tradeable market available.
- Demonstrating the incremental impact of hedge refinements.
  - The preparatory stage of work referred to above can also be used to address this requirement and, combined with independent back-testing and forward looking stochastic stress testing, could provide the required validation of the reasonableness of the capital credit being taken.

[1] Under initial CEIOPS advice for Solvency II the main concepts underlying a management actions plan were objectivity, realism and verifiability. The drafting is a little different now but can still be thought of in the same terms.

[2] In the UK insurers are required to publish Principles and Practices of Financial Management (PPFM) for their with-profits funds. The PPFM describes how a fund is managed and how the board exercises the discretion available to it in running the fund.

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