Management actions: An effective capital management solution

Milliman

Introduction

When it comes to optimising the use of capital under Solvency II, there is a wide and varied tool kit of available options. These options range from both traditional and innovative new reinsurance solutions to the use of derivatives, subordinated debt and other instruments. One area which is often overlooked, though, is board-approved future management actions. These actions can potentially provide companies with highly tailored solutions to address their own specific needs while also being particularly cost-effective (or perhaps not involving any significant costs at all). Undertakings can use management actions to achieve reductions in technical provisions and/or reductions in solvency capital requirements, depending on the action in question and the firm's circumstances.

In this note, we explore some examples of the application of future management actions as well as some of the key issues which need to be considered when using them.

Regulation

Article 23 of the Commission Delegated Regulation 2015/35[1] (the "delegated regulations") introduces the concept of a future management action, in the context of the calculation of technical provisions. In doing so, it specifies quite an extensive list of conditions which must be satisfied before any management action can be used. These conditions include requirements that assume future actions are realistic, are consistent with one another, are consistent with the firm's business practices, are documented and are approved (and reapproved annually) by the board.

In addition, Article 83 of the delegated regulations specifies that no management action can be assumed to be taken during the occurrence of any scenario that underlies the calculation of the standard formula Solvency Capital Requirement (SCR), i.e., it cannot be assumed that the impact of a given scenario is mitigated by a management action while the scenario itself unfolds. It is only in the aftermath of the scenario occurring that the effects of any management action may be recognised. This does not preclude firms using the Solvency II standard formula from being able to recognise the potential benefits of management actions in many aspects of their SCR calculations though. It simply means that the changes in economic or demographic conditions that are being stressed cannot be directly mitigated by the planned management action. Instead, the impact of the management action can be included in the calculation of technical provisions (and own funds) following the occurrence of the stress event.

Article 236 of the delegated regulations goes on to specify the conditions which must be satisfied when using management actions in the context of a full or partial internal model (and which are, for the most part, identical to those appearing in Article 23, as described earlier), thereby affording firms with such models some additional flexibility relative to those using the standard formula approach. It also sets out a requirement, in Article 310, to include in the undertaking's Regular Supervisory Report a description of the assumptions made in relation to management actions.

Some examples of management actions

Care is needed in choosing and developing suitable management actions. The starting point when making an assessment of the viability of a given management action is to compare its features against the requirements set out above.

When considering the types of management action available to the firm, the starting point is to consider the various areas of discretion available to management. These areas may relate to, for example, the ability to manage expenses, to vary product-related charges (at least for some lines of business) or to vary discretionary benefits.

Expense-related management actions

In the case of expense-related management actions, there are a variety of different circumstances in which they may be applied. For example, if the company is closed to new business (or has closed a material product line—especially one with quite different characteristics relative to the remaining open book of business) then an expense management action which limits the impact of diseconomies of scale on this block of business over time will be an effective capital management tool.

In the absence of any management actions, one would expect that the fixed element of expenses (i.e., overhead costs) will not reduce in line with the run-off of the business, thereby leading to ever-

[1] The full text of the Commission Delegated Regulation 2015/35 is available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0035&from=EN.

increasing unit costs. In the extreme, these costs can become unrealistically high (as the residual book of business approaches a de minimis level).

If realistic expense management actions can be identified which can help to stabilise unit costs over time, then this can have a significant beneficial impact on technical provisions. They include actions which can shift expenses from fixed overheads into something that varies in line with business volumes—for example, outsourcing certain elements of policy administration. They also include actions which facilitate extinguishing the company's policyholder liabilities before unit costs become unreasonably high—for example, the transfer of the closed portfolio to another entity (either a third party or a related entity within the group, if such exists). These latter actions can be somewhat more difficult to formulate though, as they may need to be deferred for quite a significant period of time, depending on the speed of run-off of the book. It may therefore be difficult to get a good sense for the likely terms on which such a management action could be executed, as third parties may be unwilling to engage in meaningful discussions far in advance of any transaction receiving formal board approval. However, if the book of business is already at an uneconomical size, then the timeframes are likely to be much shorter, allowing the terms of any management action to be much more tangible.

One of the most common examples of an expense-related management action is the maintenance of a fixed (or at least largely fixed) unit cost assumption in the standard formula mass lapse shock. This involves developing a management action which can clearly demonstrate that expense savings can be made which are commensurate with the loss in business volumes that would be experienced in the event of a mass lapse.

Charges-related management actions

Management actions which focus on varying charges in response to adverse conditions may also be used effectively to manage capital. Instead of managing the level of technical provisions, however, such actions can be used to impact the amount of the capital requirements. For example, in the case of unit-linked business with variable fund-related charges, it may be possible to mitigate some of the impacts that arise in the calculation of the SCR. Taking the mortality SCR under the Solvency II standard formula as an example, in the event of a deterioration in mortality rates it may be feasible to increase the mortality-related charges which are levied on policyholder fund values. Similarly, in the case of business with explicit policy fees, it may be possible to inflate these policy fees to mitigate the impact of the expense inflation contained within the standard formula expense shock (though the ability to do so may depend on the extent to which such fees have, in practice, been inflated in prior periods).

Benefits-related management actions

It may also be possible to vary policyholder benefits, under certain circumstances, as part of a board-approved management action plan. For example, in the case of business with discretionary profit-sharing features, such as traditional with-profits business, the annual rate of profit share or the annual bonus declaration may depend, to some extent, on prevailing economic and/or demographic conditions. In such cases, it may be possible to cut benefits in the event of certain adverse scenarios. Article 206 of the delegated regulations outlines the adjustment to SCR that can be made in respect of the "loss-absorbing capacity of technical provisions" (in the context of discretionary benefits) and this, in turn, requires compliance with Article 23 (setting out the conditions supporting the recognition of management actions, as described earlier).

Key considerations

There are, of course, a number of important considerations to bear in mind when employing management actions. As mentioned above, the delegated regulations specify quite a lengthy list of conditions which must first be satisfied, and which can lead to the need to compile a significant volume of documentary evidence before seeking formal board approval. We examine some of the more important ones below.

Care needs to be taken to ensure the credibility of any proposed management action. For example, management actions can only apply to situations that are actually within management control. If a management action were to include a plan to increase sales, for example, this can only really be credible if the company is currently restricting sales volumes under normal conditions. If there is reliance on third parties as part of a given management action, for example a plan to outsource administration of business to a third-party administrator, then it may be necessary to engage, even if only at a high level, with such providers in order to gather information on the realistic level of per policy administration fees which might be expected to apply under such an arrangement. This might typically involve developing a plan to the point at which there are clear actions and a good deal of certainty in terms of the potential third parties that might be involved, the expected costs and the likely timescale for implementation. It is also necessary to explicitly consider the firm's actual past practice if similar situations have already arisen in the past. This can significantly impact the overall credibility of any proposed future management action.

Another key consideration is that of policyholders' reasonable expectations and the concept of treating customers fairly. In situations like a low interest rate environment (as may be reflected in the interest rate down shock), would it be reasonable, for instance, to apply a management action which leads to higher product charges? Similarly, if a company is unilaterally experiencing high expense inflation, or higher than expected mortality, but this is not the general experience in the wider market, then is it reasonable to pass some or all of this on to policyholders? These questions need to be considered carefully when determining whether or not a planned future management action could actually be implemented in reality.

If a company chooses to mitigate the impacts of adverse economic or demographic conditions through varying charges or benefits, this may have an adverse impact on the portfolio over time (and may ultimately impact the wider business objectives of the firm). For example, higher charges may unexpectedly lead to higher rates of surrender, which will ultimately impact upon the calculation of the technical provisions as and when best estimate assumptions are revised. This may ultimately undo the beneficial impact of the management action. If such policyholder reactions can reasonably be anticipated in advance, then they should be recognised in the calculation of the technical provisions at the time that the management action itself is recognised.

Due to these wider issues that must be addressed when it comes to management actions, it is therefore usually necessary to establish a cross-functional team within the company when developing such actions. This helps to ensure that planned actions are credible, fair, realistic and can be implemented within the desired timeframe. It is also important to ensure that any such action is not double-counted. For example, if a management action is recognised in the calculation of the technical provisions at the balance sheet date, then it should not also appear in the company's preemptive recovery plan as a further recovery option (unless there is some additional beneficial impact which has not already been fully recognised on the balance sheet).

Summary and conclusions

While the regulations governing the use of management actions contain quite a few requirements which must be satisfied, they can serve to support the development of robust and effective actions, which will have the desired effect if called upon in a time of need.

We have looked at a number of examples of potential management actions alongside some of the key considerations which need to be borne in mind when developing and implementing them.

The use of these company-specific actions—which can vary from those which address expense levels to those which seek to vary management fees and other sources of revenue under adverse conditions—is often overlooked when it comes to considering the range of capital management techniques that are available. Such actions can provide companies with a highly tailored, accessible and cost-effective way of meeting their needs and should be an essential part of the capital management tool kit.

How Milliman can help

At Milliman we have extensive experience in assisting clients in developing and implementing capital management solutions. We are involved in the development and approval of management actions, in addition to an extensive range of alternative capital management solutions, including reinsurance, unit underfunding, securitisations, product development, issuance of subordinated debt and hedging. If you are interested in learning more about how we can support you in developing and implementing capital management solutions to suit your business please get in touch.

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