Capital management activities by Irish (re)insurers

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Introduction

When it comes to managing and 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 reinsurance solutions to investment strategy and hedging, internal models, future management actions, subordinated debt and other instruments.

In this briefing note, we focus on key capital management activities by Irish (re)insurers recently, particularly across 2022 and early 2023. This analysis stems from our work with clients and knowledge of the Irish market. We have also utilised Solvency and Financial Condition Reports[1] (SFCRs) and public Quantitative Reporting Templates (QRTs) data for year-end 2022 to get as complete a view as possible.

We have grouped the different actions taken around a number of key themes emerging from the analysis:

- Capital raising and distribution
- Reinsurance
- Investment strategy and hedging
- Use of Solvency II measures (particularly volatility adjustment)
- Future management actions

These themes are discussed in the following sections.

Capital raising and distribution

The most obvious way to change a company's capital position is of course to either directly increase or reduce the capital available to it. We have seen a good deal of activity from Irish (re)insurers on both fronts in 2022 and 2023.

Equity raising

There were a relatively small number of equity-raising activities in 2022 for life and non-life insurers, and this is confirmed by only a few noting capital contributions or injections during the year in their SFCRs. There have, however, been quite a number of capital-raising measures by reinsurers.

Dividend payment and share buyback

A large number of companies paid out dividends in 2022 and many have done so or will again in 2023. This is no surprise given 26 companies included amounts within "foreseeable dividends, distributions or charge" in their year-end 2021 public QRTs. This was made up of 13 life insurers, eight non-life insurers and five reinsurers, with foreseeable dividend amounts totalling €355 million, €337 million and €422 million, respectively.

The exact dividend payouts for 2022 are not explicitly available in the 2022 public QRTs and are therefore only publicly available where mentioned in the body of an SFCR. However, we can see that many of the companies that had foreseeable amounts did indeed note payments made in their year-end 2022 SFCRs and typically noted the amounts distributed. Total dividends paid out by a number of companies in 2022 exceeded the amounts included as foreseeable at year-end 2021, and in some cases considerably so. There can be valid reasons for not considering dividends subsequently paid as foreseeable at the previous year-end; for example, where dividends are only anticipated as experience emerges over the year.

Given 24 companies have included amounts within "foreseeable dividends, distributions or charge" in their year-end 2022 public QRTs, we might expect broadly similar dividend payment trends in 2023 and this is what we have seen in practice for a number of companies for the year to date, with others expecting to pay dividends nearer to the end of the year. It's worth noting, however, that the total foreseeable amounts at year-end 2022 are €230 million higher than at year-end 2021. This increase is primarily driven by the life insurers, likely partially the result of interest rate increases in the period.

The overall dividend level and foreseeable dividend level highlight the strength of the Irish (re)insurance market.

We also saw the completion of a share buyback programme for one company in 2022.

Use of ancillary own funds

Ancillary own funds are items other than basic own funds that can be called up in order to absorb losses. They include unpaid share capital or initial fund that has not been called up, letters of credit and guarantees and other legally binding commitments. They are

[1] Note that we have analysed other elements of the year-end 2022 SFCRs of Irish (re)insurers elsewhere. See Analysis of Solvency and Financial Condition Reports for Life Insurers Based in Ireland: Year-end 2022, available at https://ie.milliman.com/en-GB/insight/ireland-life-insurers-sfcr-year-end-2022.

most typically provided by parent companies or other companies within a (re)insurer's group, although this does not necessarily need to be the case.

The use of ancillary own funds is subject to regulatory approval in Ireland but can be a very useful capital item that can be used to cover up to 50% of the Solvency Capital Requirement (SCR).

A total of 18 companies have ancillary own funds, totalling €1.4 billion, as of year-end 2022. This group consists of two life insurers, 10 non-life insurers and six reinsurers.

The majority of ancillary own funds (€1.2 billion) are classified as Tier 2 capital, with the remainder as Tier 3. No (re)insurance company in Ireland has both Tier 2 and Tier 3 ancillary own funds.

For most of the 18 companies, ancillary own funds increase their solvency coverage ratio by the maximum allowable amount of 50% of the SCR.

The total number of companies with ancillary own funds increased by two in 2022, as two additional (re)insurers had ancillary own funds approved in 2022. One of those additional companies signed a loan facility agreement with another entity in its group.

Subordinated loans

Subordinated loans or debt are another means of raising capital that can be used to cover a portion of the SCR. These types of loans have been used by many Irish (re)insurers and are most commonly in place with parents or other group entities, although this does not necessarily need to be the case.

We have seen relatively little change to subordinated debt issued by life and non-life insurers in 2022. However, a number of reinsurers have made new issuances in the same period.

Reinsurance

Undertakings have continued to make use of new reinsurance arrangements in 2022 and 2023, including both traditional reinsurance and more innovative solutions.

On the life risk side, there have been some material transactions in relation to longevity risk for life insurers. This included a significant immediate annuity reinsurance transaction for one life insurer and an amendment to the longevity reinsurance arrangements of another, both resulting in SCR reductions for those companies. Additionally, those companies will also have seen a sizeable reduction in risk margin as a result, which is an additional own funds benefit.

On the non-life risk side, we have seen a material increase to the quota share retention percentage of a risk treaty held by a non-life insurer, increasing that company's SCR.

Many insurers continue to make use of financing reinsurance arrangements to help fund acquisition costs. We have also seen the implementation of a new financing reinsurance contract by a life insurer, involving an initial commission payment in return for the ceding of business on a quota share basis.

We also see reinsurers continue to use retrocession arrangements to manage their risk. One example of this is a new stop-loss retrocession treaty within one reinsurer's group.

In terms of more innovative reinsurance solutions, we have seen some further activity in respect of mass lapse reinsurance, with a few insurers implementing new mass lapse treaties and a further life insurer taking on a mass lapse inwards reinsurance treaty. We have also seen a lot of activity in mass lapse reinsurance in other European markets. Some of the arrangements seen are intragroup arrangements, without the involvement of an external reinsurer.

We have previously produced an extensive analysis of the use of reinsurance by life insurers as a capital management tool.[2] This may act as a useful reference guide for insurers considering their options.

Investment strategy and hedging

Solvency II provides a good degree of freedom for insurers from an investment strategy perspective (subject to meeting some requirements such as the prudent person principle), but also promotes a greater focus on the implications of investment decisions on risk profile and capital requirements.

There are a variety of approaches that can be taken in relation to overall investment strategy that can have a significant impact on companies' risk management and capital management. These approaches include asset-liability matching, hedging and the use of derivatives, or the exploration of "alternative" but potentially suitable assets that may meet return, risk and capital tolerance levels of companies. On the latter point, previous research[3] we have conducted suggests that there can be assets which provide additional yield without significantly increasing capital requirements from an insurer's point of view. In fact, some alternative assets can help diversify risk profiles while generating yield pickup.

A number of companies have made significant adjustments to their investment strategies over 2022 and 2023, whether to improve capital management or for other commercial or operational reasons. For example, some (re)insurers have implemented

[2] Comerford, E., Fulcher, P., van Beers, R. & Maher, R. (July 2020). Reinsurance as a Capital Management Tool for Life Insurers. Available at https://www.milliman.com/en/insight/reinsurance-as-a-capital-management-tool-for-life-insurers.

[3] Comerford, E. & Manning, K. (October 2018). Investment Strategy Under Solvency II. Available at https://ie.milliman.com/en-gb/insight/investment-strategy-under-solvency-ii.

relatively substantial changes as a result of significant interest rate increases over the year. This has included significant reductions in cash balances for a few companies to avail of increasing yields on other assets, which has helpfully also decreased market concentration risk SCR in some cases. A few insurers made a shift to shorter-duration assets, which decreased market risk SCR. A few other insurers reduced holdings in investment funds, replacing those holdings with lower capital assets like bonds, driving a decrease in SCR. Another life insurer took the decision to reduce use of derivatives and recapture currency and equity risk exposure, which came at the cost of a higher market risk SCR, whereas one reinsurer expanded its currency hedging, which had the opposite impact. Other companies have seen material changes to total derivative assets and/or liabilities. Overall, the general trend we are seeing is (re)insurers reacting to the rapidly changing interest rate environment, albeit in many different ways.

Unit underfunding is another approach that can be used as part of the risk management and capital management of unit-linked portfolios. A number of life insurers have implemented or explored developments in this space in recent years also.

Use of Solvency II measures

There are various long-term guarantee measures or other optional approaches that may be utilised by companies in their calculation of technical provisions and/or solvency capital requirements. These are mostly subject to Central Bank of Ireland (CBI) approval, with formal application processes in place.

Volatility adjustment

In Ireland, the volatility adjustment is used by 13 (re)insurers at year-end 2022 in calculating their technical provisions and SCR. This includes two additional companies compared to year-end 2021, meaning two successful applications were completed in 2022 (both life insurers). The overall impact for those companies from using the volatility adjustment ranges:

- From a 0.8% to a 3.6% increase in own funds (average 1.7%)
- From a 0.0% to a 5.1% decrease in SCR (average 0.9%)
- From a 2% to a 12% increase in solvency coverage ratio (average 4.3% absolute increase in ratio)

While an application to the CBI is required in Ireland (this is not the case in all countries), it could be a worthwhile undertaking for some companies that can meet the CBI's requirements (which do not impose very strict restrictions on asset holdings). In addition to the point-in-time impact, the volatility adjustment can also be a useful protective measure against market spread movements and we have seen the volatility adjustment materially increase at times in the past few years, benefiting the companies that are approved to use it.

Internal models

The use of full internal models is unchanged between year-end 2021 and year-end 2022, with 12 (re)insurers using full internal models to calculate their SCRs.

There are now two companies using partial internal models, with one life insurer having received CBI approval for use of its partial internal model in 2022.

Loss-absorbing capacity of deferred tax (LACDT)

LACDT provides the potential to significantly reduce the SCR by taking into account the tax relief arising out of the future losses under the SCR stresses. We have previously covered in a briefing note[4] how (re)insurance firms can maximise the benefit of capital relief through LACDT.

A few firms have seen significant decreases to LACDT as a result of material changes to their deferred tax liabilities. This may warrant further exploration by those companies going forward. However, this is an area of potential complexity and requires a number of expert judgements, particularly in demonstrating projected profitability post a 1-in-200 stress scenario.

Matching adjustment

The matching adjustment is not used in Ireland (and indeed not used in most other European countries). However, some of the changes proposed as part of the Solvency II review currently underway could potentially make this measure more attractive to some companies in future so it is likely to get further attention in the coming years.

Other

No companies are using the transitional approach on technical provisions with one company using the transitional approach on interest rates.

Future management actions

One capital management area which is often overlooked 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 SCR, depending on the action in question and the firm's circumstances.

[4] King, E. & Jain, A. (August 2021). Loss-Absorbing Capacity of Deferred Tax in Ireland. Milliman Briefing Note. Available at https://ie.milliman.com/en-gb/insight/loss-absorbing-capacity-of-deferred-tax-in-ireland.

We have explored this area in more detail in a recent briefing note.[5]

We are aware that a number of life insurers have implemented future management action plans that would be triggered in the wake of a mass lapse event. This gives those firms a solid basis, based on a documented plan approved by the board, for using a reduced expense level in their mass lapse SCR calculations.

This continues a trend we have seen in recent years of more companies making use of future management actions.

Other

Portfolio transfers or other strategic initiatives such as new business strategy or diversification of the product portfolio can be useful capital management tools in some situations.

A few portfolio transfers completed in 2022 and early 2023. They are mostly small portfolios from a large entity. It is also important to note those items can equally be driven by other strategic or operational considerations unrelated to capital.

We have also seen a strategic change for one cross-border life insurer, with a project initiated in 2022 to merge the company, by way of absorption, with its parent and to subsequently establish a branch in Ireland.

A few (re)insurers are also developing new product lines, which will change their risk profiles and capital dynamics over time.

Conclusion

There is a wide and varied tool kit of options available to (re)insurers when it comes to capital management. Our analysis shows that a number of companies are actively making use of many of these options. We expect to see further strategic consideration by (re)insurers in the coming years, particularly once transformational changes resulting from International Financial Reporting Standard (IFRS) 17 have been completed, leaving finance and actuarial teams and senior executives (a little) more bandwidth to consider strategic developments for their business.

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[5] Phelan, E., Comerford, E. & Walsh, A. (June 2022). Management Actions – An Effective Capital Management Solution. Milliman Briefing Note. Available at https://ie.milliman.com/en-gb/insight/management-actions-an-effective-capital-management-solution.