Have you made the Standard Formula yours?

Solvency and Financial Condition Reports (SFCRs) and public Quantitative Reporting Templates show that UK non-life and health insurers are overall well capitalised. However, it appears that undertakings using the Standard Formula (SF) have not utilised all possible ways available to better reflect their risk profile, thereby missing out on potentially reducing their Solvency Capital Requirement (SCR) and improving their solvency ratio.

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What means are available to you that could better reflect your own risk and potentially reduce your capital requirement when using the Standard Formula?

Now that undertakings have made their first annual submission they can start thinking about ways to better reflect their own risks while using the SF, thus potentially reducing their SCR, such as Undertaking Specific Parameters (USPs) and Loss Absorbing Capacity of Deferred Taxes (LACDT). It is now too late to get regulatory approval for year-end 2017 but undertakings could start planning for their next submissions.

Undertaking Specific Parameters

WHAT ARE USPs?

Undertaking Specific Parameters are a sort of halfway house between the SF and an Internal Model (IM), which enable undertakings to replace a subset of SF parameters with their own. Relative to the SF, USPs better reflect your own underlying insurance risks and could lead to a reduction of your regulatory SCR.

The SF parameters that non-life and health insurers may replace with a USP are:

- Standard deviation for premium risk
- Adjustment factor for non-proportional reinsurance (NP_{lob})
- Standard deviation for reserve risk

HOW DOES IT WORK IN PRACTICE?

USPs are simpler to develop than partial and full IMs (a well-designed Excel spreadsheet is usually sufficient), and the application process is less onerous (methods are prescribed so the focus is on the quality of the data, as well as an assessment as to whether the underlying assumptions of the prescribed method are satisfied).

An undertaking can use USPs for selected Solvency II lines of business (i.e., it does not have to be for all lines) as long as it can justify why USPs have: 1) only been applied for some lines rather than for all, and 2) that SF parameters are appropriate for lines of business for which USPs have not been applied (there should be no cherry picking).

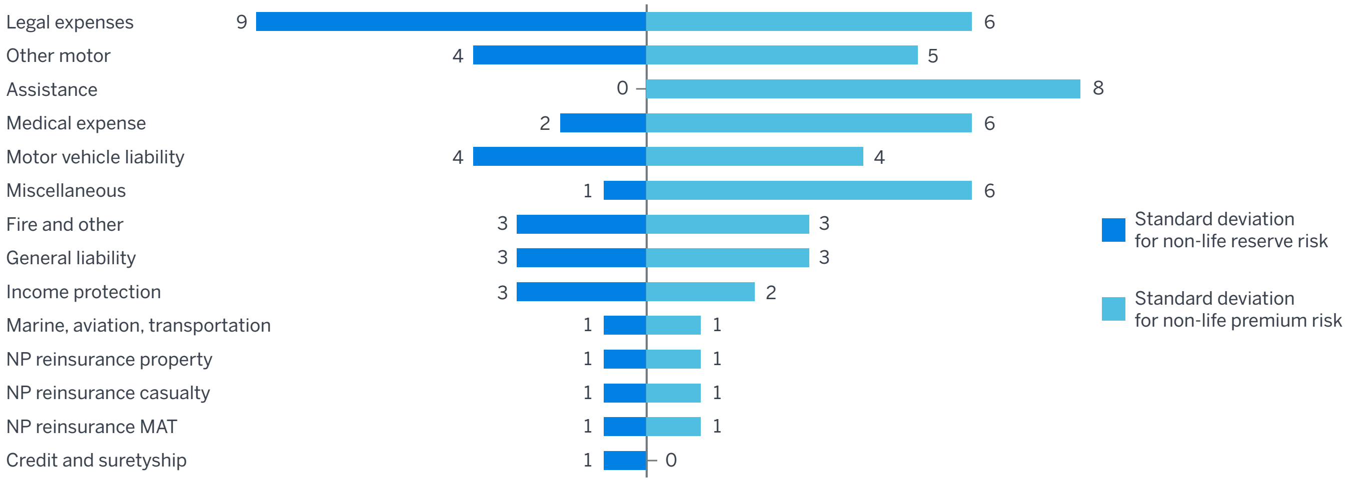
For a selected line of business, a non-life or health undertaking can decide to use USPs for premium risk only, reserve risk only, non-proportional reinsurance only, or premium and reserve risks together. The decision should again be justified.

THE APPROACH OUTLINED BELOW COULD BE FOLLOWED IN THE DECISION TO PURSUE THE USP ROUTE

EXPLORE	DECIDE	COLLATE	TEST	DRAFT	ENSURE	SUBMIT
Complete a preliminary USP impact analysis and corresponding assessment of data. [1]	Determine which USPs will be used on which lines of business.	Gather the data, ensure they are of good quality and adjust if needed.	Run statistical tests on the data to demonstrate its fitness for purpose.	Write the application report.	Review the application report to ensure it is complete.	Present the application report for regulatory approval.

1 USPs are calculated using aggregated data (i.e., across all applicable geographical areas), so that the diversification benefit of geographical spread is implicit in the USP. Therefore, when applying USPs in the SCR calculation, no further credit can be taken for geographic diversification.

NUMBER OF USPs APPROVED BY NSAs



USPs facts:

The chart above shows the number of USPs approved by National Supervisory Authorities (NSAs) for premium and reserve risks, as recently disclosed by EIOPA in their first set of advice to the European Commission on specific items in the Solvency II Delegated regulation.[2]

- As at 1 October 2017, only five undertakings in the UK and Gibraltar had received approval for USPs. NSAs have estimated that a further 15 undertakings will have their USPs approved in the near future across Europe.
- We believe that many undertakings have deferred consideration of USPs while they become comfortable with their implementation of Solvency II, thus reflecting the relatively modest number of USP applications. We are also aware that some undertakings were interested in applying to use USPs but did not have the required amount of data (minimum of five years). We note that some undertakings benefited from the credibility approach (i.e., the risk factor used is a credibility weighted average of the USP and the prescribed SF factor, depending on the length of historical data available) to reduce their SCR.
- So far, no application for USPs has considered the use of relevant external data. We suspect that this reflects both insufficient awareness about this possibility, and also the difficulty in collecting relevant external data in the European market.

WHAT'S HAPPENING NEXT?

EIOPA issued a questionnaire asking for suggestions on USPs, Group Specific Parameters (GSPs), in particular on the introduction of USPs in the mortality and longevity risk modules, and any other standard parameters which respondents thought could be sensibly replaced by USPs for calculating the life, non-life and health underwriting risk modules. They also asked for suggestions on how the current non-proportional reinsurance factor USP method could be amended or replaced, and about issues and suggested solutions related to the application of GSPs.

Following the consultation paper and feedback, it seems unlikely that the existing prescribed methods will change in the near future.

The definition of volume measure for premium risk used in the SF is currently under EIOPA consideration. EIOPA has requested some insurers to provide information to assess the impact of a change. The suggested change, if effective, could lead to a material increase in SCR (everything else being equal). The use of USPs might therefore be a viable option to mitigate the impact.

2 http://eiopa.europa.eu/Publications/Reports/EIOPA-BoS-17-280_Final_report_on_First_set_of_Advice_on_SII_DR_Review.pdf.

Loss-Absorbing Capacity of Deferred Taxes

WHAT IS LACDT?
Under Solvency II, all insurance undertakings are required to fully consider the cash flows resulting from taxes (deferred taxes). A loss situation in the financial year of reference will impact the value of undertaking's existing and future tax liabilities. If the loss situation results in a reduction of current or future tax liabilities, the effect will reduce the total economic loss or what is called the loss-absorbing capacity of deferred taxes.

The resulting adjustment should only be recognised fully where it is probable that future taxable profit will be available to be offset by the deferred tax asset, thereby taking into account any legal time limits relating to the carry forward (or carry back) of unused tax losses/credits.

HOW DOES IT WORK IN PRACTICE?
Under Solvency II, undertakings should assess the impact on their current and future taxes of an instantaneous loss equal to the Basic SCR plus the operational risk charge.

To take into account the tax relief, insurers have to demonstrate the recoverability of the tax deductible following the hypothetical instantaneous loss (equivalent to a 1 in 200 year scenario). There appears to be a reasonable degree of freedom with regards to the approach used to demonstrate the projections of future profits after suffering the instantaneous loss.

A possible methodology to support recovery of the potential tax credit on the LACDT is as follows:

- Offset against any deferred tax liabilities on the Solvency II balance sheet
- Loss carry back
- Carry forward from business planning profits on a post stress basis

WHAT'S HAPPENING NEXT?
EIOPA is still investigating the need to prescribe more detailed calculation methods and assumptions for projecting the utilisation of the deferred tax asset after the shock loss (including taking account of new business and the time horizon).

LACDT facts:

As recently disclosed by EIOPA in their Final report on the Consultation paper on specific items in the Solvency II Delegated Regulations:

Across EEA[3]:

- LACDT represents 81[4] billion euros
- 76% of it is related to Net DTL on the Balance Sheet
- LACDT represents 13.5% of the SCR,[5] of which 10.3% is demonstrated by the net DTL on the balance sheet and 3.3% by the future profits.

United Kingdom:

- LACDT represents 10 billion euros
- 77% of it is related to Net DTL on the Balance Sheet
- LACDT represent 8% of the SCR, of which 6.2% is demonstrated by the net DTL on the balance sheet and 1.8% by the future profits.

NSAs across EEA have similar approaches with respect to LACDT for net DTL on balance sheet and carry-back taxes (when applicable) but different approaches with regards to the LACDT part that is being demonstrated by future profits. The Prudential Regulation Authority has released a Supervisory Statement,[6] in November 2016, to set out their expectations in relation to the recognition of deferred tax under Solvency II in the UK.

Based on the 2017 Solvency and Financial Condition Reports (SFCRs), it appears that many undertakings have reported a deferred tax adjustment amount lower than the net deferred tax liabilities shown in their Solvency II balance sheet and that very few of them reported a deferred tax adjustment matching the full tax relief allowable (under recoverability conditions).

3 Excluding Iceland.
4 Based on 2723 both Standard Formula and Partial Internal Model undertakings.
5 BSCR + operational risk + adjustment for loss absorbing capacity of technical provisions.
6 http://www.bankofengland.co.uk/pra/Documents/publications/ss/2016/ss214update.pdf.

How can Milliman help?

Milliman was involved in several successful USP applications over the last two years and continues to provide support for current applications. Milliman is therefore in a strong position to assist you across various tasks including:

- Providing training courses
- Providing you with tools to perform the calculations and the statistical tests
- Performing a 'mock' USP calculation data analysis exercises to help you to decide whether you should/could go through the application (including assessment of the data appropriateness)
- Helping you throughout the whole application (collate and adjust data for the calculation, calculate USPs using prescribed methods, perform statistical tests on data, and ensure the application report is complete)

Milliman has also been involved in a successful approval request for the full recoverability of the LACDT. Therefore, if you are interested in exploring further the use of LACDT, Milliman can assist you across various tasks including:

- Providing training courses
- Helping you to take full advantage of the tax relief
- Providing expert advice while you are doing the calculation
- Helping with the application report for the PRA

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