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Trials and Tribulations of Matching Adjustment

Andrew Kenyon, NatWest Markets
Stephan Erasmus, Legal & General



14 November 2018

MA Working Party | Who are we?

- Chair** • **Ross Evans** Hymans Robertson
- Deputy Chair** • **Stephan Erasmus** Legal & General
- **Michael Henderson** Legal & General
 - **Peter Maddern** Canada Life
 - **Keith Neil** Scottish Widows
 - **Andrew Kenyon** NatWest Markets
 - **Ravi Dubey** Reliance Life

The views expressed within this presentation are those derived from the discussions and work of the **MA Working Party**



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MA Working Party | Who are you?

Poll

What type of organisation do you work for?

- A. Insurer / Reinsurer
- B. Consultancy
- C. Asset Manager / Bank
- D. Regulator
- E. Other



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Agenda

- **Evolution of the MA**
 - Optimisation
 - Regulatory engagement
- **Future development**
 - Asset Eligibility
 - Liability Eligibility
 - Application process



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Evolution of the MA Timeline



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Evolution of the MA | Benefits

- Total capital: **+£66bn**
Source: Sam Woods, PRA
- Estimated DB pension scheme liabilities outstanding: **£2trn**
- Individual annuities: **£4bn p.a.**

The MA is **crucial** for delivery of **competitive / acceptable** de-risking products for **policyholders** and **UK pension schemes**




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Evolution of the MA | Timeline

	2015	2016	2017	2018	2019
Pension Scheme De-risking Market	Pension freedoms come into force	Scottish Widows / Canada Life enter bulk market Prudential exit bulk market		Phoenix's first external deal "Superfund" proposed	Demand set to grow significantly
PRA Approvals	Pre-app process	MA apps approved	Further approvals		
Investment Strategy		Annuity writers begin MA optimisation	% illiquids increasing	Loan origination terms aligning with MA requirements	
Regulatory Developments		Treasury Select Committee inquiry commences	CP21/17 CP24/17	CP13/18	 Institute and Faculty of Actuaries

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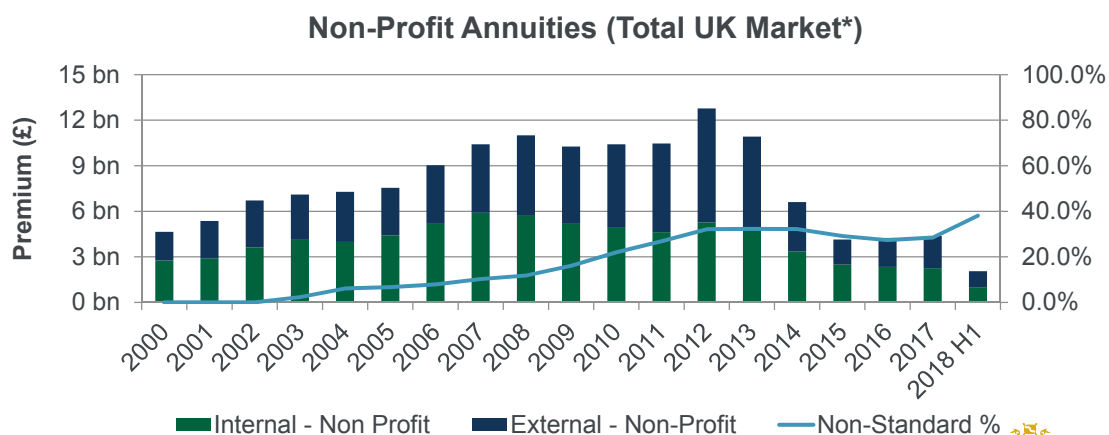
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Evolution of the MA Optimisation



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Volumes | Individual Annuities



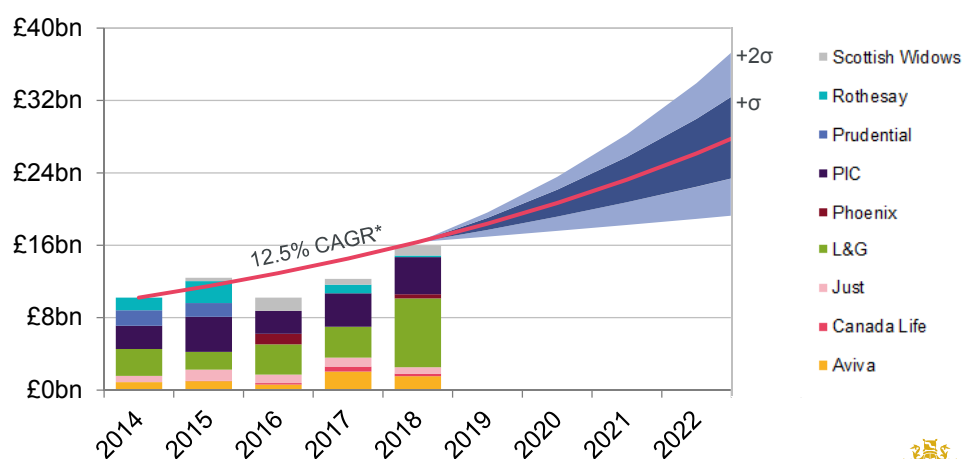
Source: ABI

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Volumes | Bulk Annuity Deals



Source: Hymans Robertson, LCP, NatWest Markets, press releases

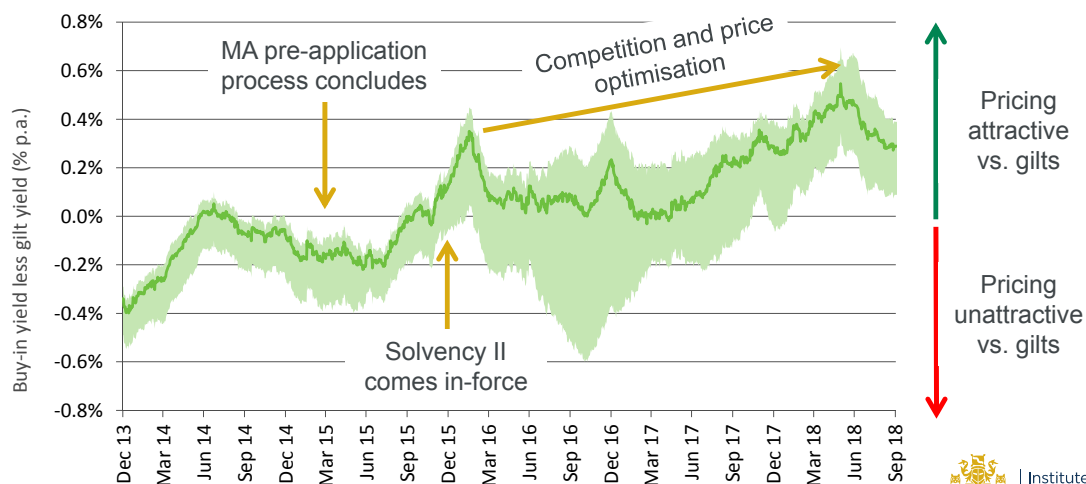
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* CAGR = Compound Annual Growth Rate

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Optimisation | Pricing



Source: Hymans Robertson

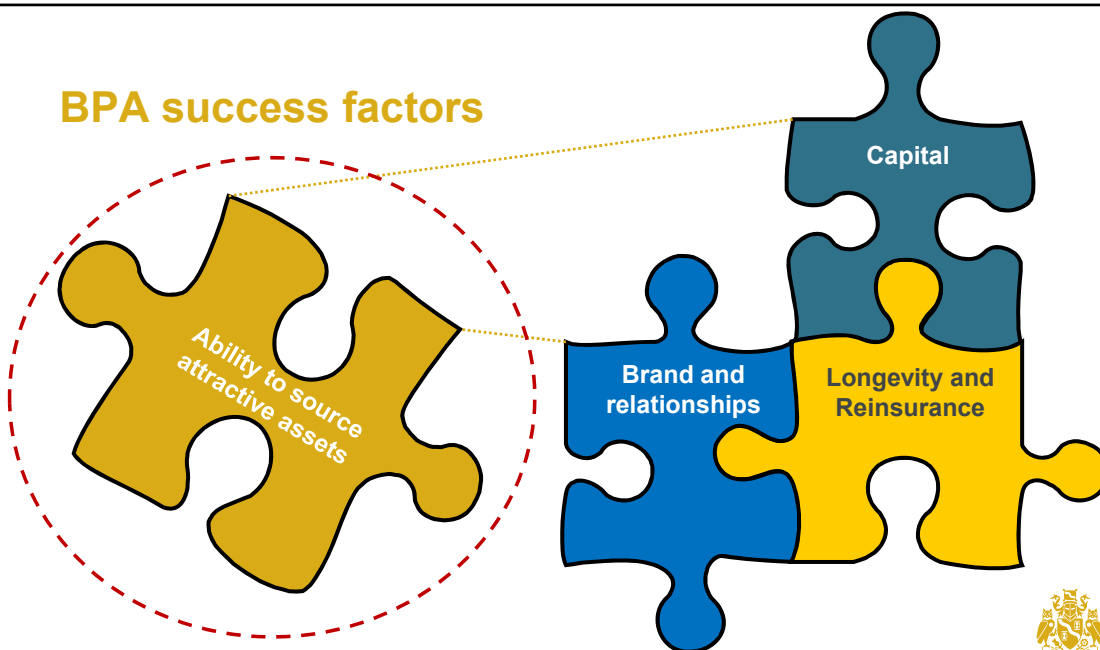


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BPA success factors

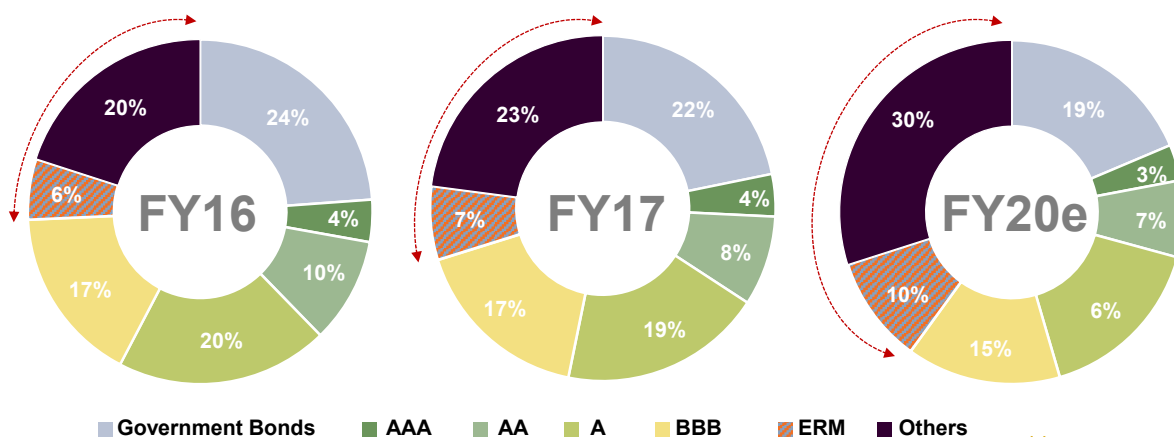


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Optimisation | Asset Mixes



Source: SFCRs, Annual Reports, FY20 estimate based on "Solvency II one year in", PRA Feb-17



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Optimisation | Asset Innovation

Bespoke Cash Flows

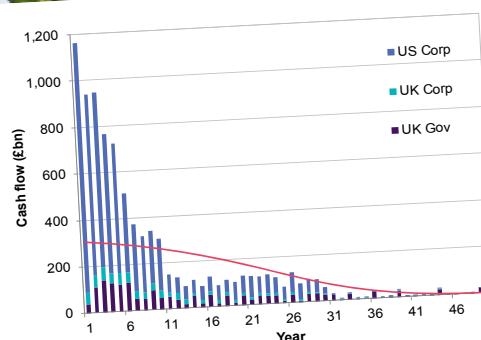
- Delayed draw
- Specific tenors
- Repayment profile



Example

The National Trust (2063):

- £100m split into two tranches
- Delayed draws: 2020 and 2022



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Optimisation | Asset Innovation

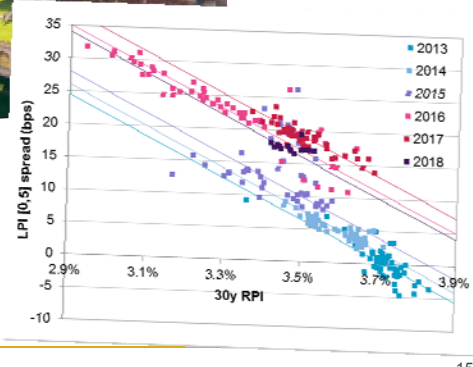
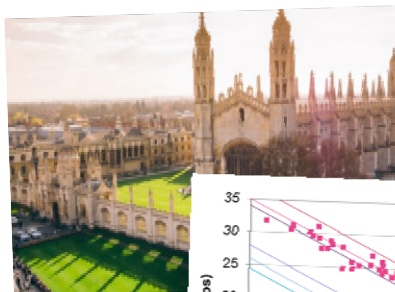
Bespoke Cash Flows

- Reference index
- Caps / floors

Example

University of Cambridge (2068):

- £300m
- $CPI(0, 3)$
- Amortising profile: 2028-2068



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Evolution of the Matching Adjustment Regulatory Developments



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Regulatory Developments | Timeline



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Looking to the future Working Party Considerations



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Looking to the future | Key challenges

Assets

- **Approvals:** new “features”
- **Uncertain** cash flows
- **Pre-payment compensation**

Liabilities

- **Eligibility requirements**
- **Liability Management Exercises**

Application Process

- **Streamlining**



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Looking to the future | Assets

Poll

What do you see as the biggest challenge when sourcing MA assets?

- A. Cash flow characteristics** e.g. tenor, indexation
- B. Credit assessment / ratings** (including internal ratings)
- C. Pre-payment compensation**
- D. Regulatory approvals**



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Assets | Sufficient Compensation

- **Insufficient** compensation vs. approved spread limits
- **Ambiguity** in legacy documentation e.g. “Breakage Loss”
- **Credit protection** e.g. pre-payment on downgrade
- Replacement with an **equivalent asset** e.g. commercial mortgages
- **Inflation-linked** assets e.g. availability of CPI-linked replacement

Increased **borrower** awareness of **annuity writers’** needs for **make-whole / Spens** language



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Looking to the future | Liabilities

Poll

If you were the PRA, what concessions would you make following a “no deal” Brexit?

- A. None**
- B. I’d be more restrictive**
- C. Less formal application process – just rely on internal governance**
- D. Allow insurers to underwrite more types of risk – not just longevity**
- E. No more eligibility restrictions – just hold enough capital**



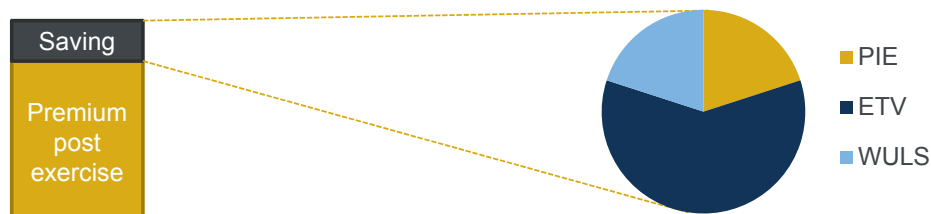
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Liabilities | Liability Management Exercises

- Liability management exercises* can lead to better member outcomes and/or buy-out affordability:



- But not always quick to execute, during which time insurer pricing might move away
- If scheme is in PPF then this means lower benefits to members for longer
- Limited scope under MA rules to take surrender risk, which arise if pay-outs > "cost neutral"

Should insurers have **more flexibility** to **underwrite** these exercises?



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* PIE = Pension Increase Exchange; ETV = Enhanced Transfer Value; WULS = Winding Up Lump Sums

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Closing remarks



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Summary

- Demand for **pension de-risking** expected to **grow** substantially over the next 10-15 years
- **Reinsurance** and **asset optimisation** underpinning competitive BPA pricing at the moment
- So **asset sourcing** is a **key** part to annuity writers' ongoing success
- However, current growth in **illiquid allocations** may **not** be **sustainable**
- **Limited flexibility** around **liabilities**, so insurers end up with **just asset risk**
- **Brexit** may pose some opportunities to relax the rules – but **landscape still very unclear**



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Questions

Comments

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