Institute
and Faculty
of Actuaries

CP16/16 Solvency II: Matching Adjustment

IFoA response to the Prudential Regulation Authority

15 July 2016

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

SII: CP16/16 Response
Romain Labaune
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

15 July 2016

Dear Romain,

IFoA response to CP16/16 Solvency II: Matching Adjustment

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Prudential Regulation Authority's (PRA) consultation paper on the Matching Adjustment (MA), under Solvency II. The IFoA's Life and General Insurance Boards have been involved in the drafting of this response. Members of these boards have been actively engaged with the ongoing implementation of Solvency II.

2. The MA has a material impact on many insurers, and clarity on its future management, including the impact of changes to MA portfolios, is welcome.

Annuity assets purchased in a secondary annuity market

3. Although a secondary annuity market is not yet active, it is likely that some insurers may consider buying annuity cashflows on the secondary market as an asset to provide a hedge against longevity risk exposure, including trends in future longevity. Secondary annuity cashflows may also provide a better match for annuity cashflows than corporate bonds.

4. We acknowledge that secondary annuity cashflows will be impacted by the underlying longevity of the original annuity policyholders. However, buyers of annuities in a secondary market are likely to underwrite them, i.e. carry out an investigation of the health and lifestyle of the individuals concerned in order to base the price paid on an assessment of their life expectancies. Underwriting in this way will help mitigate longevity basis risk. Buying large numbers of secondary annuities should also smooth out specific risk exposures.

5. We therefore suggest a pragmatic approach to asset eligibility to encourage investment in secondary annuity cashflows by insurers. Although asset restructuring may become relatively common in relation to equity release mortgage assets, the secondary annuity market may not be large enough for insurers to warrant complex asset restructuring; any restructuring costs arising may ultimately be passed on to consumers.

6. The IFoA agrees that secondary annuity cashflows would effectively be a new class of asset. Given this, insurers will need to consider carefully any corresponding valuation uncertainties, liquidity requirements and wider risks relating to holding such assets, including whether they are within the insurer's risk appetite.

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7. Some insurers may be willing to ‘buy back’ annuities from policyholders, particularly where the annuity is trivial in size. It would be helpful if the PRA could clarify if annuity buy back is to be treated as a surrender, and if so, the implications on the MA.

Ongoing MA compliance/ Changes to MA portfolios

8. The consultation paper explains that firms need to develop a robust MA compliance and monitoring process as part of their wider Governance framework. We would strongly encourage this, particular given the potential implications should a firm fail to meet its MA eligibility criteria.

9. Opening MA portfolios will clearly not remain static, and we welcome clarity from the PRA on the regulatory process as MA portfolios evolve from their initial position. Paragraph 5.2 of the draft supervisory statement is helpful in setting out some of the potential circumstances impacting the MA portfolio, under which firms might have to consider a fresh MA application.

10. We support the principle that firms should develop and document a robust MA portfolio review process, and share their portfolio review policy with the PRA. With this, both parties should have clarity over the extent and circumstances when a change to the MA portfolio would be considered material.

11. While the consultation paper sets out some considerations when looking at consistency, more guidance on what the PRA might regard as being material or might accept as being immaterial may facilitate greater consistency in this respect.

12. Section (iv) of paragraph 5.2 explains that ‘changes to the scope of the MAP(s), including the addition or removal of MA assets or liabilities and…’. We presume that additions/ removals to assets and liabilities should be considered where they are material, and if so, suggest that this be clarified within the supervisory statement.

13. Paragraphs 5.5-5.8 of the draft supervisory statement note that a new MA application may be required under the relevant circumstances described. Rather than requiring a full new application, it would be helpful if firms were able to follow a streamlined change process, focussing on the sections of the original application which need to be updated. We look forward to further guidance from the PRA on this, as noted in paragraph 5.7 of the draft supervisory statement.

14. Our understanding of the wording of the directive is that firms should notify the regulator when a breach occurs, but the consultation paper states ‘Firms should engage with the PRA as early as possible where there is a risk that the MA conditions will be breached’. This suggests much earlier engagement and raises the question about what constitutes a ‘risk’ that the conditions will be breached. More clarity around what the PRA expects here would be helpful.

15. The IFoA has set up a working party focussing on the MA, with the aim of developing a pragmatic approach to its ongoing management, and this consultation is helpful to the work of the working party. We look forward to engaging with the PRA as the thoughts of this working party develop.

Should you wish to discuss any of the points raised in further detail please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk / 0207 632 2146) in the first instance.

Yours sincerely

Colin Wilson
President, Institute and Faculty of Actuaries