Managing the Matching Adjustment – Perspectives from Asset Management and Audit

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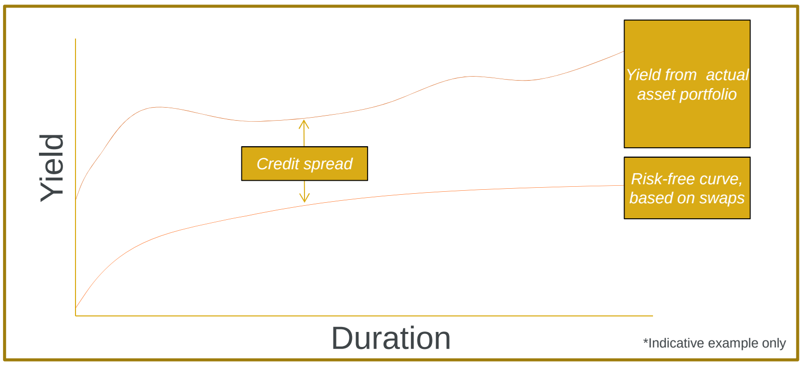
Agenda

- Introduction
- Impact on Systems, Processes & MI
- Investing in New Assets - Equity Release Case Study
- Internal Credit Ratings
- Impact on the Investment Process
- Enhancing Returns with Gilts
- A Spanish Perspective
- Conclusions

05 May 2016 2

A quick reminder: what was the problem?



Under Solvency II how much of the "credit spread" can be reflected within the liability discount rate?

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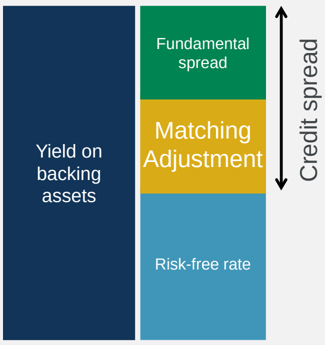
A quick reminder: the matching adjustment

Illustrative example



Key features

- Set with reference to yield earned from <u>insurer's asset portfolio</u>
- Deduction for credit default risk provided by EIOPA = termed the "fundamental spread"
- Fundamental spread based on long-term default statistics, and contains an element of prudence

Key requirements

- Only available for annuities – immediate, deferred and bulk
- Asset portfolio must be "notionally ring-fenced"
- **<u>Strict conditions</u>** on assets which can be held in portfolio:
  - Must be "bond-like"
  - Must be in same currency as liability – cross currency swaps v FX forwards
  - Derivatives only allowed if paired with asset
  - Issuer (or third parties) cannot change asset cash flows…unless they provide "sufficient compensation"
- **<u>Strict cash flow</u>** matching required between assets and liabilities – assessed by three tests defined by the PRA

Impact on Systems, Processes & MI

- Similar to Solvency I discount rate…

  …but much stricter conditions around cash flow matching and asset admissibility
- Insurers typically proposed to start with Solvency I processes/models and adjust
- However **BIG** promises made in MA applications – meaning significant changes required
- MA approvals didn't happen until late 2015, leaving very little time for embedding
- Embedding remains a key activity in 2016

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Impact on Systems, Processes & MI

Asset data validation

New management information

MA compliance committees

Solvency II reporting timetable

Monitoring of cash flow match

MA within internal models

New asset trading criterion

Board training

Telling the story externally…

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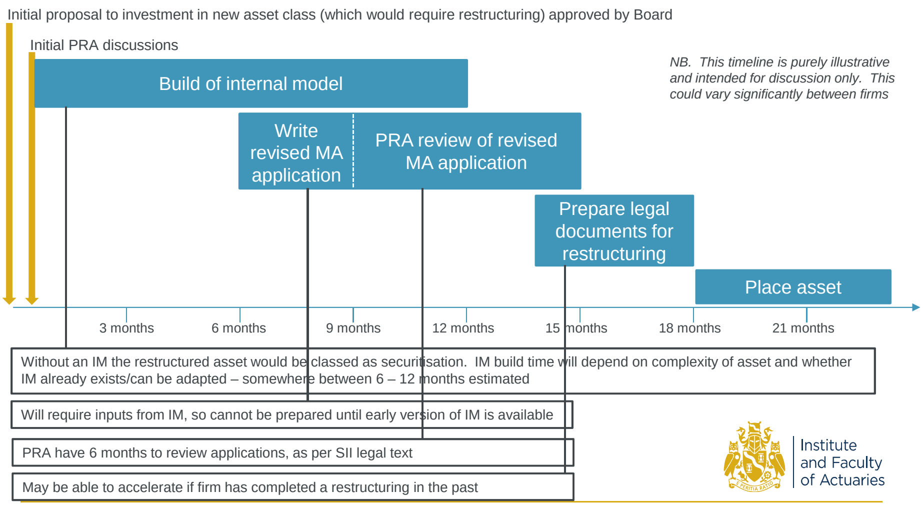
Investing in New Assets



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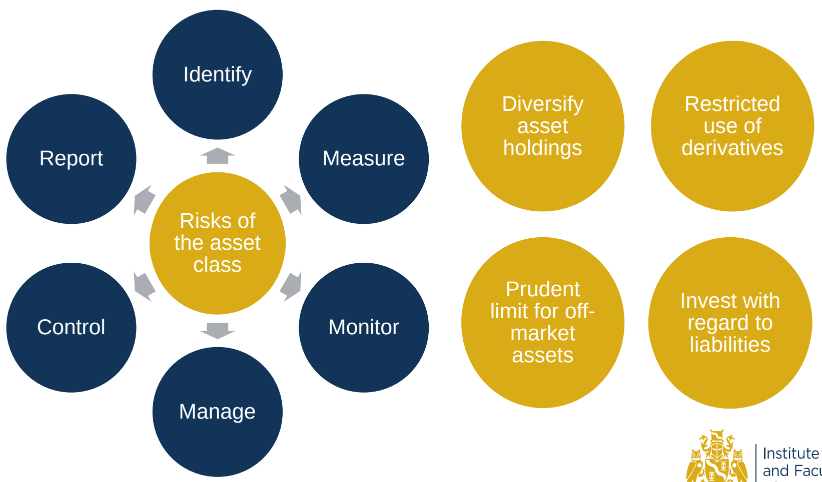
Prudent Person Principle



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Asset restructuring – equity release case study

Equity Release Mortgages cannot be included in the MA portfolio without restructuring

Omnibus II Article 77b para 1 (h) states:

> *"the cash flows of the assigned portfolio of assets are fixed and cannot be changed by the issuers of the assets or any third parties…*
>
> *…in the event that issuers or third parties have the right to change the cash flows of an asset in such a manner that the investor receives sufficient compensation to allow it to obtain the same cash flows by re-investing in assets of an equivalent or better credit quality, the right to change the cash flows shall not disqualify the asset for admissibility"*.

Equity Release Mortgages do not meet these conditions because:

- Prepayment risk
- NNEG
- Longevity risk

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Asset restructuring – equity release case study

PRA letter of October 2014

"some features are common to most equity release mortgages, such as cash flows that depend on longevity, morbidity, and the realisable value of property, and exposure to prepayment risk. In the PRA's view, an asset with this combination of features is very unlikely to be compatible with the eligibility criteria in Article 77b"

"The PRA expects that firms will need to undertake restructuring or hedging actions to transform the cash flows of such assets into an eligible format."

The PRA letter of 20th Feb 2015 outlined a way forwards for firms....

1. ***Firms may restructure via an internal company***
2. ***Capital modelling necessary given type 2 securitisation charges under SF***
3. ***Internal rating assessment and validation important***
4. ***Attention to any use of liquidity facility***
5. ***Product features specific to ERM (e.g. security of underlying mortgage assets) need due consideration***

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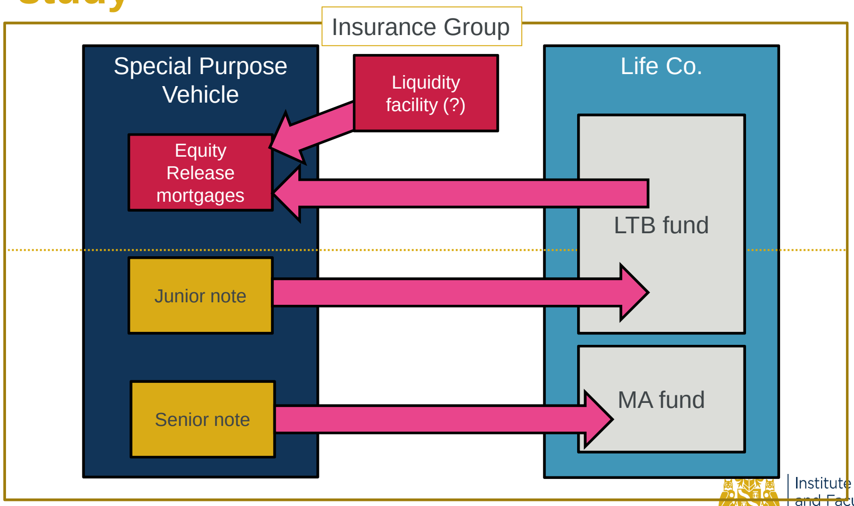
Asset restructuring – equity release case study



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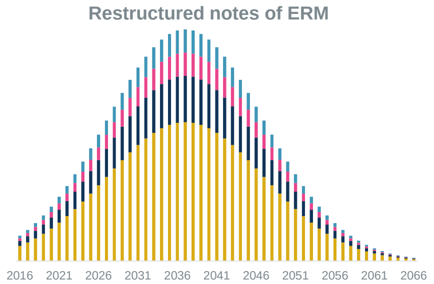
Asset restructuring – equity release case study

Structuring should consider trade off between yield, tranche size and security of cash flows



Structure should identify optimal rating for senior note and minimise "surplus" in tranche

Key considerations…

1. Level of fixed payments needed to support annuity book
2. Setting assumptions – NNEG, prepayment, mortality and morbidity
3. Modelling stochastically v closed form deterministic (& PRA thematic review)
4. Treatment of new business – issue new notes?
5. Internal or external credit rating?
6. Need for a liquidity facility
7. Stress testing of structure to understand resilience
8. Valuation of senior and junior notes – what discount rate to use
9. IFRS treatment of structure – and implications for SII
10. Interaction with SII internal model

Internal Credit Ratings

- “New” asset classes often do not have credit ratings issued by external rating agencies
- For these assets insurers need to come up with own assessment of the credit rating
- Internal credit rating used for MA (and possibly internal model SCR) calculations – can be extremely material assumption, as determines level of fundamental spread applied to asset
- Not just an issue for unrated assets - Article 4 para 5 of the Delegated Acts states:

  “Where an item is part of the larger or more complex exposures of the insurance or reinsurance undertaking, the undertaking shall produce its own internal credit assessment of the item…”

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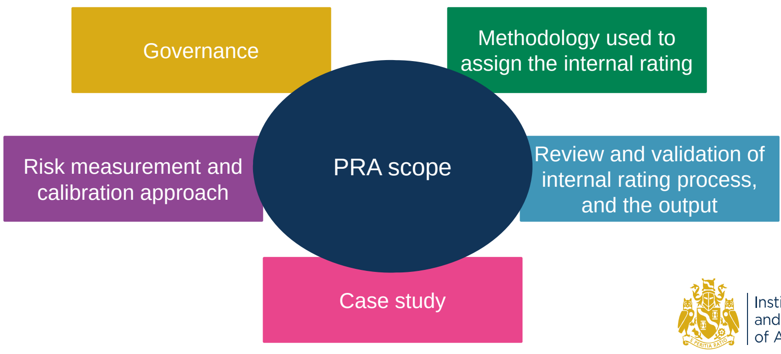
Internal Credit Ratings

- In 2015 the PRA required many firms applying for MA approval to obtain an independent review of internal credit rating process
- Most firms received similar scope letter, although extent of review varied depending on materiality of holding



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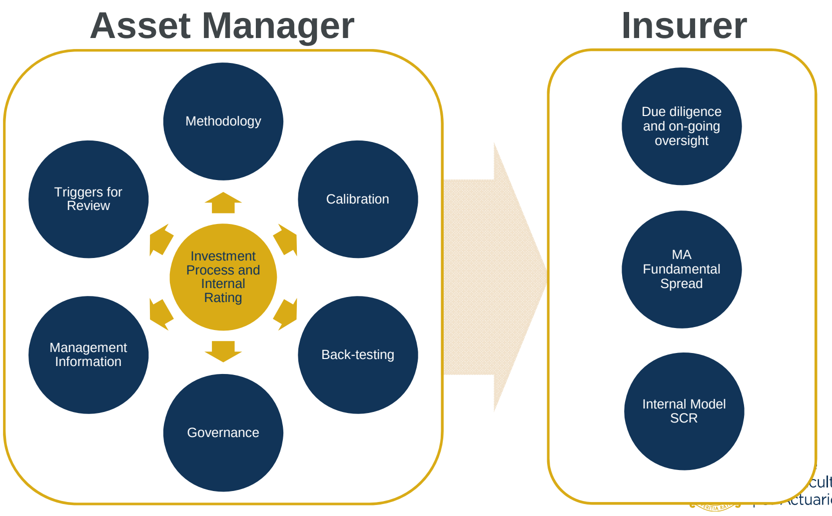
Internal Credit Ratings



Impact on the Investment Process

- Objective Investment Mandates
- Trading
  - Rationale and Reporting
  - Turnover limits
- Asset Selection
  - MA Eligibility
  - Optimising Risk-Adjusted Return
- Quality of Cashflow Matching

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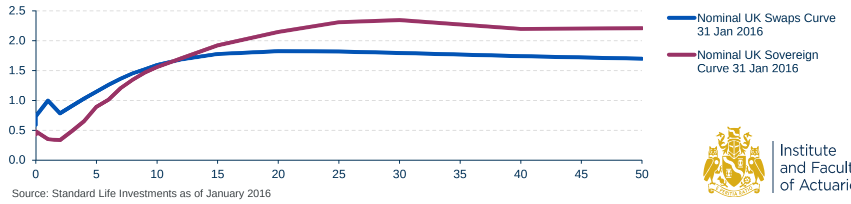
Enhancing Returns with Gilts

- Liability cashflows can be matched with interest rate derivatives.
- UK government bonds yields were significantly higher than swap yields.



Source: Standard Life Investments as of January 2016

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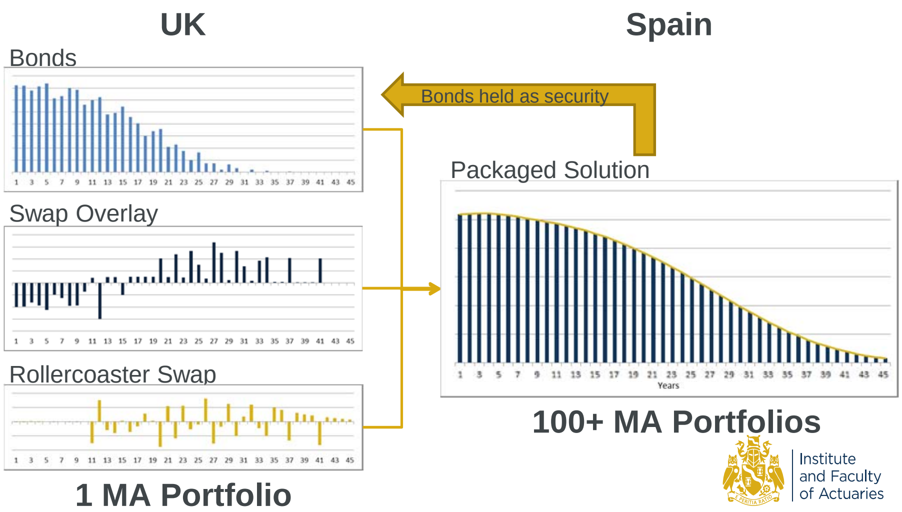
A Spanish Perspective



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Conclusions

- Embedding processes
- Second wave of applications
  - New instruments
  - New liabilities
- Developing regulatory position
  - CP 16/16
  - EIOPA annual report on Long-Term Guarantee package

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Questions

Comments

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