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Matching Adjustment: Potential implications of Brexit – A presentation by the IFoA Matching Adjustment working party

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Matching Adjustment Working Party

- ✓ **Chair:** Ross Evans, Hymans Robertson
- ✓ **Deputy Chair:** Stephan Erasmus, Legal & General
- ✓ Michael Henderson, Legal & General
- ✓ Peter Maddern, Canada Life
- ✓ Keith Neil, Lloyds Banking Group
- ✓ Andrew Kenyon, NatWest Markets
- ✓ Ravi Dubey, Reliance Mutual Insurance Society

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Agenda

- The Matching Adjustment – why is it such a big deal?
- What is the Matching Adjustment?
- Why are we still talking about it 18 months into Solvency II?
- Areas of the Matching Adjustment framework that are far from perfect
- Thoughts of the Working Party
- What's next …

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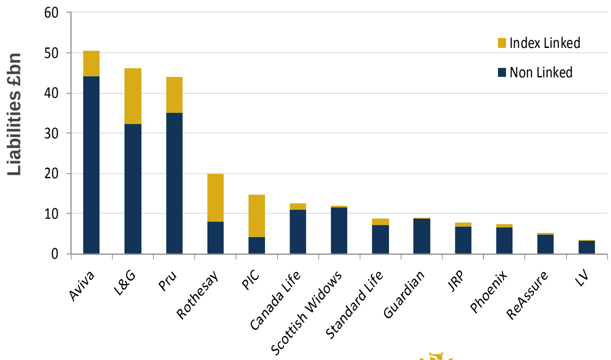
Significant impact on insurance and pension de-risking

- PRA calculates that the Matching Adjustment (“MA”) is worth close to £60bn to the UK insurance industry
- With £2 trillion of pension scheme liabilities outstanding, MA could become worth significantly more over coming years
- Therefore crucial for insurers to deliver competitive/acceptable de-risking solutions to UK pension schemes

Companies applying a MA[1]



[1] Source: NatWest Markets Life Review, PRA Returns end-2015

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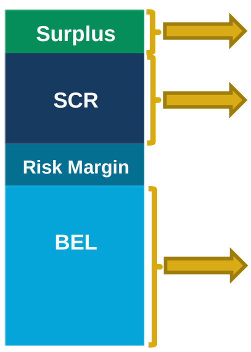
Important for managing the insurer balance sheet

- Matching Adjustment has a significant impact on key elements of the balance sheet
- It reduces liabilities by allowing a discount rate higher than risk-free
- Also reduces capital:
  - c.50% of credit spread risk capital
  - c.20% of longevity risk capital
- Overall effect is also to dampen balance sheet volatility



- Volatility
- Capital
  - Credit spread risk
  - Longevity risk
- Best Estimate Liabilities

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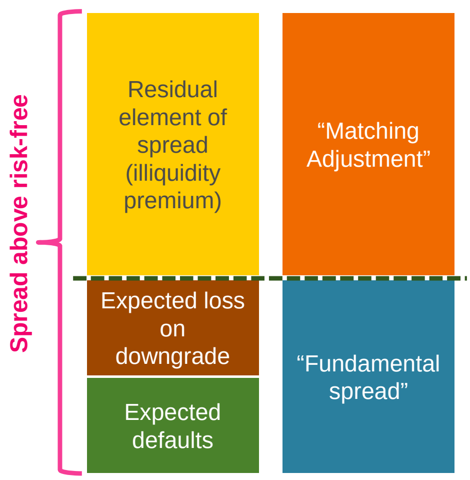
What is the Matching Adjustment?

Background

- Original draft of Solvency II rules required firms to value all their liabilities using risk-free rates
- However, it was argued that a cash flow matched buy and hold investment strategy would mean illiquidity premium could be earned on the matching assets, and this should be allowed for in liability valuation
- Restricted to certain asset and liability types
- EIOPA produces “fundamental spreads”
- Approval required



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Assets and liabilities subject to eligibility assessments

MA rules (summary)	
Asset eligibility	Bond-like, fixed cash flows
	No issuer optionality, unless sufficient compensation provided to replace lost cash flows
Liability eligibility	No future premiums
	Longevity, expenses, revision and minimal mortality risk only
	Policyholder options cannot exceed asset value
	No splitting of liabilities below contract level
Portfolio management	Buy-to-hold strategy, with restrictions on trading
	Assets and liabilities managed separately to other business
	Close cash flow matching and currency matched
	Other areas include e.g. surplus extraction and collateral management

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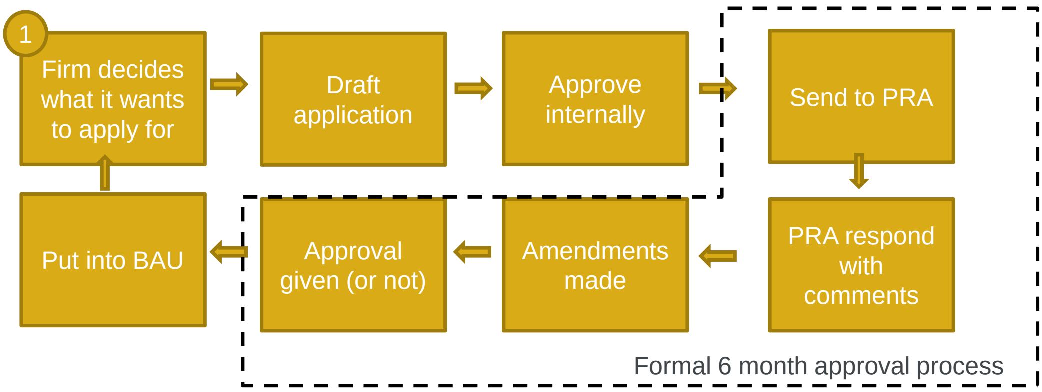
Stringent approval process



- Long and involved process but prize is high
- Firms very conservative initially

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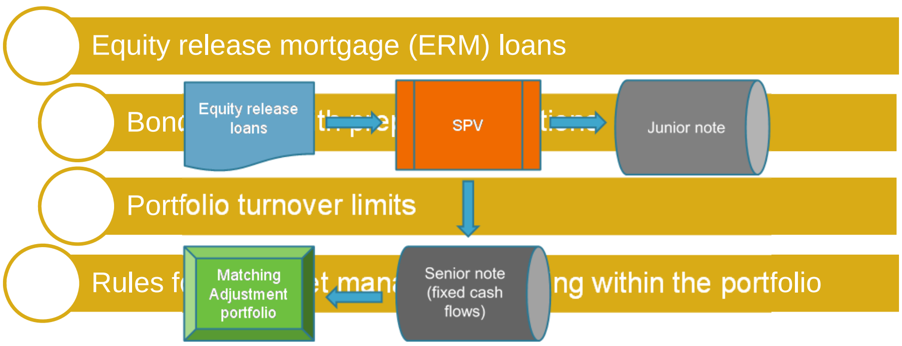
Why are we still talking about it 18 months into Solvency II?

Theory now meets practice

- Shifting focus from implementation to optimisation
- Complexity in a number of areas
- Interpretation not straightforward and varying between companies



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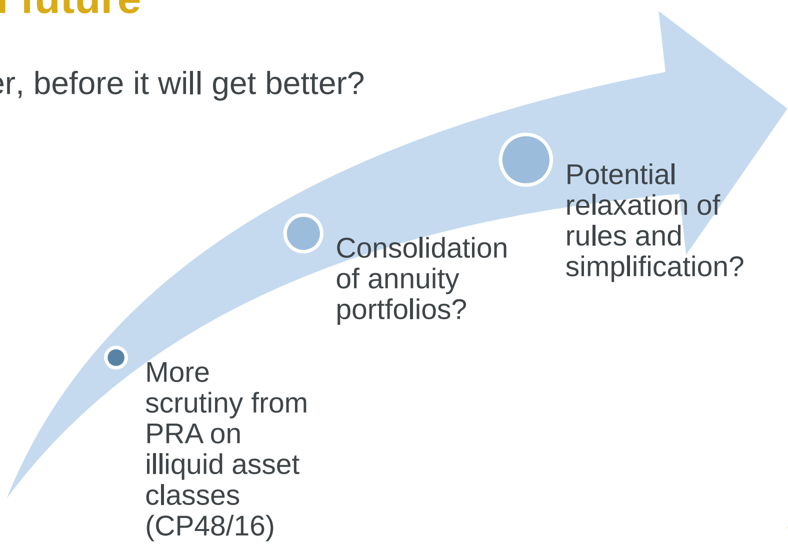
Uncertain future

Getting harder, before it will get better?



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The politics of the Matching Adjustment

Opportunities ahead for changes to be made to the MA framework

PRA to ABI

- Matching Adjustment was designed with the needs of the UK industry in mind
- Aware that some still see the Matching Adjustment as complex and too restrictive
- Open to suggestions that fit within the current legal structure

PRA to Treasury Select Committee

- Complexity around ERM restructuring is major disadvantage
- Have been driven to current rigidness by Solvency II rules
- May want to be "slightly" more flexible on "fixed cash flow" requirement

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Putting elements of the Matching Adjustment framework into the dock

Case to answer – Assets

MA rules (summary)	
Asset eligibility	Bond-like, fixed cash flows
	No issuer optionality, unless sufficient compensation provided to replace lost cash flows

Examples

- Equity release mortgages
- Bonds and loans with prepayment options

Considerations

- Predictable cash flows ×
- Pre-payment risk ×
- Property price risk (NNEG) ×
- Restructures permitted ✓
- Complexity / liquidity risk ×

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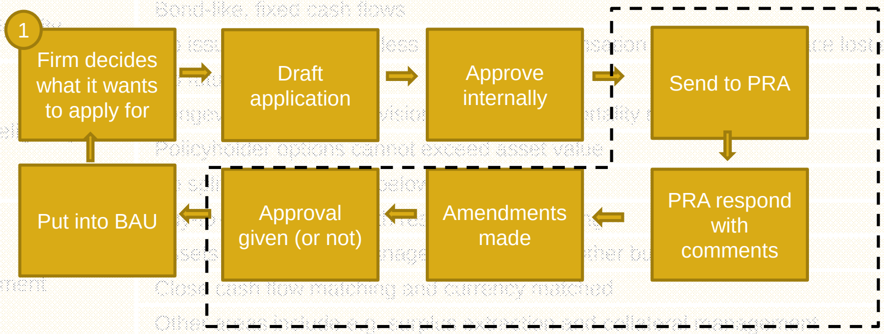
Case to answer – Approvals

MA rules (summary)



Approvals	Approval from the PRA is required before changes can be made to how the MA portfolio is managed, and before new assets and liabilities can be added to the portfolio
	Approval may take up to 6 months

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Case to answer – Liabilities

MA rules (summary)	
Liability eligibility	No future premiums
	Longevity, expenses, revision and minimal mortality risk only
	Policyholder options cannot exceed asset value
	No splitting of liabilities below contract level

Examples

- Deferred premium products
- Ill-health early retirement benefits

Considerations

- Future premiums ✗
- Morbidity risk ✗
- Contract splitting ✗
- Separate contracts ✓

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Thoughts of the Working Party

Lessons from further afield

- More inclusive liability criteria – predictability of cash flows is evaluated based on stress tests
- More relaxed hedging requirements – capital can be held in respect of currency mismatch risk
- More flexibility in terms of grouping assets and liabilities for the purposes of satisfying matching tests
- Longer time horizons for restoring Matching Adjustment compliance

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Potential changes

- No changes have been committed to by the PRA or EIOPA
- ……but if there were changes, we think:
  - More **principles based**, removing the black and white nature of the rules
  - Allow firms to apply a level of judgement based on **materiality**
  - Allow firms to use **capital buffers** for certain types of risks

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What's next?

What next?

- UK general election
- Brexit
- Working party influencing the public debate

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Questions

Comments

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