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Implementing unit linked matching

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Unit shorting

1. Technical justification
2. How it works
3. Scope
4. Approaches
5. Practical implications
6. Risk management

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Technical justifications

The technical provisions regulation

- Firms no longer compelled to match full unit-linked liabilities, only the Technical Provisions – generally lower than the unit linked liabilities.
- Opens possibility for reduction for market risk capital charges

Article 23(1) of the Directive – Benefits directly linked to units

Article 132 of the Directive – Prudent person principle

- Under Solvency II, the technical provisions can be lower than the surrender value
- Introduces flexibility in the asset selection

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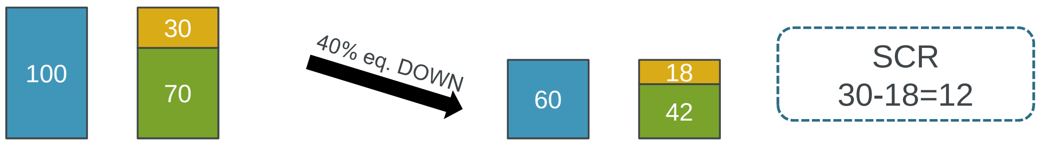
Technical justifications

Reducing SCR – The downward **equity** shock

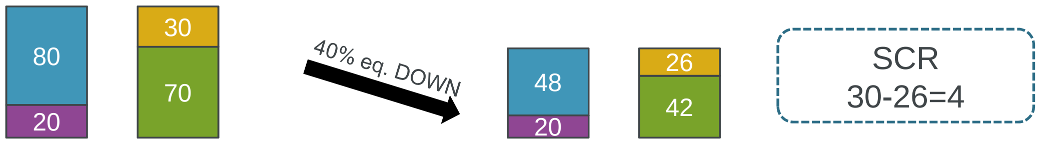
Fully invested in **equity**

- Asset position: 100 in equities
- Unit liabilities: 100, Technical provisions: 70



Surplus invested in **cash**

- Asset position: 80/20 in equities/cash
- Unit liabilities: 100, Technical provisions: 70



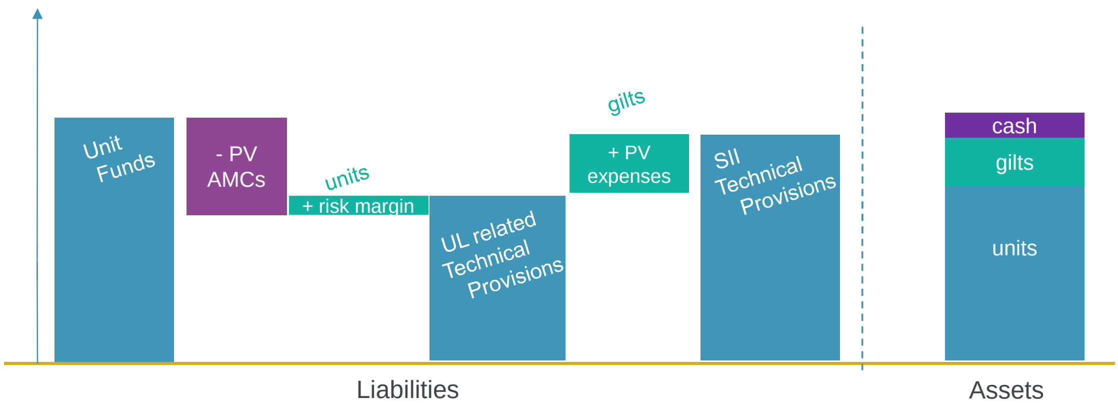
Technical justifications

Pro's and con's

Advantages	Disadvantages
Greater Investment Freedom	Introduces IFRS volatility
Better Asset and Liability Matching	Lost equity risk premium
Reduced Capital Requirement	Operational complexity
Fungible liquidity	Liquidity risk on lapse up, equities up
No change to policyholder benefits	Conduct & Reputational risk

How it works

Sell down units and then set up expense reserve, match capital



Scope

Considerations

Predictability of lapses
- Group contracts
- Life styling
- Small vs large funds

Existing VIF arrangements

Fund futures
- Growing vs closed
- Impact on pricing basis
- Size of AMC's

TCF and consistency with policyholder communications

Approaches

	Continuous	Discrete
What is it?	Application of the appropriate shorting factor to both the block and all policyholder flows	Total amount that can be shorted is treated as a facility that can drawn upon when needed
SCR Impact	Known prior to execution, relatively stable, maximised	Can be estimated prior to execution, will change as a result of the liquidation of each tranche of units
Liquidity Impact	Taken in one go, with uncertain future impacts driven by behaviour of the block. New business written can immediately be shorted, producing additional liquidity.	Taken in discrete tranches in order to meet liquidity demands, greater certainty over future liquidity impacts. New business written adds to available liquidity
Monitoring & Control	Very close and frequent oversight required to maintain position within risk appetite.	Less frequent unless amount liquidated approaches a similar percentage to that of the continuous approach

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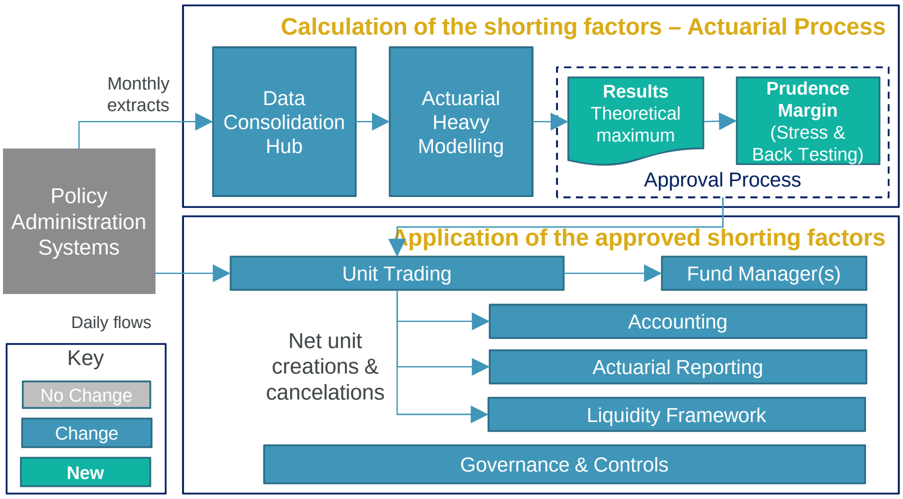
Practical implications

Conceptual Life Insurance Finance Architecture



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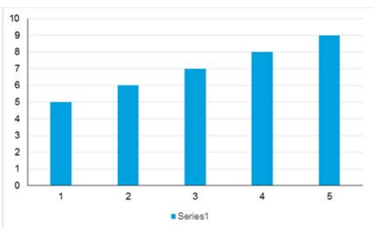
Approach to recognising AMCs

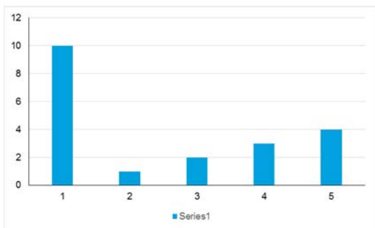
Open growing fund

With an open, growing fund, future AMCs are expected to grow in the future. This provides flexibility in shaping future AMC recognition

Without shorting



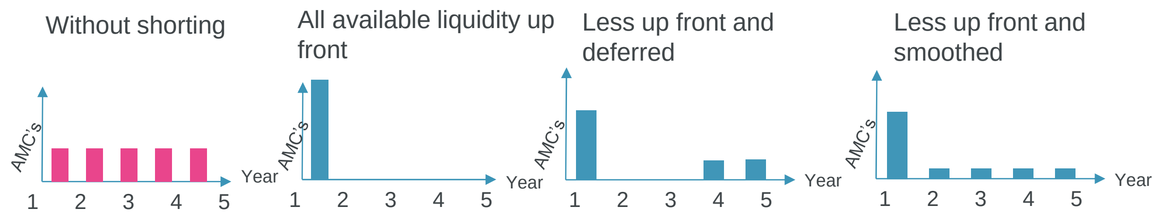
With shorting, annual liquidity still arises from new business



Approach to recognising AMCs

Closed declining fund

With a closed, declining fund, future AMCs are expected to run off in line with the expected future duration of the block. This provides less flexibility in determining the profile of future AMCs after shorting. The choices are:



Risk management

Risks introduced	Mitigants
Calculation error	Leverage existing actuarial models Ongoing monitoring of close matching Prudence margins Governance and review
AMCs lower than expected due to for example: • Lapses higher than expected • Fund switches	Choice of products/funds in scope Lapse and fund monitoring Prudence margins
Reputational risk	Operational design to avoid changes to customer interface systems
Operational risk	Automation Controls built into process
Liquidity risk following a mass lapse event combined with an increase in funds	Lapse and fund monitoring Prudence margins Liquidity framework and buffers

Discussion points

- Impact on competitiveness relative to fund managers
- Application across Europe
- Relevance for monolines vs multi-product
- Allowance for the lapse equity cross term in capital models

Questions **Comments**