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
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

Agenda

• Evolution of the MA
  – Optimisation
  – Regulatory engagement

• Future development
  – Asset Eligibility
  – Liability Eligibility
  – Application process
Evolution of the MA | Benefits

- Total capital: +£66bn
  Source: Sam Woods, PRA
- Estimated DB pension scheme liabilities outstanding: £2trn

The MA is crucial for delivery of competitive / acceptable de-risking products for policyholders and UK pension schemes.
### Evolution of the MA Timeline

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

### Evolution of the MA Optimisation

14 November 2018
Volumes | Individual Annuities

Non-Profit Annuities (Total UK Market*)

- Internal - Non Profit
- External - Non-Profit
- Non-Standard %

Source: ABI

Volumes | Bulk Annuity Deals

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

* CAGR = Compound Annual Growth Rate
Optimisation | Pricing

Source: Hymans Robertson

BPA success factors

- Ability to source attractive assets
- Capital
- Brand and relationships
- Longevity and Reinsurance
Optimisation | Asset Mixes

![Pie charts](Image)

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

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
Optimisation | Asset Innovation

Bespoke Cash Flows
- Reference index
- Caps / floors

Example
University of Cambridge (2068):
- £300m
- CPI(0, 3)
- Amortising profile: 2028-2068

Evolution of the Matching Adjustment
Regulatory Developments
Regulatory Developments | Timeline

SS3/17
CP21/17
CP24/17
Treasury Committee

SS7/18
SS8/18
CP13/18

Jul 2017 Oct 2017 Nov 2017 Jul 2018

Looking to the future
Working Party Considerations
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

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
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**

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
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?

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

Closing remarks
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

Questions

The views expressed in this [publication/presentation] are those of invited contributors and not necessarily those of the IFoA. The IFoA do not endorse any of the views stated, nor any claims or representations made in this [publication/presentation] and accept no responsibility or liability to any person for loss or damage suffered as a consequence of their placing reliance upon any view, claim or representation made in this [publication/presentation].

The information and expressions of opinion contained in this publication are not intended to be a comprehensive study, nor to provide actuarial advice or advice of any nature and should not be treated as a substitute for specific advice concerning individual situations. On no account may any part of this [publication/presentation] be reproduced without the written permission of the IFoA [or authors, in the case of non-IFoA research].