Matching Adjustment: Update from IFoA MA 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
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?
  – Industry feedback
  – Case studies
• What’s next …

The Matching Adjustment – why is it such a big deal?
**Significant impact on insurance companies and pension scheme de-risking**

- Matching Adjustment ("MA") = increase to discount rate for annuity business

- The MA is worth **£59bn** to the UK insurance industry  
  Source: Sam Woods, PRA

- There is around **£2trn** of pension scheme liabilities outstanding, so the MA could become significantly more over the coming years  
  Source: Working party estimate

- The MA is crucial for insurers to deliver competitive/acceptable de-risking solutions to UK pension schemes

**Crucial for the insurer balance sheet**

A **Solvency II balance sheet**

- **Reduces volatility**
- **Reduces SCR**
  - by c.50% spread risk
  - by c.20% longevity risk
- **Reduces BEL**
  - Increase to discount rate
Effect of stripping out the MA

Source: Hymans Robertson analysis of 2016 Solvency and Financial Condition Reports
Regulatory coverage ratio = Eligible own funds ÷ SCR
Figures refer to the Solvency II groups
For some firms the reported coverage ratio drops below 0% when the MA is removed

What is the Matching Adjustment?
Matching Adjustment 101

- Investment in long-dated fixed-income type assets
- Close cash flow matching
- Buy and hold strategy

Matching Adjustment 101 (continued)

Spread above risk-free

- Residual element of spread
  - "Illiquidity premium"
- Expected loss on downgrade
- Expected defaults

"Matching Adjustment"

"Fundamental spread"
Assets and liabilities subject to eligibility assessments

<table>
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<tr>
<th>MA rules (summary)</th>
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<tr>
<td><strong>Asset eligibility</strong></td>
<td><strong>Bond-like, fixed cash flows</strong></td>
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<td><strong>No issuer optionality, unless sufficient compensation provided to replace lost cash flows</strong></td>
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Stringent approval process

- Firm decides what it wants to apply for
- Draft application
- Approve internally
- Send to PRA
- PRA respond with comments
- Amendments made
- Approval given (or not)
- Put into BAU

- Long and involved process but prize is high
- Some firms very conservative initially
Why are we still talking about it 18 months into Solvency II?

What you’ve been telling us – Assets

• Everyone chasing the same MA eligible assets → Yields down → Annuity rates down

• Rules can lead to significant additional complexity e.g. SPV repacks

• The all or nothing nature of the rules is very unhelpful

• Macro effect of the rules → Stifling lending to the economy

• How to deal with the risk of prepayment
What you’ve been telling us – Approvals process

• Insurers missing opportunities → Bad for consumers
• Some firms deciding to just walk away from opportunities
• Increasing the lead time on large BPA deals
• Impacting the price of BPA deals
• Need for more reliance on firms’ internal governance

Case study 1 – Infrastructure

British insurers commit £25bn to UK infrastructure

UK life insurers can help boost infrastructure

More government encouragement is needed for private sector investment
Infrastructure (continued)

- Construction risk periods
- Credit protections
- Inflation linkage
- Walk away from deals
- Borrowers removing clauses
- Restructuring

Case study 2 – Benefit restructures

Philip Green agrees to pay £363m into BHS pension fund

Tata Steel agrees deal to offload British Steel pension fund
Benefit restructures (continued)

- Surrender options
- Flexible buy-in terms
- Future premium
- Fewer insurers quoting
- Higher cost
- Scheme enters PPF

What’s next?
Work underway and what’s to come

**ABI/PRA working party**
- Looking at how to ease practical burdens and hurdles **under existing rules**
- More clarity on “features”
- Extending callable bond treatment to other assets
- Ease application burden

**IFoA MA working party**
- Looking at potential changes to ease practical burdens and hurdles **post Brexit**
- More principles based
- Applying a level of judgement based on materiality
- The use of capital buffers for certain types of risks

More scrutiny from PRA on illiquid asset classes (SS3/17)

Questions

Comments

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