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Slaughter and May Podcast

Solvency II - The Matching Adjustment

Robert Chaplin	Hello and welcome to this overview of the matching adjustment. For more information please see chapter 6 of our Solvency II App. If you don't already have the App please email solvency.two@slaughterandmay.com to request access. The matching adjustment is one of the more complex features of the Solvency II regime and one which has given rise to large amounts of structuring work for UK insurance groups. We lead the market in this field. The MA is an adjustment to the calculation of the best estimate of a firm's insurance liabilities. The best estimate is based on the probability-weighted average of cash flows under the relevant insurance policies, which is then discounted to reflect the time value of money. In the absence of any adjustment, the discount rate is a centrally set risk free rate, usually calculated based on interest rate swap rates. The matching adjustment adjusts the discount rate to reflect the investment return on assets actually held by the insurer, after allowing for default and downgrade risk. This can result in a higher discount rate, and therefore a lower calculation of the best estimate. There are, however, a number of conditions to the application of the matching adjustment, which Beth will explain.
Beth Dobson	Firstly, in order to apply the matching adjustment, the insurer must identify a portfolio of liabilities to which the adjustment will apply and a corresponding portfolio of assets which are held to back those liabilities. This portfolio must be managed separately from the rest of the insurer's assets and liabilities. Secondly, the matching adjustment can only be applied to insurance liabilities which meet the criteria set out in the Directive. These criteria were designed to apply in particular to life time annuity policies but do apply to other types of liability as well, such as various life savings products. The key requirements are that the contracts underlying the liabilities must not give rise to future premium payments and must not include any policyholder options, other than a surrender option where the surrender value does not exceed the value of the assets backing the liabilities at the time the option is exercised. The liabilities must also be life insurance liabilities or annuities stemming from non-life insurance contracts. The UK has the largest amount of MA compliant liabilities but there are other material pools around Europe, for example in Spain. Thirdly, the assets in the matching adjustment portfolio must meet criteria set out in the Directive. Principally, the Directive requires that the portfolio must consist of bonds and other assets with similar cash flow characteristics. In addition, the cash flows of the portfolio of assets must be fixed and must not be able to be changed by the issuers of the assets or any third parties, including as a result of early termination

	rights. These criteria have been subject to a significant amount of discussion and interpretation, particularly in the UK, as we will come back to. There are a couple of exceptions to the fixed cash flow requirement – where inflation-linked assets replicate liability cash flows which depend on inflation and where an asset contains a "Spens" clause, or similar, in the event of early termination.
Robert Chaplin	The basic criteria for application of the matching adjustment fit well for a portfolio of annuity policies backed by long-term fixed rate corporate bonds or gilts, denominated in the same currency as the liabilities. In practice, however, most insurers' books of business are more complex than this – and there is an obvious desire to use higher yielding assets in order to enhance returns. This has led to issues of interpretation as well as the restructuring of assets. Insurers have sought to interpret the rules in a way which allows assets other than "plain vanilla" bonds to be used within the matching adjustment portfolio. In the UK, the PRA has responded to this by issuing initially a series of letters and subsequently a consolidated supervisory statement giving guidance on asset eligibility. Some key points are: • The PRA considers that pairing of assets can be used to meet the MA criteria. In principle, for example, a foreign currency bond could be matched with an appropriate currency swap – although in practice it is likely to be difficult to obtain sufficiently long-dated currency swaps for this to work. Similarly, the pairing of a floating rate bond with an interest rate swap might allow for asset eligibility • Firms may be able to include callable bonds in their MA portfolios but, unless restructured, only the cash flows up to the first call date can be included, plus the final redemption payment if it is only recognised at its final redemption date • Similarly, bonds backed by construction projects may be capable of MA eligibility provided the cash flows are only recognised at the latest date when payments may start under the bonds. It is worth noting that EIOPA has expressed the view in its consultation on the 2020 review of Solvency II that these types of bonds should not be viewed as eligible for the MA portfolio. Given that the UK will exit the Brexit transition period at the end of the year it is perhaps unlikely that the PRA will change its approach to reflect the EIOPA view • Reinsurance receivables are MA compliant even where payments under the agreement are variable, provided the variation reflects fluctuations in underlying claims – a properly drafted reinsurance treaty should be a perfect matching asset.

Beth Dobson	Where assets held by insurers are not capable of meeting the matching adjustment criteria but have traditionally been used to back annuity and similar liabilities, the alternative approach has been taken by many firms of restructuring their non-compliant assets into structures which involve the issuance of MA and non-MA compliant notes. This typically involves putting the non-compliant assets into an SPV which then issues MA compliant fixed rate notes to the insurer's MA portfolio. To address the non-fixed aspects of the cash flows on the underlying assets (such as the capital value of a real estate asset after the expiry of a 25 year lease), floating rate notes are also issued and held outside of the MA portfolio. Payments under these notes will depend on the asset cash flows. A number of additional features may be present in these structures, including tranching of notes and liquidity facilities to improve the rating of the notes. There are also a variety of third party structures in the market, typically created by investment banks or alternative asset managers, which offer access to MA compliant repacks, albeit at a price. Structures on which we have advised include ones used to restructure normal commercial property, properties under construction, equity release mortgage assets, Dutch mortgages, CLOs and foreign currency denominated bonds. Although the PRA accepts the use of this type of SPV structure for MA purposes, there are ongoing tensions around the valuation of the notes issued by the SPV to the MA portfolio, as shown in the PRA's recent COVID-19 related statement on this subject. This is part of a larger concern of the PRA's regarding valuation of illiquid, unrated assets. The calculation of the matching adjustment requires all assets to be assigned a credit quality step, in other words a rating. This then feeds into the "fundamental spread", which is a component of the matching adjustment calculation intended to reflect the amount of spread corresponding to the probability of default, and the expected loss resulting from any downgrade of the asset. For externally rated assets this is obviously a straight forward process. Where an internal rating is assigned by the insurer, however, there is scope for that rating to have a large impact on the amount of matching adjustment benefit. The PRA has published guidance on the process for determining the fundamental spread using an internal credit assessment. Amongst other things, it has stated that the credit quality step to which an internal credit assessment maps should lie within the "plausible range" of credit quality steps that could have resulted from an external credit assessment. The PRA may seek additional assurance from firms where it has concerns about their ratings processes, and is likely to focus on more complex assets and those where a high amount of MA benefit is being derived. This is part of a broader regulatory concern that firms should have the skills, systems and controls appropriate to the asset classes into which they invest.

Robert Chaplin	A particular area of focus for the PRA has been MA structures involving equity release mortgages, which are a large asset class for UK life insurers, due to their inherent matching characteristics. In 2018 the PRA published guidance on equity release mortgages which set out its expectations as to how firms should value equity release mortgage assets and how they should test the amount of MA benefit being claimed for corresponding SPV notes against the economic value of the underlying assets. In particular, the PRA specified how firms should value any "no negative equity guarantees" embedded in the ERMs, using a methodology which many firms considered excessively conservative with regard to future property prices. This is a difficult subject and perhaps demonstrates the importance of ensuring that an appropriately diversified portfolio is maintained. Looking ahead, the matching adjustment is one of the areas which the Government has flagged to be reviewed when looking at the post-transition regulatory regime. The approach of the PRA to date suggests that a major relaxation of the rules is unlikely but significant simplification may be possible. There is speculation that the need to restructure might be replaced with an accounting segregation of returns - although there is little appetite for any solution that would prejudice the possibility of equivalence. This brings us to the end of this podcast but if you have any questions about the matching adjustment, please get in touch with either of us or your usual contact at Slaughter and May.