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Briefing note

Matching adjustment

With Omnibus II having set out the finalised matching adjustment criteria, the focus has now turned to the practicalities of how firms will ensure their assets (and liabilities) are eligible and how to provide the evidence required by the application process. The purpose of this note is to provide a summary of the current position regarding the matching adjustment application process and the questions that remain outstanding.

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The PRA also ran a trial submission exercise during June/July 2014, which a number of companies completed on the basis set out in the draft ITS.

Background

EIOPA produced a draft Implementing Technical Standard (ITS) in April 2014 and the PRA has included several comments on the matching adjustment in recent correspondence to firms.

The PRA also ran a trial submission exercise during June/July 2014, which a number of companies completed on the basis set out in the draft ITS. The PRA will undoubtedly use this to inform the UK specific application process.

Application requirements

Based on the draft ITS, applications need to include the items given below.

- Evidence that assets and liabilities meet the matching adjustment criteria, as set out in the Omnibus II text.
- Line-by-line asset information (class, quality, duration, etc.).
- Description of how assets will be managed, including when cashflows change.
- Evidence that adequate processes are in place to manage assets and liabilities separately from other activities.
- Evidence that own funds have been adjusted to reflect reduced transferability.
- Evidence that SCR reflects reduced scope for risk diversification.
- A ‘liquidity plan’.
- Sensitivity analysis.
- Assessment of capital requirements without the matching adjustment.
- Detailed explanation and demonstration of the calculation process used to determine the matching adjustment.
- Information about other applications made or expected for approval (internal models, ancillary own funds, SPVs, etc).

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No template is due to be provided and so insurers will have to decide themselves on the form of their submission. The impact of this was shown in the trial submissions which were very varied in both length and content as a result. The finalised ITS is expected in October 2014 with a supervisory statement due out in Q4 2014 to confirm the PRA's UK specific application process.

Once an application is made, the PRA will have up to six months to reach a decision. The application window opens on 1 April 2015. We expect most insurers to be targeting the early stages of this window to help mitigate any delays caused by the PRA asking for further information.

Remaining questions

Whilst the application process is being consulted on, it is clear that there are still different interpretations in the market on some aspects of the rules. In particular, the trial submission highlighted that there are still some fundamental questions outstanding about what will be allowed under the matching adjustment. Some of these are considered below.

Eligibility of liabilities

It is generally understood that most types of annuity in payment will be eligible for the matching adjustment. For the most part this includes contracts with inflation-linking or guarantee periods.

The situation for deferred annuities is not so straightforward. Certainly, any contracts with future premium income are ineligible but single premium or paid-up deferred annuities may still be eligible.

Evidencing cashflow matching

A fundamental requirement is that asset and liability cashflows match with any mismatch being immaterial. Immateriality is not defined in the Solvency II documentation and so is left at the discretion of the insurer and supervisor to decide.

The PRA has intimated that some cashflow analysis will be needed to prove the criteria have been met, rather than simply relying on the results of the Solvency Capital Requirement for example. A liquidity plan is also needed, and it is not clear how this should differ.

Asset eligibility

Asset cashflows need to be ‘fixed’. This is likely to exclude some assets currently used to back annuity liabilities. Potentially inadmissible assets include those with prepayment risk, including equity release and mortgage loans.

Insurers will need to assess whether their current asset portfolios meet the criteria. Inadmissible assets could be transformed (via SPVs or similar) but this is likely to be a substantial exercise. Ultimately, assets may need to be sold (and replaced with eligible assets) or transferred around the group as a result.

Assets with optionality are not necessarily excluded from matching adjustment portfolios “provided the risk of not being able to replace the cash flows if the option is exercised is negligible”. In particular, ‘Spens’ or similar redemption clauses could be allowed and different types of callable bonds will be assessed on a case-by-case basis.

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The overriding consideration will be whether the matching adjustment portfolio is exposed to the risk of changing spreads on the underlying asset, contrary to the fundamental rationale for the matching adjustment. It may be possible to apply haircuts to assets that do not otherwise meet this criterion in order to make them admissible.

Asset management

The premise of the matching adjustment is that assets will be held to maturity and therefore there is a question about whether assets included in assigned portfolios can be bought and sold, and under what circumstances. In particular, corporate bond assets are rarely held on a buy-and-hold basis; buy-and-maintain is now more prevalent.

Typically, bond managers will sell stocks where rating downgrades occur (or are expected), to reflect changing economic conditions, or where they see better value elsewhere. The Omnibus II text uses the term 'maintain' in reference to the assigned portfolio and explicitly allows replacing assets where cashflows have materially changed. However, there is still uncertainty around exactly when assigned assets can be sold.

Do you need to re-apply?

There has been no formal word on how often the matching adjustment needs to be applied for, once it has been granted. It seems unlikely that insurers will be able to use it indefinitely without periodic updates to confirm the criteria are still being met.

The treatment of new business is also an area where guidance has been lacking. Can it simply be inserted into an existing assigned portfolio? If insurers need to apply for the matching adjustment separately in respect of new business this may cause dips in solvency levels and/or additional capital requirements in the period before the adjustment is granted.

Other options

The volatility adjustment and transitional measures (or using both together) are alternatives to the matching adjustment. The Government is currently consulting on how the volatility adjustment application process will work but it is still likely to remain a viable alternative for some insurers with annuity liabilities.

Conclusion

For the most part the details of the matching adjustment have been decided and insurers wishing to use it should be making preparations now, ahead of the opening of the application window in April 2015. However, there are still many unanswered questions and firms should be considering their arguments and the potential impact of various interpretations where direction has not yet been given by EIOPA or the PRA.

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Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

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