Institute and Faculty of Actuaries

CP21/17: Matching adjustment

IFoA response to Prudential Regulation Authority

31 January 2018

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute
and Faculty
of Actuaries

CP21/17
Henrietta Tait
Bank of England
Threadneedle Street
London EC2R 8AH

31 January 2018

Dear Henrietta,

IFoA response to Consultation Paper CP21/17: Matching adjustment

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the PRA's consultation paper (CP) on the Matching Adjustment (MA). A number of IFoA working parties (including parties considering the MA and Equity Release Mortgages, ERM) and our Life Insurance Board have been involved in the drafting of this response. Members of these working parties and the Life Board are actively engaged with the operation and management of MA portfolios by life insurers.

2. Our detailed response to the consultation is set out in the Annex; however the most important issues are noted below.

3. As the PRA will realise, the MA is of vital importance not only to the insurance industry but also to the wider public and to the national economy. It has a significant impact on annuity rates, on the ability of insurers to invest in illiquid assets, and on the viability of pension scheme de-risking. Streamlining the MA process would be helpful in encouraging innovation and reducing reliance on contingency plans.

4. We welcome the fact that this CP proposes to consolidate material previously set out in various Directors' letters published between April 2013 and February 2016. Having a single reference document for all of the PRA's guidance is helpful for practitioners.

5. It is also welcome that the CP proposes adjustments to the insurance prudential framework to reflect firms' experience following the UK introduction of SII, and the areas for reform raised by the Association of British Insurers (ABI).

6. The CP proposes several useful clarifications, for example the treatment of changes to the MA portfolio that may inadvertently breach firms' previous approvals, and the point from which the two month period for rectifying any breach begins.

7. We are also pleased to see that the PRA is open to considering different methods for restructuring or transforming assets to make them eligible for inclusion in firms' MA portfolios, not just restricting firms to the use of Special Purpose Vehicles (SPVs). We agree that for any form of restructuring or transformation, firms will need to demonstrate their compliance with the SII Directive's requirements for risk management, and with the Prudent Person Principle (PPP).

London 7th Floor · Holborn Gate · 326-330 High Holborn · London · WC1V 7PP · **Tel:** +44 (0) 20 7632 2100 · **Fax:** +44 (0) 20 7632 2111
Edinburgh Level 2 · Exchange Crescent · 7 Conference Square · Edinburgh · EH3 8RA · **Tel:** +44 (0) 131 240 1300 · **Fax:** +44 (0) 131 240 1313
Oxford 1st Floor · Park Central · 40/41 Park End Street · Oxford · OX1 1JD · **Tel:** +44 (0) 1865 268 200 · **Fax:** +44 (0) 1865 268 211
Beijing 6/F · Tower 2 · Prosper Centre · 5 Guanghua Road · Chaoyang District · Beijing China 100020 · **Tel:** +86 (10) 8573 1000 · **Fax:** +86 (10) 8573 1100
Hong Kong 2202 Tower Two · Lippo Centre · 89 Queensway · Hong Kong · **Tel:** +11 (0) 852 2147 9418 · **Fax:** +11 (0) 852 2147 2497
www.actuaries.org.uk

8. The PRA will also be aware of the House of Commons Treasury Committee's inquiry into Solvency II (SII) and the UK insurance industry. We have considered the conclusions of this inquiry in our comments below. In particular, we highlight in our response areas in the current guidance where we believe the complexity and cost of regulation may be inhibiting competition.

9. Nevertheless, we do not believe that the new and additional guidance proposed by this CP (over and above what is set out in previous Directors' letters) will be sufficient to allay the main challenges currently being faced by UK insurers running MA portfolios:

   (a) the ability to add new assets and liabilities to MA portfolios in a timely fashion;
   (b) the process by which changes can be made to existing MA approvals; and
   (c) the likelihood that firms will need to use artificial structures to restructure certain asset classes in order to include them in their MA portfolios.

10. Regarding point (a) above, the CP provides some useful examples to illustrate what the PRA may deem to be a 'new feature' in relation to an asset that a firm wishes to add to its MA portfolio. However, the examples provided imply that it is going to be extremely difficult for a firm to justify that features are materially similar to those of assets already held in the MA portfolio.

11. Regarding point (b), our interpretation is that there is nothing new in the CP which will make it easier for firms to make changes to their existing MA approvals, particularly where these changes are relatively minor.

12. In addition, there are a number of areas where we believe that the CP applies an unnecessarily onerous approach: for example, the presumption that new reinsurance arrangements are unlikely to have the same features as assets within the scope of the MA approval. In many circumstances, new arrangements are very similar to existing reinsurance treaties.

13. The requirement that firms making changes to existing approvals need to approach them as they would for a completely new MA portfolio is also onerous. We suggest that some form of lighter touch re-application process be allowed, particularly if firms are making only small changes, such as minor amendments to processes.

14. Taken together, these points affect insurers' ability to operate efficiently and to contribute to the wider UK economy through infrastructure and household lending, and de-risking pension schemes.

15. We strongly support further flexibility to use partial recognition of cash flows to meet the MA eligibility criteria. It would be useful if the PRA could provide further clarity on whether the approach to partial cash flow recognition in the MA calculation could be extended to deal with other areas of quantifiable deviation from the eligibility requirements.

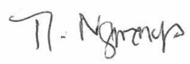
16. Finally, we would welcome clarification on how to reflect the new guidance in the CP into the scope of existing MA approvals. We would hope that firms will not need to submit new applications to the PRA. Further, guidelines should be provided on what a firm should do where it believes that any of the new guidance conflicts with any firm-specific guidance that has been received in the past. We would suggest that in the first instance firms contact their supervisors to discuss any discrepancies, with the aim of a simple update process to the firms' existing approvals.

17. As mentioned above, more detailed consideration to support this response is given in the Annex, and we would be happy to clarify/elaborate on any of our responses within the Annex.

Should you wish to discuss any of the points raised in further detail please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk / 0207 632 2146) in the first instance.

Yours sincerely

Marjorie Ngwenya



President, Institute and Faculty of Actuaries

Annex – Detailed Response to PRA Consultation Paper CP21/17

Our detailed response below primarily considers those areas of the CP which are new or updated compared to the various Directors' letters published between April 2013 and February 2016.

Asset eligibility

1. We agree with paragraph 2.2, but would suggest that the wording of the last sentence be modified so that the requirement is for firms 'to be able to demonstrate' rather than just 'to demonstrate'. This will avoid the unintended consequence of the need for constant reporting and unnecessary overheads. It would also make this paragraph consistent with other parts of the section of the CP on asset eligibility (e.g. paragraph 2.43).

2. There is also a mix of the words 'conditions' and 'requirements' in paragraph 2.4 that appears to refer to the same concept, and so we suggest replacing all references to 'conditions' with the word 'requirements' to aid clarity for readers of the Supervisory Statement (SS).

Extension on default clauses

3. Our interpretation of paragraph 2.23 is that extension in the event of default clauses can be treated by firms like market standard redemption clauses. We would welcome some examples for this type of clause: giving examples of both assets which are permissible, but also assets which are not permissible.

Cash flows with uncertain but bounded timing

4. We welcome the proposal (paragraphs 2.32 and 2.34) of extending the treatment of cash flow uncertainty on callable bonds to other assets with uncertain but bounded cash flow timing.

5. In particular, the proposal to extend this treatment to assets that have cash flows with uncertain but bounded start times (such as loans with an initial construction phase), provides the opportunity to include these assets within the MA portfolio. This avoids any inconsistencies that may arise from a potentially arbitrary classification.

6. However, our view is that the permitted treatment of callable bonds, as set out in Paul Fisher's letter dated October 2014, is punitive, as it leads to a significantly diluted (or even negative) MA for these assets. The approach could be amended to recognise at least a prudent level of cash flows where there is uncertainty. We believe this could be achieved through either a yield to worst approach, or setting to zero spreads earned on the uncertain cash flows.

7. Our interpretation of paragraph 2.35 is that the PRA does not view 'yield to worst' as an acceptable approach for determining the cash flows on a callable bond, for use in the MA calculation and cash flow matching tests. We regard this as a punitive outcome for firms.

8. A yield to worst approach is a prudent but economic approach where the lowest values of future cash flows are recognised for matching purposes. The current permitted approach results in total cash flows that are lower than any realistic future expectation of those cash flows.

9. A yield to worst approach for callable bonds can meet the requirements of Article 42 (4) (e) and (f) of the SII Delegated Regulations, by demonstrating in Test 2 of the three cash flow matching tests, that the risk of the cash flows changing as circumstances change is not material to the portfolio.

10. We would also ask the PRA to consider whether the permitted approach, as set out in Paul Fisher's letter dated October 2014, should be modified to recognise that firms would in practice expect to earn at least a risk-free rate of return (in accordance with the risk-free rate curve prescribed by EIOPA), between the first call date and the legal final maturity date.

11. Recognition of risk-free returns could be restricted to the component B element of the MA calculation only, to ensure that firms do not place any reliance on uncertain cash flows when

performing their cash flow matching tests. This would mean that coupons after the first call date are included back within the component B calculation, but with those cash flows adjusted to exclude the spread (or the fundamental spread if higher). We believe this approach would be consistent with the requirements of the SII Delegated Regulations.

Sufficient compensation

12. We welcome the clarification on requirements for assessing ‘sufficient compensation’ on early redemption clauses. The new guidance appears to widen the scope under which firms can apply the methodology for partial recognition of cash flows, as set out in paragraphs 2.15-2.16, to a modified spens context.

13. The PRA’s proposed interpretation would seem to reduce the risk of assets arbitrarily switching from being MA eligible to ineligible, as a result of early redemption clauses falling outside a firm’s spens limits; e.g. due to assets upgrading, a refresh of limits etc.

14. However, it is not clear whether firms would need to submit a revised application in order to benefit from this new guidance, and it would be helpful if the PRA could set out its expectations in this regard. We suggest that firms should be able to update procedural notes and any impacted items within their governance frameworks, keeping the PRA informed, without the need to submit a new application.

15. It would also be helpful if the PRA could provide further examples to clarify how broad the range of scenarios is, under which partial recognition of cash flows could be applied within the modified spens context. For example, would firms be able to argue for a new investment in an asset with early redemption clauses that fall outside its limits, if it applied a suitable haircut to the cash flows of that asset?

16. In addition, it would be useful if the PRA could comment on whether the approach to partial cash flow recognition in the MA calculation could be extended to deal with other areas of quantifiable deviation from the eligibility requirements. If an opportunity arose for a firm to invest in an asset with a new feature, for example, could the firm apply a prudent haircut to cash flows until such time as it has received approval to include that feature? For example, where modified spens is expressed relative to a different reference curve (say LIBOR), compared to that which the firm already has approval for (say gilts), could the firm apply a haircut allowing for the maximum historic difference between these curves, assuming reinvestment into the reference curve which it already has approval for? Such an approach would provide greater flexibility when investing (or taking on new liabilities) and would remove some of the current artificial barriers to competition introduced by differences between various firms' MA applications.

17. We would very much support further flexibility to use partial recognition of cash flows to avoid MA ineligibility. We believe this would also enable insurers to play a much more active and leading role in supporting infrastructure and other long term illiquid investment within the UK economy, without needing to resort to artificial restructurings.

18. We note that in previous guidance, the PRA asked firms to consider cases such as asset upgrades within their Own Risk and Solvency Assessment. The new guidance now reduces the risk of mass upgrades causing any material issues for some firms in terms of their MA portfolio and potentially requiring forced sales/removal of certain assets. We believe this is an appropriate and pragmatic view to take and fully support it.

19. However, we note that there is scope for a range of approaches when recognising cash flows to ensure that an asset’s compensation would remain sufficient to replace the cash flows needed to match relevant MA eligible liabilities. For example, a firm may want to consider either differences in its internally assessed modified spens limits when deciding on which haircut to apply to asset cash flows, or alternatively differences in fundamental spreads between ratings.

20. We would encourage flexibility in this regard, and as such it would be helpful if the PRA could comment on the approaches it would consider both acceptable and unacceptable, for adjusting

cash flows for this purpose. We believe that the PRA should permit those approaches which encourage economically intuitive outcomes when managing MA portfolios.

Cash items

21. We support the sentiment of paragraph 2.48 and welcome the clarification to practitioners. We believe it would be helpful if the PRA could confirm that each individual investment, underlying cash or money market fund, for example, does not itself need to be MA eligible; but rather, that firms should be able to demonstrate that the fund is liquid and therefore can be treated as a time 0 cash flow in its MA calculation and cash flow matching tests.

22. However, we suggest that the PRA adds additional wording to the end of the first sentence in paragraph 2.48: '… the PRA does not consider that expected future cash interest can satisfy these eligibility conditions *unless paired or grouped with a suitable contract'*. This would be consistent with existing practice.

Asset Restructuring

23. In paragraph 2.55, the PRA explains that it expects restructuring arrangements to be used exceptionally. However, we note that restructuring arrangements are commonplace in the context of ERM assets. We understand that the use of 'exceptional' in the context of asset restructures is intended to refer to the entire 'universe' of possible assets i.e. ERM (and similar) assets are supposed to be identified as the exception, rather than suggesting that ERM assets could only be restructured in exceptional circumstances.

24. We also understand that the intention of this is to permit firms to use another approach if they can identify one. If our interpretation of these points is correct, we suggest the PRA clarifies this to avoid any potential ambiguity.

25. Paragraph 2.58 explains that the PRA expects firms to consider whether un-restructured assets are likely to remain appropriate over time. We have a number of questions in the light of this:

    - how does this affect companies who have already agreed a structure with the PRA? In particular, how does this apply to a restructured asset based on a portfolio of loans with variable Loan to Value (LTV)? A small proportion may have a high LTV; should these be excluded?;
    - does this mean that a securitisation of home reversion plans is not MA eligible?;
    - since LTV generally increases over time, does this mean loans may cease to be MA eligible and 'drop out' of the SPV at some point in the future? The internal ratings process already assesses the credit quality of the senior note over the full life of the mortgages, allowing for deterioration of the LTV over time.
    - how can this be applied consistently to further loan advances on a property?;
    - should this be allowed for under stress, e.g. Property value stress?; and
    - does this create an additional requirement on ERM compared to infrastructure investment or investment in any other securitisation?

    We suggest the PRA considers adding further detail or some encompassing principle to the SS to address these questions, where appropriate.

26. Paragraphs 2.59 and 2.60 discuss robust rating processes for SPVs including Total Return Swaps (TRS). We note that the cost of obtaining an external rating may be disproportionate for smaller firms. It would also be helpful for the PRA to suggest how its concerns with TRS could be addressed in a cost-effective manner.

Liquidity facilities

27. Paragraph 2.66 appears to require a further rating assessment and hurdle in relation to SPVs, i.e. an assessment of the credit rating worthiness of the senior note as well as non-MA portfolio. It would be useful to understand how this is anticipated to apply to providers without an external rating. It may create a further competitive disadvantage to smaller insurers and an additional barrier to entry to the lifetime mortgage market. It may also drive providers to seek external liquidity facilities; there is likely to be considerable further cost attaching to this. Given this, we suggest that the PRA take a proportionate approach in these contexts, and revise the SS accordingly.

Capital requirements

28. Paragraph 2.72 suggests that standard formula firms with ERM risk exposure may wish to develop a partial internal model. This would seem to create a barrier to entry to the ERM market. As noted by the Treasury Committee in their SII inquiry, there is a concern that the burden of developing and applying for partial internal model approval could limit competition and growth. It would be helpful to apply proportionality in this context, such as where firms had limited ERM exposure.

Rebalancing assets in an MA portfolio

29. We welcome the addition of paragraph 7.15 to the published guidance; our understanding is this is what insurers are largely doing in practice, and it therefore levels the playing field for insurers who may have been more cautious previously. However, we believe it may aid understanding and create consistent interpretation across firms if the illustration of examples were expanded to include a re-risking scenario; this is a scenario permitted in the earlier part of the paragraph.

Ongoing MA compliance

30. We also welcome the addition of paragraph 8.2 to the published guidance. We support the PRA's view that firms should engage with the regulator as early as possible where there is a risk of breach of any of the MA portfolio requirements.

31. The clarification in paragraph 8.3 regarding the PRA's approach towards a firm's possible breach of MA requirements is also useful, i.e. that the two month period to restore compliance begins when a breach is detected or confirmed.

Changes to MA portfolios

32. We recognise that a 'feature' is not defined in the SII Directive. We believe that it should be interpreted at a level which allows firms to operate efficiently and access new opportunities without undue delay caused by constant referral to the PRA. No two assets are the same and, particularly in the private credit market, almost every single asset could be viewed as having new features if it is defined in minute detail. Additionally, only features which affect MA eligibility should need to be considered.

33. We believe that firms should form their own views and come up with their own definitions of what constitutes a 'feature' that is relevant or material in the context of the MA. Although it would be helpful to have some guidance from the PRA on this, we believe reliance should be placed on firms' internal governance processes to determine what constitutes a feature.

34. Subject to approval from the PRA, we believe firms should be able to redefine the relevant sections of their current MA approvals, to give them the flexibility to rely on their internal governance processes, to determine when a new asset or liability contains a new feature.

35. The current process of having to seek approval from the PRA every time a firm wants to add an asset with a new feature to its MA portfolio is onerous and lengthy. In our view the process for seeking approval to add an asset with a new feature needs to be far more streamlined to avoid impacting on firms' ability to invest.

36. With the above in mind, we believe the infrastructure example provided in paragraph 9.5 is too restrictive, and it is not clear why it only applies to this specific asset class. We suggest the following example may be more appropriate: ‘investments with materially different risks affecting cash flow timing or amount, such as those referred to in paragraph 2.32’.

37. We do not agree that new reinsurance arrangements are likely to contain new features. In many circumstances, they are very similar to existing treaties, particularly for firms open to new business, where deal-specific longevity reinsurance treaties (but on the same terms as previous treaties) are common. We suggest that paragraph 9.6 be changed to make it clear that only new reinsurance contracts that are significantly different in nature, or are a change to the reinsurance strategy of the company, are likely to result in new features resulting in the need for a revised MA application.

38. The requirement that firms making changes to existing approvals need to approach it as they would for a completely new MA portfolio (as stated in paragraph 9.7) is onerous, given the significant amount of time and resources taken up in producing full MA applications. We suggest that some form of lighter touch re-application process be allowed, particularly if firms are making only small changes; such as adding new asset classes or minor amendments to processes.

39. A lighter touch re-application process with a quick PRA turn-around time would also enable firms to request individual changes for approval (such as adding an asset with a new feature), rather than having to defer requests for approval until a sufficient number of items can be aggregated together and submitted to the PRA in one batch. This ‘batching’ is typical of the approach currently being adopted by firms because of the time and effort required to produce an application, but also because firms can only have one live request for approval at any given time.

40. We welcome the clarification in paragraph 9.9, given this has previously been an area of uncertainty for firms with potentially large financial consequences.

Other comments

41. We note that the draft SS does not contain any guidance on the eligibility of assets which have either defaulted or (particularly) for loans in work-out phases or similar. We are aware of firms’ uncertainty in this area now that MA portfolios are being used in practice. It would be helpful if the PRA were happy to allow firms to continue holding such assets in their MA portfolios, to avoid issues such as the ability to remove and/or sell the assets, particularly in a stressed scenario.

42. We note that for general insurers, the MA is of particular relevance in relation to Periodic Payment Order (PPO) liabilities. However, due to the long duration and specific inflation characteristics of PPOs, meeting MA eligibility requirements is challenging in this context. Although paragraph 4.4 of the draft SS acknowledges difficulties with such liabilities (lack of assets inflating on a similar basis), it would be helpful to identify potential solutions to such issues.

43. The CP says that ‘Appendix 2 provides a summary of the Directors’ letters the PRA proposes to incorporate into the draft SS, <u>as well as the location in the draft SS of that material</u>’. However Appendix 2 shows only where the Director’s letters can be found on the Bank of England’s website; there is nothing to indicate which section(s) of the draft SS the various Director’s letters have been incorporated into. We see this as an important part of the overall document and would ask that it be added. Firms will also want to be able to see where anything has been dropped from the previous Director’s letters.

44. We note that references to certain past Director’s letters have been omitted from the table in Appendix 2, even though they are quoted in the CP, such as the August 2015 letter on intra-group reinsurance.