EIOPA Consultation Paper on the Opinion on the 2020 review of Solvency II

LTG Measures: the matching adjustment

In October 2019, EIOPA published a consultation paper on its opinion on the Solvency II 2020 review. This briefing note summarises the section of the consultation paper on the matching adjustment. EIOPA has requested stakeholders to provide feedback on this consultation paper by 15 January 2020.

Overview

On 11 February 2019, the European Commission (**EC**) issued a formal Call for Advice[1] to the European Insurance and Occupational Pensions Authority (**EIOPA**) on the review of the Solvency II Directive. This relates to the full review of the Solvency II rules required by the end of 2020 (**2020 Review**) as required by the Solvency II Directive.

On 25 June 2019 EIOPA published a first wave of consultation papers on its proposals for the 2020 Review regarding supervisory reporting and public disclosure and Insurance Guarantee Schemes. Milliman has written briefing notes on each of these papers (available here).

On 15 October 2019 EIOPA issued a second wave of consultation entitled "Consultation Paper on the Opinion on the 2020 review of Solvency II" (the **CP**). This was accompanied by an impact assessment document including an assessment of the combined impact of the proposed changes. The CP is 878 pages long and covers a wide range of topics as follows:

- Long-Term Guarantee (**LTG**) and equity risk measures
- Technical Provisions
- Own Funds
- Solvency Capital Requirement (**SCR**)
- Minimum Capital Requirement (**MCR**)
- Reporting and disclosure
- Proportionality
- Group supervision
- Freedom to provide Services (**FoS**) and Freedom of Establishment (**FoE**)
- Macroprudential policy
- Recovery and resolution
- Fit and proper requirements

Milliman has produced a briefing note giving a summary of EIOPA's proposals in the CP (available here) and separate briefing notes covering each of these topics in more detail.

[1] Formal request to EIOPA for technical advice on the review of the Solvency II Directive
[2] 2018 LTG Report

This briefing note covers the matching adjustment (**MA**) under the LTG and equity risk measures.

Matching adjustment

The MA is currently used by insurers in just two countries, the UK and Spain, with both countries being heavily dependent on this LTG measure. For example, the LTG 2018 Report[2] showed that removing the MA would reduce the SCR coverage ratio of UK insurers as a whole by around 50% to 105%, and for those companies that use the MA from 154% to 75%, meaning a number of UK insurers would be insolvent without the MA. In Spain, the impact on the market as a whole is less pronounced[3], but for those companies that use the MA, its removal would reduce SCR coverage ratios from 249% to 170%.

In its Call for Advice the EC explicitly asked EIOPA to assess the quantitative impact on the calculation of the best estimate and the solvency position of undertakings of the following two alternative approaches for the calculation/application of the MA:

- **Diversification benefits in the calculation of the standard formula SCR:** a reconsideration of the current approach of assuming no diversification between the risks within a matching adjustment portfolio (**MAP**), and any other part of the business; and
- **Eligibility of assets:** a review of the criteria for assets to be considered eligible for inclusion in a MAP.

In its Call for Advice the EC also raised the possibility of moving to a system with just a single adjustment mechanism (rather than both the volatility adjustment and MA) that aims to recognise an illiquidity premium and prevent procyclicality in financial markets.

The UK's referendum decision to leave the European Union (**Brexit**) means that, going forward, the MA will only be used by a single Member State (Spain). This could strengthen an

[3] The LTG 2018 Report showed that removing the MA would reduce the SCR coverage ratio of Spanish insurers as a whole by around 19% to 217%.

argument for moving to a single adjustment mechanism. Assuming that the UK aims to gain equivalence under Solvency II following Brexit. UK insurers who are currently heavily reliant on using the MA may be relieved that EIOPA has restricted the scope of its review and proposals to the two areas on which the EC requested technical advice, and provided no comment on moving to a single adjustment mechanism.

DIVERSIFICATION BENEFITS

Fundamental to the MA is the concept of having a MAP containing assets and liabilities, where the assets in that portfolio are used exclusively to cover the best estimate liabilities included in that portfolio. That said, there is no requirement for the MAP to be treated as a legal ring-fenced fund under Solvency II, and the separation from other assets and liabilities only needs to be understood in an economic sense.

However, Article 217 of the Delegated Regulation, that applies only to standard formula firms, treats assets in a MAP in the same way as a ring-fenced fund in the calculation of the SCR; namely that the SCR of an undertaking with MAPs is calculated as the sum of the notional SCRs calculated for each MAP and the notional SCR for the remainder of the business. There is no allowance for diversification between the risks in the MAPs and those outside of the MAPs.

Consequently, the loss of diversification benefits in the SCR arising due to the MA can act as a disincentive from using the MA. In its most extreme case, the loss of diversification can even exceed any increase in Own Funds resulting from the use of the MA in the calculation of the technical provisions, negatively impacting the SCR coverage ratio. It also creates an inconsistency between standard formula and (partial) internal model firms, as similar restrictions on recognising diversification do not apply to the latter.

In the CP, EIOPA explains that restrictions on diversification between sub-portfolios of a business arise when, following a risk event, surplus assets in one portfolio cannot be used to cover losses arising from risks on other sub-portfolios. However, the SCR is designed to be sufficient to cover unexpected losses in the business as a whole, and it is backed by assets that are separate to those in the MAP. Although assets in any MAP cannot be used to cover losses arising elsewhere in the undertaking, the assets backing the SCR, and assets other than those assigned to any MAP, can be used to cover any unexpected loss, including losses arising in the MAPs. Consequently, in the CP EIOPA argues that the rationale for limiting the diversification benefit in calculating the SCR for a company applying the MA based on the notional ring-fencing of MAP assets and liabilities is flawed.

EIOPA goes on to suggest that should no allowance for diversification be made, it would imply that either the risks inherent to a MAP are higher than assets and liabilities if they were held outside a MAP (which it rejects as a MAP has a lower risk given that the "hold-to-maturity" investment approach for MAPs results in lower interest and spread risks, and restrictions on liabilities means that there is a lower risk of losses from forced sales), or that the correlation of risk between a MAP and any business outside the MAP is higher (of which EIOPA has also seen no evidence).

Given this, maintaining the current restriction on diversification would imply that the SCR of a firm using the MA reflects a higher than a 99.5% Value-at-Risk (**VaR**), which is inconsistent with the Solvency II regulation.

Consequently, in this CP EIOPA proposes to remove the restriction on diversification benefits for MAPs in the standard formula SCR. The CP suggests that an indicative impact of this change, based on the analysis of 14 Spanish (all standard formula) and 18 UK firms (4 standard formula, 9 partial internal model, and 5 full internal model) would be to:

- Reduce the SCR by:
  - **Spain**: between 0.3% and 19.6%, with a weighted average of 8.5%.
  - **UK**: between 0% (i.e. for internal model firms), and 6.15%, with a weighted average of 0.29%. It should be noted that the weighted average is skewed by partial and full internal model firms where typically there is no impact, and for just standard formula firms the weighted average impact is 2.59%.
- Improve SCR coverage ratios by:
  - **Spain**: 20.3% on average, with a maximum observed improvement of 53.8%.
  - **UK**: 1.5% on average, with a maximum observed improvement of 12%. Looking at just standard formula firms the average improvement is around 4.4%.

The differences in the materiality of the impact between firms will be driven by the size of any MAPs in comparison to the other business of a firm, and the extent to which the risks in a firm's other business would diversify against those in the MAP (i.e. if the firm is a monoline writing predominantly annuity business the impact would be non-existent or minimal).

The proposal may be received positively from those MA firms using the standard formula, most commonly in Spain where the impact is more material. In addition, the change provides greater harmonisation in the calculation of the SCR between (partial) internal model and standard formula firms.

ELIGIBILITY OF ASSETS

In the CP, EIOPA states that although it is satisfied that the MA is functioning as intended, it has concerns about 'borderline cases' that present a challenge to asset eligibility, such as:

- **Asset restructuring**: firms looking to overcome restrictions on asset eligibility by holding assets whose legal form appears to be bond like with fixed cash flows (i.e. they would be MA-eligible) but that expose the firm to the same risks as assets that would not be eligible.
- **Uncertainty:** there are some assets[4] where there is some uncertainty around the first, or last, cash flow, and yet otherwise have certain and fixed cash flows.

In addition, supervisors have commented that the existing Solvency II legislation lacks the provisions needed to allow them to assess the adequacy of assets in the MAP, particularly in the context of such borderline cases.

In response, EIOPA proposes to introduce a look-through approach to assess the adequacy of restructured assets included in a MAP by looking through to the assets underlying them. It proposes that there are four criteria that must be met so that these restructured assets are MA eligible:

1. The underlying assets must have a sufficiently fixed level of income.
2. The cash flows of restructured assets must be supported by loss absorbency features, such that those cash flows are "sufficiently" fixed, and will remain so under different operating conditions. For example, for a securitisation, profits made on junior tranches must provide loss absorbency to the MA-eligible senior tranches in order to cover any defaults on the assets underlying the senior notes.
3. Where the underlying assets include financial guarantees, those guarantees cannot result in additional MA benefit (i.e. the element of spread attributed to this risk should not give rise to MA benefit).
4. There must be sufficient governance and controls (i.e. similar to the Prudent Person Principle[5]) on the underlying assets, such that a firm must be able to demonstrate it can properly identify, manage, monitor, mitigate, control and report on the risks for the underlying assets.

The look-through approach will not be applied retrospectively so as to avoid market disruption.

In the CP EIOPA also considered allowing a yield-to-worst approach to allow assets with uncertainty of timing of cash flows. Under such an approach it is assumed that, wherever there is uncertainty over whether cash flows have started or ended the most onerous date is chosen that produces the lowest MA benefit. However, EIOPA rejected this approach, as it exposes a firm to the risk that cash flows do not arise at the time that they are expecting in their MA calculations, which (even in the case where this results in a higher MA benefit) may force the company to sell the asset in order to restore cash flow matching, exposing the firm to reinvestment risk. This does not maintain consistency with the underlying principles of the MA and so at this stage EIOPA does not propose that a yield-to-worst approach should be adopted.

Overall, the degree to which this change will impact insurers may vary by geography, to the extent that regulators in different Member States take different views on the use of restructured assets in MAPs, and the extent to which these investment classes are used in MAPs.

For example, these proposals may not have such a profound impact on UK insurers who use the MA as they are unlikely to widen the pool of assets that are deemed to be MA eligible. UK insurers have for some time used restructuring to create assets that are MA eligible, and the criteria proposed by EIOPA are reasonably aligned with those currently expected by the UK supervisor, the Prudential Regulation Authority (PRA), for example as set out in its most recent Supervisory Statement[6] on the MA. Instead, for the UK it may be perceived as a formalisation by EIOPA of processes that are already carried out, that may protect such practices should the UK leave the European Union. In turn, this may assist the UK, following Brexit, if it aims to gain equivalence under Solvency II, but wishes to continue to use the MA unchanged. In Spain where the 2018 LTG Report suggested that the majority of assets in MAPs (87% if excluding unit and index-linked business) are held in government and corporate bonds, this change could provide a basis for the consideration of further investment in restructured assets, provided there are suitable underlying assets that can be restructured.

More widely, the look-through clarifications may provide an opportunity for more countries to benefit from using the MA. In particular, it may open the door for insurers in Member States where they have liabilities that are MA-eligible but whose supervisor has, to date, objected to the use of asset restructuring to create assets that are MA-eligible.

CONCLUSION

To date, some Eurozone insurers may have felt that the costs and challenges to creating and running a MAP far outweigh any solvency benefits of applying the MA in the valuation of their long-term liabilities. In particular, Euro cash flows in the mid-to-long term are more heavily discounted in the calculation

[4] For example, infrastructure investments, where a loan finances the construction phase of an infrastructure project, have an uncertain first payment, as repayments start once the physical asset goes into operation. Callable bonds also have uncertainty over the timing of redemption payments, and whether coupons will continue to be paid past the next call date.

[5] Article 132 of the Solvency II Directive.

[6] Supervisory Statement SS7/18

of the best estimate liability than Sterling cash flows, due to a combination of a high Ultimate Forward Rate (**UFR**)[7] but a much shorter Last Liquid Point (**LLP**)[8].

However, in other sections of the CP, EIOPA also have proposed changes to the extrapolation of risk-free interest rates for the Euro that would see the UFR reduced and the LLP extended, with the impact of these changes being particularly material for insurers in Germany and the Netherlands.

In light of the potential changes to the risk-free rates, and the changes discussed in this note that will encourage the use of the MA[9], some Eurozone insurers may choose to revisit their approach to the MA, as the benefits of applying it may now potentially outweigh the costs.

[7] Both Sterling and Euro currencies currently have a UFR of 3.9%.
[8] Sterling: 50 years, Euro: 20 years.

[9] To introduce a look-through approach to assess asset eligibility, and to remove restrictions on diversification.

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