

## The Matching Adjustment

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### Executive summary

Solvency II came into force in January 2016 after many years of discussion. Insurance Europe supported, and continues to support, its primary objectives, namely a risk-based, harmonised European rule book for the insurance market which ensures a robust level of policyholder protection and a level playing field for all insurers. Equally important is the ability of the industry to provide affordable, long-term insurance products which are much needed, particularly given the ageing populations across Europe.

In the decade preceding 2016, during the development of Solvency II, Insurance Europe consistently raised concerns about certain aspects of the design and calibration of the framework and, in particular, the treatment of long-term business. To address some of these concerns, the Omnibus II Directive was adopted, which updated the regulation to reflect the LTG package agreed by legislators.

One of the measures which was introduced as part of the Omnibus II Directive was the matching adjustment (MA). This tool allows insurers to recognise the excess returns that they earn when investing in long-term assets to meet long-term obligations. In addition, the MA permits undertakings to calculate their capital requirements for credit risk based on long-term default risk rather than short-term market volatility.

Eligibility for the use of the MA is governed by a set of strict criteria. These relate to the risk management practices of the insurer, the separate treatment of MA business within the wider activities of the insurer and the asset and liability characteristics. Due to the restrictive nature of these criteria, the MA is only applied to 15% of European liabilities, arising from two jurisdictions.

However, in these jurisdictions, the MA has proven to be a very powerful and valuable tool, which has provided many benefits for policyholders and insurers. It has also benefitted the wider financial system by ensuring the supply of long-term capital and mitigation of systemic risk. This has been evidenced by many industry participants as well as supervisors and regulators.

The MA will be reviewed as part of the 2020 Review of Solvency II, a process which is currently ongoing and is expected to conclude in 2021.

**Insurance Europe supports the retention of the MA framework within the Solvency II framework as a separate and distinct measure**, which recognises the long-term and predictable nature of certain liabilities, the ability to hold assets to maturity that are not exposed to real forced-selling risk, and the rigorous asset liability management (ALM) techniques that insurers employ to manage these portfolios.



Given the evidenced benefits provided by the MA, **Insurance Europe further supports the redefinition of certain criteria as part of the 2020 Review to permit wider application of the MA measure** to similar kinds of liabilities, managed under defined ALM techniques.

**Insurance Europe does not support any changes to the MA framework which would diminish the current level of benefit provided by the measure.**

## Background

The EU's Solvency II insurance regulation, which came into force in January 2016, is a ground-breaking, risk-based regulation that remains strongly supported by the European insurance industry.

From the outset, the insurance industry supported the core objectives of Solvency II because it wanted a modern, risk-based framework that:

- was consistent with the good risk management methods many insurers were already using;
- created a harmonised rulebook for Europe; and,
- ensured both fair competition and a consistently high level of policyholder protection across Europe.

Particularly welcome is Solvency II's three-pillar approach, which recognises that internal governance, risk management and supervisory interaction (Pillar 2), along with supervisory and public disclosures (Pillar 3), are as important as capital requirements (Pillar 1).

During Solvency II's development, the insurance industry highlighted a range of technical problems and, in particular, voiced major concerns about the treatment of long-term business and guaranteed products. In an attempt to fix this, a package of long-term guarantee measures was added to Solvency II in the "Omnibus II" Directive.

The Matching Adjustment (MA) was one of the measures which was introduced in the Omnibus II directive.

## Mechanism and rationale behind the matching adjustment

The fundamental assumption underlying the MA framework is that insurers who hold fixed income investments to back stable and predictable liabilities are long-term investors who can hold the bonds to maturity. As such, they can collect the excess returns available on the fixed income assets and are only exposed to default and downgrade risks, rather than short-term market volatility.

The MA permits insurers who meet a set of specified eligibility criteria to apply an adjustment to the risk-free rates used to value the MA-eligible liabilities. The adjustment is based on the excess returns which the insurer earns on its own asset portfolio, adjusted for expected default and downgrade.

The application of the MA has a dual effect:

1. It ensures the **liability valuation is not exaggerated** (by adequately reflecting the returns the insurer will earn over the life of the obligations).
2. It **mitigates artificial balance sheet volatility** as any short-term variations in the value of the insurer's bond portfolio are also reflected in the liability value.

In addition, the MA framework enables insurers to calculate the capital requirements for spread risk under the assumption that they are long-term investors and only exposed to default and downgrade risk.

For certain assets which do not currently meet the strict cash flow eligibility requirements, but which nonetheless provide a predictable source of future income (for example, certain types of mortgage loans), it is possible under the current framework to securitise these into an internally-rated senior note that sits inside the MA portfolio, and an unrated junior note that sits outside the MA portfolio.

Where such securitisations are currently undertaken, there is close supervisory oversight of the process to ensure that the MA benefit obtained is appropriate. However, the securitisation process is complex from an operational perspective, and there would be benefit from both a regulatory and practitioner perspective if it was streamlined.

### **The benefits of the matching adjustment**

Insurance Europe supports the continued inclusion of the MA measure within the Solvency II framework. The MA has proven to be a powerful and effective tool which has had a positive impact for insurers, policyholders and the wider financial system.

#### ***Impact on consumers and the investment markets***

- The MA has enabled insurance undertakings who apply the measure to continue to offer guaranteed insurance products, such as annuities, which are highly valued by consumers and are a valuable product offering given the demographic trends in Europe.
  - EIOPA found that 94% of firms surveyed indicated that they use the MA in the design and pricing of their products<sup>1</sup>, allowing them to offer more competitive prices.
- It has also permitted insurance undertakings to continue in their role as long-term investors. This enables MA insurers to provide capital to long-term financing, including (for example) infrastructure and other, societally useful retirement products.

#### ***Impact on risk management practices***

- The MA provides good risk management incentives that eliminate or substantially mitigate some market risks (interest rate risk, reinvestment risk, spread risk and liquidity risk).
  - EIOPA has found no significant evidence<sup>2</sup> of insurers lowering the credit quality of MA portfolios in order to benefit from higher yields or that portfolios have become riskier due to the introduction of the MA. Insurance undertakings are incentivised by the framework to maintain a high-quality portfolio of matching assets.
- MA matching requirements also promote undertakings to monitor ALM and ensure that asset and liability cashflows are closely matched.

#### ***Impact on policyholder protection***

- EIOPA has found no evidence of undue capital relief from use of the MA<sup>3</sup>, and no cases have been identified in which the application of the measures prevented supervisors from taking any measures that they would have considered desirable for policyholder protection.
- In jurisdictions where the MA is currently applied, national supervisors set strong regulatory requirements around the treatment of MA portfolios, justifying the level of the adjustment.
  - The Spanish supervisory authority, DGSFP, has found that the MA has contributed to the stability of the financial system and the real economy<sup>4</sup>.
  - The Bank of England has found the MA to be beneficial from a financial stability perspective by reducing the potential instability across the financial system<sup>5</sup>

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<sup>1</sup> [EIOPA LTG Report 2018, page 73](#)

<sup>2</sup> [EIOPA LTG Report 2018, page 114](#)

<sup>3</sup> EIOPA LTG Report

<sup>4</sup> [EIOPA, Solvency II tools with macroprudential impact, page 30](#)

<sup>5</sup> Bank of England, [Financial Stability Report, November 2016, page 47](#)

### ***Impact on financial stability***

- The MA helps to reduce the impact of a low interest rate environment on insurers, because long-term products are matched, thereby avoiding problems of procyclicality. Both jurisdictions in which the MA is applied were affected less by the low-for-long scenario in EIOPA's 2016 stress test.
- The MA minimises the asset-liability duration gap, as also demonstrated in EIOPA's 2016 stress test report.

### ***Products supported by the MA***

- Typical business lines that firms may be disincentivised to participate in without the associated MA are:
  - Products guaranteeing life annuities or a lump sum payment, including both individual policies and bulk transfers of pension risk from corporate pension schemes.
  - Products offering a guaranteed interest rate.
  - Article 52 of the Commission's draft regulation<sup>6</sup> on a pan-European Personal Pension Product (PEPP) states that PEPP providers may make annuities available to PEPP savers as a form of out-payment. Given that the choice of decumulation method is exercised by the PEPP saver, insurers who may want to offer PEPPs would need to be able to offer annuities, and therefore would presumably have illiquid liabilities that could qualify for the Matching Adjustment.

### **The eligibility criteria**

The application of the MA is governed by Article 77b of the Solvency II Directive. This requires prior supervisory approval and is subject to a set of conditions which can be summarised<sup>7</sup> as follows:

- The insurer has a designated portfolio of bonds and other fixed income assets which support the liabilities and is maintained over the lifetime of the obligations;
- The portfolio of assets and liabilities is identified, organized and managed separately;
- The expected asset and liability cashflows are well-matched;
- There are no future premiums related to the contracts within the MA portfolio;
- There are very limited underwriting risks arising from the MA portfolio;
- Any mortality risk relating to the portfolio does not increase by more than 5% under the standard formula mortality stress;
- Any surrender options relating to the portfolio will not have a detrimental financial impact on the portfolio, should they be exercised;
- The asset cashflows are fixed and cannot be changed;
- There is no unbundling of insurance contracts.

Some of the benefits and positive impacts of the MA outlined above are a direct consequence of these criteria. For example, the strict cashflow matching criterion incentivises good risk management practices. However, the current criteria are unnecessarily restrictive in several areas.

**Insurance Europe believes that several improvements can be economically justified and are needed to avoid unnecessary negative impacts for customers in terms of costs, product design and product availability.** Such improvements can be made while maintaining rigorous levels of policyholder protection and appropriate risk management incentives.

### **Draft proposals for changes**

Overall the matching adjustment works very well, and it is important that no changes are made that would reduce its current effectiveness or create further complexity for those insurers who have sold policies based on the existing MA framework.

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<sup>6</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52017PC0343>

<sup>7</sup> See Article 77b of the Solvency II Directive for full details

### ***Identification, organisation and management of portfolios***

The criteria which govern the identification, organisation and management of the portfolio (Art 77b (a) and (b)) are desirable.

However, the standard formula assumption of no diversification between MA portfolios and the remainder of the undertaking's activities is economically unjustified. From an economic perspective, there will be diversification between these risks for standard formula firms, which should be reflected in the calculation of the undertaking's capital requirements. Firms with Solvency II internal models can already assume diversification between their MA portfolios and non-MA portfolios.

### **Insurance Europe supports the full recognition of diversification within the standard formula between MA portfolios and the remainder of the undertaking's business.**

### ***Nature of the asset cashflows***

The existing asset eligibility criteria preclude the use of assets which have prepayment risk embedded into them. However, there are many assets, such as mortgage loans, which have prepayment risks but are well suited to backing long-term liabilities.

The prepayment risk is typically not material in the context of the wider portfolio and these assets should be eligible for inclusion in MA portfolios where the insurer can reliably demonstrate its ability to cover any deficit arising from the prepayment risk.

The asset eligibility criterion of fixed cash flows in the assigned portfolio could be prudently relaxed by introducing an allowance for materiality up to [x]% of the MA book – the cash flows would still be sufficiently predictable. The allowance for materiality [x] can be calibrated such that the portfolio is fixed at 99.5% VaR.

### ***Disclosure***

The Matching Adjustment is a fundamental part of the Solvency II framework and should be respected as such. While the financial position of an undertaking without the MA may be of interest to NSAs, the requirement to publicly disclose the impact of the MA is unnecessary and undermines the validity of the measures.

Therefore, the requirement to publicly disclose a scenario in which the MA is set to zero should be removed. The MA is a permanent LTG measure under the SII framework. Requiring companies to publicly disclose the impact of a scenario in which the MA would not exist might convey the unintended message to the markets that the MA might be a potentially movable or ancillary element of the framework that might at some point cease to exist, which is not the case.

### ***Materiality thresholds***

The MA framework defines a materiality threshold for the inclusion of mortality risk. This permits liabilities which are exposed to mortality risk to be included in the portfolio provided the risk is immaterial.

Insurance Europe believes consistent materiality thresholds could be used for other criteria without detracting from the high levels of risk management required. The inclusion of appropriate materiality thresholds for the inclusion of future premiums and surrender options would broaden the scope of application of the MA and extend its benefits to other products and markets.

The calibration of the materiality thresholds should ensure that products which are a natural "fit" to the MA framework, such as workers compensation and deferred premium annuities, would be MA-eligible. Without MA eligibility, these products become uneconomical, and as such are likely to be prohibitively expensive for policyholders.



### ***Unbundling***

In addition to the extension of materiality thresholds, the eligibility of certain products may require the removal of the restriction on unbundling. Insurance Europe does not believe that this requirement serves a prudential purpose and proposes the deletion of this unnecessary restriction.

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