



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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Solvency II – Matching Adjustment Asset Eligibility

The matching adjustment (MA) will be an important measure for many PRA-regulated firms under Solvency II. The MA allows firms to adjust the relevant risk-free interest rate term structure for the calculation of a best estimate of a portfolio of eligible insurance obligations. Firms using the MA will be subject to several risk management requirements, such as providing a liquidity plan, in addition to the usual risk management requirements that underpin all investments, including the Prudent Person Principle.

The MA is similar in purpose to the current UK regime's 'liquidity premium', but it is different in design and will require prior supervisory approval. EIOPA is currently consulting on an Implementing Technical Standard (ITS) including the evidence firms will need to submit within their applications¹. The PRA has also written to you separately inviting you to submit a trial application to help the PRA test the procedure we will use for the approval process. Regardless of whether or not firms decide to submit a trial submission, the PRA encourages all firms that intend to make an application to familiarise themselves with the procedures of the proposed ITS and start considering how to demonstrate compliance with each of the eligibility criteria.

The eligibility criteria for using the MA are set out in Article 77b of the Directive. The PRA is aware that firms have questions about the interpretation of these criteria, particularly those relating to the assigned portfolio of assets. This letter addresses some of those questions that firms have already raised. It aims to provide additional clarity on asset eligibility, both to help firms prepare for Solvency II and to ensure that firms can take any necessary steps towards compliance in an orderly way.

¹ The proposed ITS is available at: <https://eiopa.europa.eu/en/consultations/consultation-papers/index.html>

Asset eligibility is a case-by-case judgement and there is no 'closed list' of eligible asset classes

The eligibility criteria in Article 77b define some specific behavioural features that the asset portfolio (and in some cases the individual assets within it) must have. These behavioural features determine eligibility - not the notional class to which an asset (or group of assets) belongs. For this reason, the PRA is not in a position to prescribe a 'closed list' of acceptable asset types. Instead, firms must apply their judgement, and consider carefully whether they are compliant with the criteria laid out in the Directive.

The PRA will review asset portfolios on a case-by-case basis as part of the approval process, taking into account all of the evidence provided by the firm within its application.

The Prudent Person Principle underpins all investment decisions, including those for the MA

The PRA recognises firms may be planning to undertake certain risk transformation transactions in order to obtain a portfolio of eligible assets. In particular, firms may be considering entering into securitisation transactions or putting in place hedging arrangements, specifically to secure compliance with the Article 77b criteria. The PRA reminds firms that, as well as needing to meet the requirements of Article 77b, firms must assess carefully, and be able to demonstrate, their compliance with the Directive's requirements for risk management and with the Prudent Person Principle. The latter requires firms to be able to identify, measure, and manage risks within their asset portfolios, to invest in the best interest of all policyholders and beneficiaries, and to only use derivative instruments where they genuinely contribute to a reduction in risk or facilitate efficient portfolio management.

In practice, this means firms will need to consider carefully the prudence of any transactions or arrangements they enter into for the purposes of applying to use the MA, including their behaviour under stress, and whether the associated risks are well understood and appropriately managed. Securitisation transactions, for example, can vary in their features, and firms should refer to initiatives of international bodies and evolving standards to understand the features that underpin high-quality securitisations. Firms should have also considered any new risks generated by risk transformation arrangements, such as counterparty exposure, and how to account for these. In all considerations about asset eligibility, the key question the PRA expects firms to consider is whether they are exposed to the risk of changing spreads on the underlying asset, contrary to the fundamental rationale for the matching adjustment (Recital 31 of the Omnibus II Directive).

The portfolio must have fixed (and not simply 'very predictable') cash flows

Firms must be able to demonstrate that the overall cash flows from the portfolio are fixed in terms of timing and amount, and cannot be changed by the issuers of the assets or any third parties. For this purpose, it is not sufficient for a portfolio of assets to provide cash flows that are predictable in aggregate to a very high degree.

There are two exceptions to the requirement that the cash flows at the level of the portfolio be fixed. This is where firms have used:

- 1) Inflation-linked assets to match the cash flows of inflation-linked obligations in the matching portfolio; or
- 2) Assets with cash flows that may be changed at the request of the issuer or a third party, provided that in such an event the firm receives sufficient compensation to allow it to obtain the same cash flows by re-investing in assets of an equivalent or better credit quality.

'Sufficient compensation' for any variation of cash flows must be adequately demonstrated

In the second case above, where assets have cash flows that may be changed at the request of the issuer or a third party, firms must be able to clearly demonstrate that the compensation they would receive in the event of a change in the cash flows would be sufficient to negate any risk. This could be demonstrated through the existence of a contractual compensation clause- for example, an adequate 'Spens' clause. If there is no such clause, an alternative will be necessary to illustrate that reinvestment risk is negligible, even in a range of suitably extreme scenarios. Firms should bear in mind that the standard of evidence required to demonstrate this will require a high degree of certainty.

Pairing or grouping of assets is possible to demonstrate compliance with the criteria

Article 77b(1)(c) requires that the asset portfolio's expected cash flows replicate each of the expected liability cash flows in the same currency. This does not necessitate individual assets being denominated in a particular currency. For example, a foreign currency bond with an appropriate currency swap could be used in combination to generate a cash flow in the relevant currency of the liabilities. The requirement that the portfolio consist of 'bonds or other assets with similar cash-flow characteristics' could also potentially be satisfied by considering relevant pairings or groupings of assets. As noted above, firms should consider carefully how any such arrangements comply with the Directive requirements on risk management and on the Prudent Person Principle. This includes considering the reliability and predictability of such arrangements under stressed conditions.

The PRA is aware that firms will have several other questions relating to the MA, not all of which can be answered now. The PRA plans to release further material on the MA approval process later in 2014. In the meantime firms should continue to raise any questions they have with their usual supervisory contacts.

Yours sincerely



Chris Moulder
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