BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Executive Director
Insurance Supervision
Prudential Regulation Authority

1 June 2015

Solvency II: matching adjustment

Since June 2014, the PRA has published updates and feedback in respect of the Solvency II matching adjustment (MA). We also ran a trial submission exercise in summer 2014 and a pre-application exercise in Q1 2015. We are grateful to the firms that took part in these exercises, which have enabled us to provide feedback to the industry, with our most recent publication being released on 28 March 2015 following completion of the pre-application phase.

Firms that participated in the pre-application exercise were asked (as part of this feedback) to provide some additional information on their collateral arrangements, treatment of reinsurance and treatment of future management actions in cash flow projections. The PRA has now received and analysed this additional information and engaged with interested stakeholders.

Using information obtained as part of this work, this letter provides further clarification around three specific areas of feedback given in Paul Fisher's letter of 28 March 2015 i) management of collateral arrangements, ii) collateral received against stock-lending activity and iii) the treatment of reinsurance in the MA calculation. It also provides additional points of feedback on issues that have emerged following the pre-application phase.

Firms have been able to make formal MA applications since 1 April 2015 and some firms have either already submitted their applications or are about to do so. Should firms wish to make any changes to their applications following this feedback, then they should discuss this with their relevant supervisory contact in the first instance.

Executive Director

Appendix

Management of the MA portfolio(s)

Management of collateral

Firms are required to ensure that their portfolio of insurance and reinsurance obligations to which the MA is applied and the assigned portfolio of assets are identified, organised and managed separately from the firm's other activities. They also need to ensure that the assets of the MA portfolio cannot be used to cover losses arising from the firm's other activities.

The PRA is concerned that the way in which firms manage their collateral arrangements could potentially undermine the satisfaction of these requirements. In Paul Fisher's letter dated 28 March 2015, the PRA stated that:

"The PRA's view is that collateral in respect of an MA portfolio should be managed separately within the MA portfolio. If collateral is managed jointly for MA and non-MA portfolios, then netting of collateral across portfolios would conflict with the requirement to manage the MA portfolio separately".

The PRA does not intend to mandate the specific arrangements and processes that firms should put in place to ensure that their collateral arrangements do not undermine the satisfaction of the requirement for firms to manage their MA portfolios separately from the rest of their business. The PRA considers that separate collateral arrangements in respect of the MA portfolio would most obviously be conducive to ensuring the separate portfolio management requirement. For example, in the case of title transfer collateral arrangements, separate netting arrangements in respect of the MA portfolio would ensure that the MA portfolio is not exposed to the non-MA business of the firm. However, it is for firms to evidence in their MA applications how their arrangements and processes ensure that the MA portfolio is managed separately and is not exposed to the non-MA business. In evidencing this the PRA would expect firms to:

- explain the options they have considered and the benefits/risks of each of these;
- clearly set out the reasons for selecting their chosen approach; and,
- explain the controls they have put in place to ensure successful operation of their processes.

The PRA also expects firms to review their collateral arrangements and to evidence in their MA applications that these arrangements will be effective and enforceable. The PRA would expect the evidence provided to include consideration of how the arrangements would operate in a range of scenarios including the default of one or more significant counterparties.

Collateral posted using assets in the MA portfolio

The 28 March 2015 letter from Paul Fisher stated that *"The PRA does not consider it appropriate for an MA portfolio to post collateral in respect of business other than the insurance business of that MA portfolio".* The PRA continues to hold this view. It follows that firms are able to post collateral in respect of the MA portfolio from assets held within the MA portfolio.

In response to the information on collateral arrangements requested in Paul Fisher's letter of 28 March, some firms stated that their collateral arrangements give flexibility to their counterparties to return assets that are not identical to those posted. The PRA assumes that firms mean that the counterparties may return equivalent (though not necessarily the same) assets (e.g. in the case of financial instruments, financial instruments of the same issuer or debtor, forming part of the same issue or class and of the same nominal amount, currency and description, and in the case of cash, a payment of the same amount and in the same currency). If that is not the case, the PRA would expect firms to explain this and demonstrate the appropriateness of the arrangements. In any event:

- where liquid assets are posted as collateral, firms must consider whether the requirement to return equivalent assets is sufficiently narrowly defined to ensure that upon return, the MA portfolio will continue to satisfy all the requirements including those covering asset eligibility and liability cash flow matching; and,

- for illiquid assets, unless the collateral arrangement requires the return of identical assets, firms should consider whether such assets should be excluded from their cash flow matching assessment. For the purposes of calculating the PRA matching tests published on 9 March 2015, illiquid assets posted as collateral must be excluded unless the collateral arrangement requires the return of identical assets.

In their pre-application submissions and in responses to the information request in Paul Fisher's letter of 28 March 2015, firms did not adequately consider how collateral arrangements could constrain their ability to extract surplus from the MA portfolio. The PRA considers that any requirements on the MA portfolio resulting from the collateral arrangements to over-collateralise their positions, or arrangements that restrict the type of assets that can be posted as collateral, could restrict the ability of firms to extract surplus or to use those assets to meet other MA liabilities. The PRA expects firms to demonstrate in their applications that they have considered these issues and explain what impact this has on their ability to extract surplus from their MA portfolios.

Asset eligibility

Collateral received

The PRA is concerned that in the event of a collateral call, the MA portfolio could cease to meet the MA requirements and that it would not be possible to rectify this within the required two-month period. Paul Fisher's letter of 28 March 2015 covered only stock-lending activity and stated that the PRA is *"of the view that stock-lending can only be undertaken within an MA portfolio if the collateral received satisfies the MA asset eligibility requirements".*

On further consideration the PRA considers that an approach of over-collateralisation of the exposure to the counterparty using suitably liquid and marketable assets could be a potential alternative mitigant of this risk.

However, whilst the PRA is open to firms proposing different approaches, in all cases the PRA expects firms to demonstrate that the overall matching position of the MA portfolio could be restored were a call on the collateral to lead to the MA requirements (including the matching of cash flows) no longer being met. The PRA expects this evidence to include a review by firms of their collateral arrangements and a demonstration of why they consider that these arrangements will be effective in a range of very adverse scenarios. These include scenarios that result in the failure of one or more large counterparties, with the expected consequential market dislocations and reduced ability to sell significant volumes within the two month time frame.

For avoidance of doubt the PRA considers this feedback is relevant in the context of all arrangements where collateral is received by the MA portfolio and not just collateral received in respect of stock-lending activity.

The MA calculation process and results

Mapping to fundamental spreads

Firms are required in their applications to explain how they will map assets to the relevant asset classes and credit quality steps for the purpose of assigning a fundamental spread.

In particular, firms should explain the reliance they place on external credit ratings. The PRA expects firms to map assets based on the *issue* rating of an asset. Where such a rating does not exist, firms should produce an internal rating which is broadly consistent with the expected issue rating were it produced by an ECAI (External Credit Assessment Institution). The PRA considers it may be appropriate for firms to take into account the features of the individual asset holdings when mapping assets to an appropriate credit quality step, provided this is done consistently for all assets for which an internal rating is produced and not limited to assets for which a more favourable treatment might be expected.

Hedging assets included in component A must be included both in the matching tests and in the MA calculation. All such assets should be mapped to a fundamental spread – either in isolation or on a grouped basis (as appropriate). However, in any scenarios where the MA portfolio is required to make net cash flow payments to the counterparty in respect of such assets (e.g. payments due under a swap contract), then these payments should not be adjusted for default.

Treatment of reinsurance

The PRA continues to stress the importance of assessing the eligibility of reinsurance cash flows against the criteria set out in Paul Fisher's letter of 15 October 2014. Where firms wish to include reinsurance in their MA portfolio(s), the PRA would expect to see a clear assessment of the eligibility of the reinsurance asset(s) in their MA applications.

The PRA remains of the view (as per Paul Fisher's letter of 28 March 2015) that it would be most appropriate for the cash flows from reinsurance assets to be explicitly included within the calculation of the MA. This is commonly referred to in the industry as the "gross calculation approach". It is the approach that is most obviously aligned with the whole balance sheet approach underlying the prudential requirements under the Solvency II Directive.

For the purposes of calculating the matching adjustment and satisfying the MA eligibility criteria (including cash flow matching), firms should risk adjust the reinsurance cash flows on the basis of Technical Provisions 11 of the PRA Rulebook (transposing Article 81 of the Solvency II Directive). The adjustment made for the purposes of the MA calculation must be the same as that made for the purposes of calculating the value of the reinsurance recoverable. For the avoidance of doubt, the PRA does not expect firms to map the reinsurance to a fundamental spread.

Application of fundamental spreads

The PRA would like to reiterate the point (made in Paul Fisher's letter of 28 March 2015) that firms should pay careful attention to the fact that fundamental spreads vary for each maturity of cash flow for any given asset. The PRA expects firms to take this into account in both the default adjustment and in any 'residual' fundamental spread (cost of downgrade subject to LTAS (long-term average spread) floor) deduction. Simplifications, for example using a single fundamental spread based on the duration of the asset, would be inconsistent with the way in which the fundamental spreads are intended to be applied in practice.

Matching

Cash flow assumptions used for matching analysis

The Solvency II MA requirements envisage that (except where cash flows have materially changed) an insurer holds an assigned portfolio of assets to maturity and that these assets should closely replicate (i.e. match) the expected cash flows of the portfolio of insurance obligations to which the MA is applied.

The PRA has developed and published a suite of matching tests[1] and accompanying thresholds that are designed to assess whether firms are adequately matched. The thresholds have been calibrated on the basis that firms do not assume any management actions (including reinvestment) in their cash flow projections. The PRA expects that for the purposes of projecting future cash flows to demonstrate cash flow matching:

- firms do not assume any future management actions. This includes items such as entering into derivative contracts at some future point in time or selling assets to meet cash flow requirements; and
- firms assume that all asset cash flows arrive on their contractual date - any surplus assets cannot be assumed to be reinvested and realised at a future date. This implies that, where cash is used to demonstrate matching, the cash balance should be assumed to be realised in full in year 1 of the cash flow projection.

The PRA expects firms to carry out the tests on a 'net of reinsurance' basis and to separately consider how well matched the MA portfolio's reinsurance assets and liabilities are.

[1] The Paul Fisher letter of 9 March 2015 sets out the tests that the PRA expects to be included as part of firms' formal applications.