



BANK OF ENGLAND  
PRUDENTIAL REGULATION  
AUTHORITY

Consultation Paper | CP16/16

# Solvency II: matching adjustment

April 2016

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Responses are requested by Friday 15 July 2016.

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## 1 Overview

1.1 In this consultation paper (CP) the Prudential Regulation Authority (PRA) proposes and seeks feedback on a draft supervisory statement setting out its expectations on firms in relation to the application of the matching adjustment (MA) for the purposes of calculating technical provisions, including in the context of applications for MA approval and the ongoing management of MA portfolios under Solvency II (the Directive).<sup>1</sup>

### Background

1.2 The draft supervisory statement sets out the PRA's proposed expectations of firms with regard to the MA in the following areas:

- annuity assets purchased in a secondary annuity market;
- ongoing MA compliance;
- breach of MA requirements;<sup>2</sup> and
- changes to MA portfolios.

### Purpose

1.3 The PRA is consulting on this draft statement to allow firms the opportunity to provide feedback and highlight any issues of concern to them.

1.4 This consultation is relevant to all UK Solvency II firms and to Lloyd's.

### Responses and next steps

1.5 This consultation closes on Friday 15 July 2016. The PRA invites feedback on the proposals set out in this consultation. Please address any comments or enquiries to CP16\_16@bankofengland.co.uk.

1.6 Subject to responses received, the PRA intends to finalise the proposed supervisory statement after this consultation closes.

## 2 Proposals

2.1 The proposals in this consultation contain the PRA's expectations on firms in relation to applications for MA approval and in particular, on issues concerning the eligibility of annuity assets purchased in a secondary market. The proposals also contain the PRA's expectations on issues to be considered once MA approval has been granted, such as the issues of ongoing MA compliance, dealing with MA breaches and what happens when there are changes to MA portfolios.

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<sup>1</sup> Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast).

<sup>2</sup> Regulation 42(4)-(6) of The Solvency 2 Regulations 2015 (2015/575)

### 3 The PRA's statutory obligations

3.1 The PRA has a statutory duty to consult when introducing new rules and a public law duty to consult widely on any other measures that significantly affect firms. In discharging its general functions the PRA must, as far as it is reasonably possible, act in a way that advances its general objective and its insurance objective.

3.2 The PRA believes that the proposals in this CP are compatible with the PRA's statutory objectives to promote the safety and soundness of PRA-authorized firms;<sup>1</sup> and in the context of insurance, to contribute to policyholder protection.<sup>2</sup> By providing guidance to firms on how the PRA expects firms to comply with Solvency II requirements, the PRA is ensuring the main objective of Solvency II, described in Article 27 of the Directive as the protection of policyholders and beneficiaries, is met.

3.3 When discharging its general function in a way that advances its primary objectives, the PRA has, as a secondary objective, a duty to facilitate effective competition. The PRA has assessed whether the proposals in this CP facilitate effective competition. The effect on competition of the MA, and in general, the implementation of Solvency II, has already been considered in Financial Services Authority CP11/22<sup>3</sup> and PRA CP16/14.<sup>4</sup> In addition, the MA is considered further in HM Treasury's impact assessment on the transposition of Solvency II.<sup>5</sup> The new PRA expectations in relation to ongoing compliance and breaches do not impose additional requirements, but clarify how Directive requirements may be met, and therefore are not expected to have a material effect on competition. The PRA's expectations in relation to changes to MA portfolios help facilitate effective competition by enabling firms to correctly reflect their risk profile as it changes. Setting out the PRA's initial views on the MA eligibility of annuity assets purchased on a secondary annuity market will also help facilitate effective competition through aiding insurers' understanding of the regulator's position, the lack of which could otherwise put insurers at a disadvantage compared with other potential participants in this market.

3.4 In developing the supervisory statement, the PRA has had regard to the regulatory principles as set out in the Financial Services and Markets Act 2000 (FSMA).<sup>6</sup> The draft statement is compatible with the Regulatory Principles as the PRA sets out transparent and proportionate expectations on firms in relation to Solvency II requirements. Setting out these expectations clearly also uses the PRA's resources efficiently.

3.5 The PRA may not act in an unlawfully discriminatory manner. It is required, under the Equality Act 2010, to have due regard to the need to eliminate discrimination and to promote equality of opportunity in carrying out its policies, services and functions.<sup>7</sup> The draft statement is not expected to have any direct or indirect discriminatory impact under existing UK law.

3.6 When the PRA proposes to make a rule which would apply to both mutuals and other authorised persons, the PRA is required to make a statement as to whether the impact of the

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<sup>1</sup> See s.2B(1) and s.2B(2) FSMA.

<sup>2</sup> See s.2C FSMA.

<sup>3</sup> FSA CP11/22 'Transposition of Solvency II: Part 1', November 2011; [www.bankofengland.co.uk/publications/Documents/other/pr/policy/2013/transpositionofsolvency2-1cp11-22.pdf](http://www.bankofengland.co.uk/publications/Documents/other/pr/policy/2013/transpositionofsolvency2-1cp11-22.pdf).

<sup>4</sup> PRA CP 16/14, 'Transposition of Solvency II: Part 3', August 2014; [www.bankofengland.co.uk/pr/pages/publications/cp/2014/cp1614.aspx](http://www.bankofengland.co.uk/pr/pages/publications/cp/2014/cp1614.aspx).

<sup>5</sup> *HM Treasury Impact Assessment*, 'Transposition of Solvency II Directive (2009/138/EC) and Omnibus II', December 2014, RPC11-HMT-1094(3); [www.legislation.gov.uk/ukia/2015/143/pdfs/ukia\\_20150143\\_en.pdf](http://www.legislation.gov.uk/ukia/2015/143/pdfs/ukia_20150143_en.pdf).

<sup>6</sup> See s.2H and s.3B FSMA.

<sup>7</sup> Equality Act 2010, section 149(1).



proposed rules will be significantly different to mutuals than to other persons. This CP proposes a supervisory statement rather than rules, and it is not expected that the effect on mutuals will be significantly different to that of other firms.

### **Cost benefit analysis**

3.7 Annuity assets purchased in a secondary annuity market: by setting out the PRA's initial views on the MA eligibility of annuity assets purchased in a secondary annuity market, the supervisory statement will aid insurers' understanding of the regulator's position, the lack of which could otherwise put insurers at a disadvantage compared with other potential participants in this market. The PRA notes that the supervisory statement does not go beyond what is set out in the Directive or the guidance that has previously been given by the PRA on asset eligibility of other assets (eg equity release mortgages) in the context of the MA.

3.8 Ongoing compliance of MA portfolios and breach of MA requirements: for ongoing compliance of MA portfolios and breaches of MA requirements, the expectations set out do not impose additional requirements above what the Directive requires, but clarify how these may be met.

3.9 Changes to MA portfolios: the proposals around changes to MA portfolios aim to provide clarity as to the process that should be followed by firms in determining whether a new MA application is required (as a result of the proposed change(s)) and the key considerations that feed into this. The incremental costs associated with a new application will not be material as the firm will have the relevant information from its own assessment in relation to any change to an existing MA portfolio. The new application may lead to a change in capital requirements and own funds associated with the change to the MA portfolio, which will help realise the benefits of the MA regime as discussed in the previous consultations referred in paragraph 3.3.



## Appendix - Draft supervisory statement 'Solvency II: matching adjustment'

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## 1 Introduction

1.1 This supervisory statement is addressed to all UK Solvency II firms and to Lloyd's. It sets out the Prudential Regulation Authority's (PRA's) expectations of firms regarding the application of the matching adjustment (MA) for the purposes of calculating technical provisions, including in the context of applications for MA approval and the ongoing management of MA portfolios where a firm has been granted approval by the PRA to apply a MA.

1.2 This statement should be read in conjunction with the PRA's rules in the Solvency II Sector of the PRA Rulebook, the PRA's approach to insurance supervision,<sup>1</sup> and Supervisory Statement 15/15.<sup>2</sup>

1.3 This statement expands on the PRA's general approach as set out in its insurance approach document. By clearly and consistently explaining its expectations of firms in relation to the particular areas addressed, the PRA seeks to advance its statutory objectives of ensuring the safety and soundness of the firms it regulates, and contributing to securing an appropriate degree of protection for policyholders.

1.4 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.

1.5 The PRA will review firms' applications bearing in mind the fundamental rationale underpinning the use of the MA, as described in Recital 31 of the Omnibus Solvency II Directive.<sup>3</sup>

## 2 Annuity assets purchased in a secondary annuity market

2.1 The Government has indicated its intention to support the creation of a secondary market in annuities by removing the tax barriers that currently prevent consumers from assigning their annuities to a third party. The Consultation Outcome was published by HM Treasury on 15 December 2015.<sup>4</sup>

2.2 If insurance firms should become purchasers of annuities in the secondary market then they may seek to include these annuity assets in their MA portfolios. It is not possible for the PRA to give a definitive view on MA eligibility of annuities purchased in the secondary market, particularly as this market is not yet active at the point of this supervisory statement being issued. However, the PRA expects that such annuities will not necessarily have cash flows that are fixed or 'bond-like' in nature as these cash flows will vary in line with the mortality of the underlying annuitants. It is likely that the annuitants will also be different individuals to those underlying the firm's own annuity business, which potentially introduces basis risk between the firm's assets and liabilities and means that the asset cash flows will be unlikely to vary only in line with the liability obligations.

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<sup>1</sup> Available at [www.bankofengland.co.uk/publications/Pages/other/prasupervisoryapproach.aspx](http://www.bankofengland.co.uk/publications/Pages/other/prasupervisoryapproach.aspx).

<sup>2</sup> 'Solvency II: approvals', March 2015; [www.bankofengland.co.uk/prasupervisoryapproach/Pages/publications/ss/2015/ss1515.aspx](http://www.bankofengland.co.uk/prasupervisoryapproach/Pages/publications/ss/2015/ss1515.aspx).

<sup>3</sup> Directive 2014/51/EU of the European Parliament and of the Council and of the Council of 16 April 2014 amending Directives 2003/71/EC and 2009/138/EC and Regulations (EC) No 1060/2009, (EU) No 1094/2010 and (EU) No 1095/2010 in respect of the powers of the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority).

<sup>4</sup> See [www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/485286/creating\\_a\\_secondary\\_annuity\\_market\\_response.pdf](http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/485286/creating_a_secondary_annuity_market_response.pdf).

2.3 It is possible in principle that these risks and issues may be mitigated so that the cash flows become fixed and 'bond-like'. Firms interested in purchasing annuities from the secondary market therefore would be expected to present their proposals as to how they intend to mitigate these risks as part of any MA application that includes such assets.

2.4 Annuities purchased by insurers on a secondary market will be a new type of investment for insurers. The PRA reminds firms that they will be expected to assess carefully, and be able to demonstrate, their compliance with Solvency II requirements in respect of such investments, including risk management requirements and the prudent person principle. This would include (among other things) the management of risk concentrations and exposures, liquidity considerations and avoiding excessive volatility in their asset portfolios.

### **3 Ongoing MA compliance**

3.1 Firms need to ensure that their existing approved MA portfolios (MAP(s)) satisfy the MA conditions on an ongoing basis. The PRA expects a robust process to assess this to form part of a firm's risk governance. As part of its supervision of firms, the PRA may periodically review a firm's ongoing compliance with MA requirements, including:

- (i) documentation relating to the MAP(s)' compliance with relevant requirements; and
- (ii) management information with regards to the ongoing monitoring of the MAP(s).

### **4 Breach of MA**

4.1 The PRA takes this opportunity to remind firms of the requirements in Technical Provisions 6.3 of the PRA Rulebook in cases where a firm has ceased to comply with the conditions set out in Regulation 42 of the Solvency 2 Regulations 2015<sup>1</sup> and is unable to restore compliance with these conditions within two months of the breach occurring. Firms should engage with the PRA as early as possible where there is a risk that the MA conditions will be breached.

### **5 Changes to MA portfolios**

5.1 This section sets out the PRA's expectations of firms in relation to changes to their MAP(s) after a matching adjustment has been approved.

5.2 Firms need to consider the implications of any change to their MAP(s), including whether such a change will require a new application for MA approval. The circumstances under which firms will need to consider whether a new application is required include, but are not limited to:

- (i) restructurings, mergers or disposals;
- (ii) the entry into new, or changes to existing, reinsurance and other risk transfer arrangements;
- (iii) changes to the way firms maintain and manage their MAP(s); and

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<sup>1</sup> Regulation 42 of The Solvency 2 Regulations 2015 (2015/575) is the main transposition of Article 77b of the Solvency II Directive; [www.legislation.gov.uk/uksi/2015/575/contents/made](http://www.legislation.gov.uk/uksi/2015/575/contents/made).

(iv) changes to the scope of the MAP(s), including the addition or removal of MA assets or liabilities and changes to the features of any MA asset or liability covered by the original application.

5.3 In the first instance a firm should form its own judgement on whether a change to its MAP(s) requires it to apply for a new MA approval. The PRA expects a robust process to be in place to assess the changes to a firm's MAP(s).

5.4 The PRA expects that any material change to MAP(s) after approval has been granted will require a new application for approval. In assessing whether or not a change is material such that a new approval is required, it will be necessary for firms to consider (among other things) whether any new asset and/or liability has the same features as those included in the scope of the firm's existing MAP for the purposes of Article 7(5) of the Implementing Technical Standards (ITS) regarding supervisory approval of the application of a MA.<sup>1</sup> The PRA notes that the more bespoke the characteristics of any asset or liability, the more difficult it is likely to be to show that such asset or liability has the same features as existing assets and liabilities.

5.5 If any changes are such that a new MA approval is needed then the firm should approach its application as it would for the approval of a completely new MAP. In particular, the firm will need to provide the PRA with sufficient information in order for the PRA to be able to assess whether the MAP, on the changed basis, will satisfy the MA requirements. The PRA should be informed as soon as possible where a firm with an existing MA approval considers a new approval is required.

5.6 Where a firm considers that a change to its MAP will not require a new application for MA approval, the PRA expects the firm to be able to demonstrate the basis for its determination if required. The PRA may also ask the firm to demonstrate that the requirements of Article 7(5)(a) and (b) of the ITS are satisfied.

5.7 The PRA is currently developing further guidance on the process for submitting such applications.

5.8 The PRA expects firms to have early sight of the matters which will require a new MA approval and to plan accordingly. Firms are reminded that the six-month period for determining an application commences from the date the PRA receives a complete MA application. Firms should also bear in mind that applications for MA approval are resource intensive. Firms should plan their MA applications in the light of their own timescales, and prepare such applications carefully and to a sufficiently high quality, in order to assist the PRA to apply its resources as efficiently and effectively as possible when reviewing these.

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1 [http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L\\_.2015.079.01.0018.01.ENG](http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2015.079.01.0018.01.ENG).