

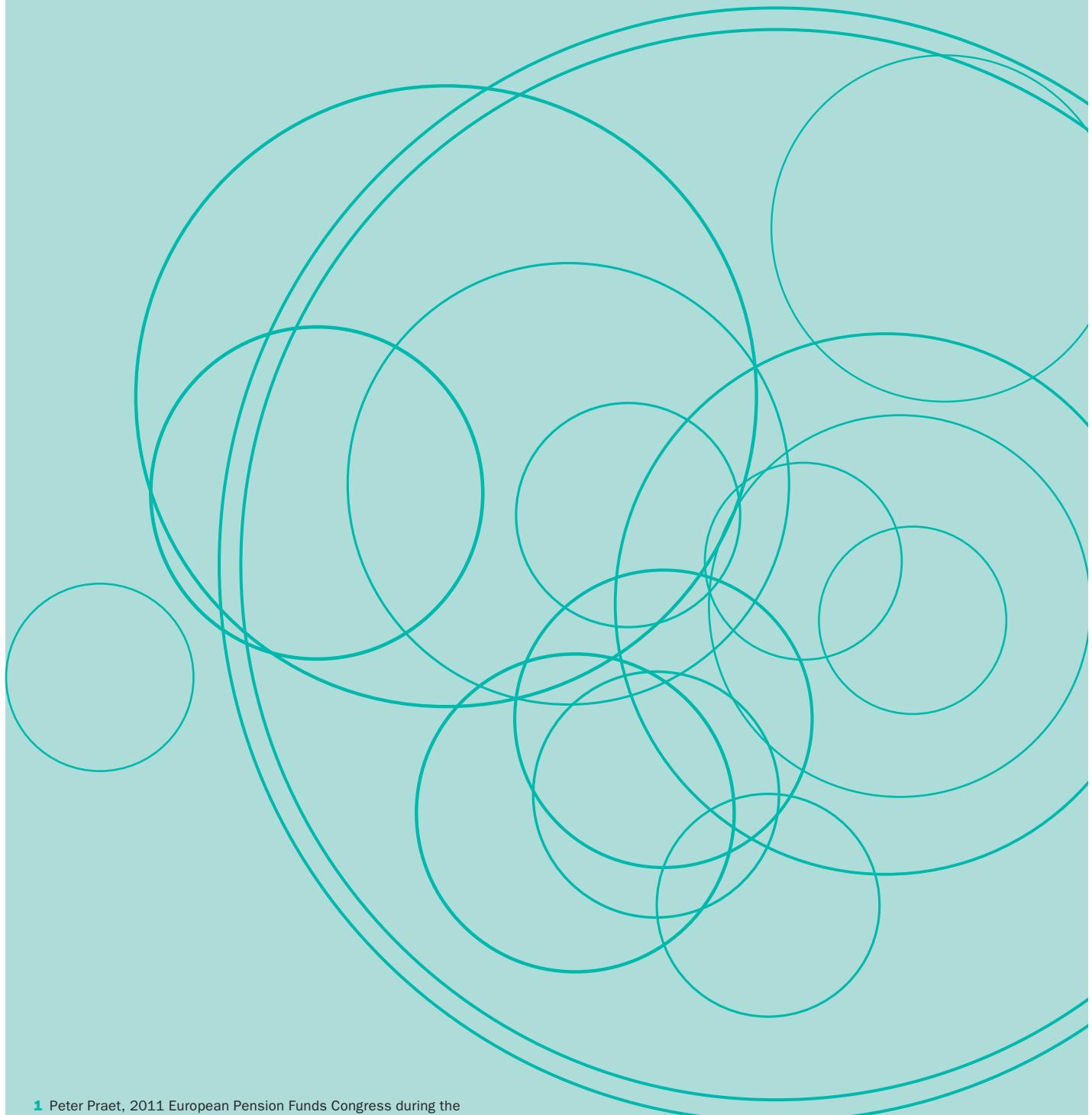


Solvency II

The matching adjustment and implications for long-term savings

“A partial retreat of institutional investors from the long-term and/or illiquid segment of the credit market could reduce private and social benefits of long-term investing, and reduce the extent to which the industry mitigates the procyclicality of the financial system.”

Peter Praet, member of the European Central Bank’s Executive Board¹



¹ Peter Praet, 2011 European Pension Funds Congress during the 14th Euro Finance Week, Frankfurt am Main, 15 November 2011.

Executive summary

Solvency II was initiated by the European Commission in 2000 and represents a fundamental change to European insurance regulations. The project aims to create a more harmonised, risk-orientated solvency regime, resulting in capital requirements that are reflective of the risks being run. It is expected to come into force in 2014.

The objectives for Solvency II include, amongst other things, deepening the integration of the European insurance market and improving the protection of policyholders and beneficiaries.

The existing EU Solvency I framework was first developed in the 1970s, based on the market and capabilities at that time. The simple factor-based Solvency I system is not risk-based and not easily comparable between companies or across territories. As markets, products and technology have developed, the need for a new regulatory regime is clear.

However, there are still areas of disagreement from stakeholders – one of which is how to ensure the framework recognises the nature of liabilities for long-term business. There have been several Quantitative Impact Studies (QIS) which have enabled stakeholders to better understand the potential impact of Solvency II. As a consequence of this work, the insurance industry has expressed concerns over the ability to provide long-term products with guarantees that represent value for money for consumers. The industry has therefore been working with policymakers to ensure that the specific features of insurance products are recognised in the new framework.

The purpose of this article is to take a critical look at the proposals being made and to consider the impact on the industry, consumers and wider economy if these measures are not introduced. We have received input and financial support from the CFO Forum, CRO Forum and Insurance Europe in developing this publication. However, the views expressed in this article are solely those of Towers Watson.

In summary, we find that the design of life insurance products means that in many cases insurers can invest assets with a long-term perspective. Insurers need not suffer losses from forced sales in times of financial crises. The current proposed regulations do not adequately recognise this feature and we therefore advocate a wider application of the proposed matching adjustment. Addressing this issue will bring benefits for consumers and the wider economy without impairing policyholder protection.

Key messages

- **Insurers play an increasingly important role in helping consumers save for retirement and close the pensions gap.**
- **The products written often have an underlying predictable and stable profile, partly due to features which prevent or discourage early surrender of the policy.**
- **The distinctive nature of the liabilities means that insurers can be long-term investors through the economic cycle.**
- **This feature was not adequately recognised in the original Solvency II proposals.**
- **Policymakers have proposed a matching adjustment whose main purpose is to reflect the degree to which an insurer is protected against credit spread volatility.**
- **However, the current scope is narrow. Our assessment suggests that a wider application of the matching adjustment is appropriate.**
- **Failure to widen the application of the matching adjustment will significantly increase the capital required by companies, with increased costs to consumers and less product diversity.**
- **In addition, removing incentives for long-term investment may also cause significant market disruption in the short term and increase systemic risk.**

Role of insurance companies in long-term savings

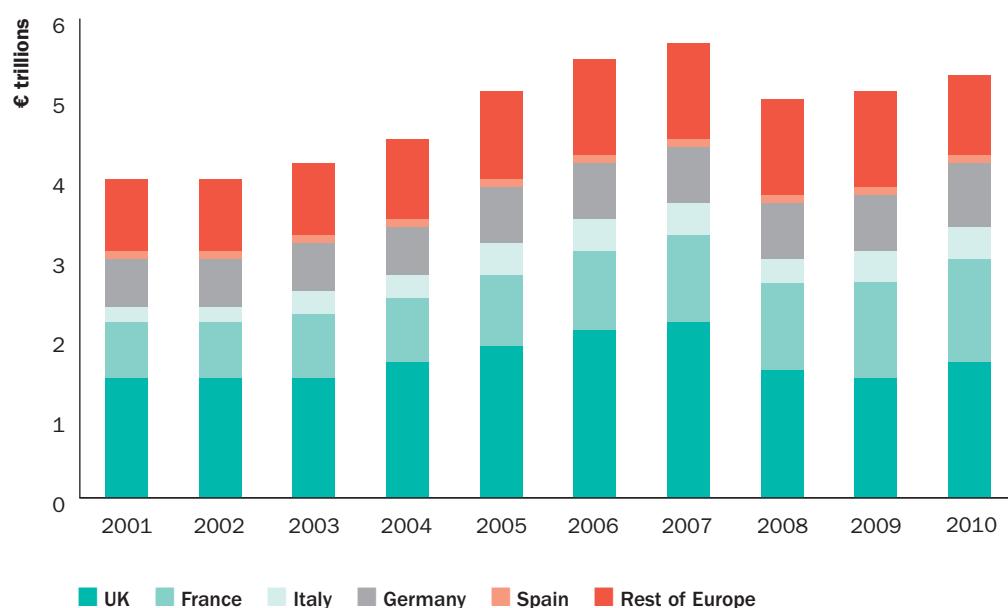
Research from the insurance industry shows that Europe's annual 'pensions gap' stands at €1.9 trillion². It is equivalent to approximately 19% of the European Union's GDP and indicates that unless individuals increase their saving for retirement, the majority will face a seriously reduced standard of living once they retire. At a country level, the UK, France, Germany and Spain have the largest national pensions gaps.

In many countries, society expects insurers to provide a viable alternative to help policyholders plan for retirement and close this gap. As at 2010, the total reserves held by life insurers in

Europe exceeded €5.0 trillion, with a majority of this held to back long-term savings products. This also illustrates the importance of the insurance industry as an investor in European economies. A split by country is shown in **Figure 01**.

Given the long-term nature of retirement planning, many policyholders are interested in having some stability in the accumulation of their savings and certainty in the payout of this fund during their retirement. Insurers have responded by designing various different products that cater to consumers' needs.

Figure 01. Total life reserves for major European insurance markets



Source: CEA Statistics N°45: The European Life Insurance Market: Data 2001-2010

² The pensions gap is the difference between the amount people need for an adequate standard of living in retirement and the pension amount they can currently expect to receive. Based on research conducted by Aviva.

Distinctive nature of products

Life insurance product design has evolved differently across Europe based on fiscal incentives, local accounting rules, regulatory regimes and consumer preferences. Nonetheless, there is a common theme in the design of many insurance products to provide a degree of certainty and stability for policyholders as part of their long-term financial planning. For example:

- In the UK a significant part of the insurance market relates to payout annuities. Here, the consumer pays a single premium, normally at retirement age, and in return receives a regular payment for life. No surrender options are available. Such products provide certainty of income and also guarantee the policyholder will not run out of money during retirement.
- Recent Spanish savings products such as PIAS³ or PPA⁴ have guarantees provided the consumer holds the policy for a minimum period or until retirement. Early surrender is possible but surrender values are based on the market value of underlying assets at the point of surrender. There are no guarantees for policyholders who surrender early but those who maintain their policy to maturity can expect to receive superior returns from holding the assets for the long term.
- Within France, retirement pensions are treated as insurance products and hence much of French life insurance business is driven by the long-term aims of saving for retirement or for inheritance purposes. Its long-term nature is reinforced by a tax regime which includes penalties on surrenders in the first eight years of the policy term, inheritance tax relief after the age of 70 and the exoneration of premium tax on annuity premiums. In the interests of stability, the French 'Code des Assurances' allows the regulator to prohibit withdrawals if the potential for a mass lapse event were to arise.

In general, comparable features can also be observed in other products across Europe. Specific examples for the German and Italian markets are discussed in more detail in the case studies that follow.

These product designs support consumers in long-term planning but also provide an advantage to insurers. The predictability and stability of cashflows mean insurers can invest for the long term and match the profile of the consumer payments with income received from government and corporate debt payments. This matching means that the insurer has sufficient resources available to pay its policyholder commitments without resorting to a sale of the underlying assets.

In cases where surrenders are possible, surrender penalties and loss of tax benefits discourage such behaviour and help protect the insurer against losses arising from the forced sale of assets.

The distinctive nature of the products and associated asset liability management (ALM) provide an advantage over products where the outflows can be volatile, particularly if assets need to be sold in unfavourable market conditions at a loss to meet the required outflows.

"In summary, we find that design of life insurance products means that in many cases insurers can invest assets with a long-term perspective. Insurers need not suffer losses from forced sales in times of financial crises."

³ Plan individual de ahorro sistemático.

⁴ Plan de previsión asegurado.

Case study 1 – German product designs

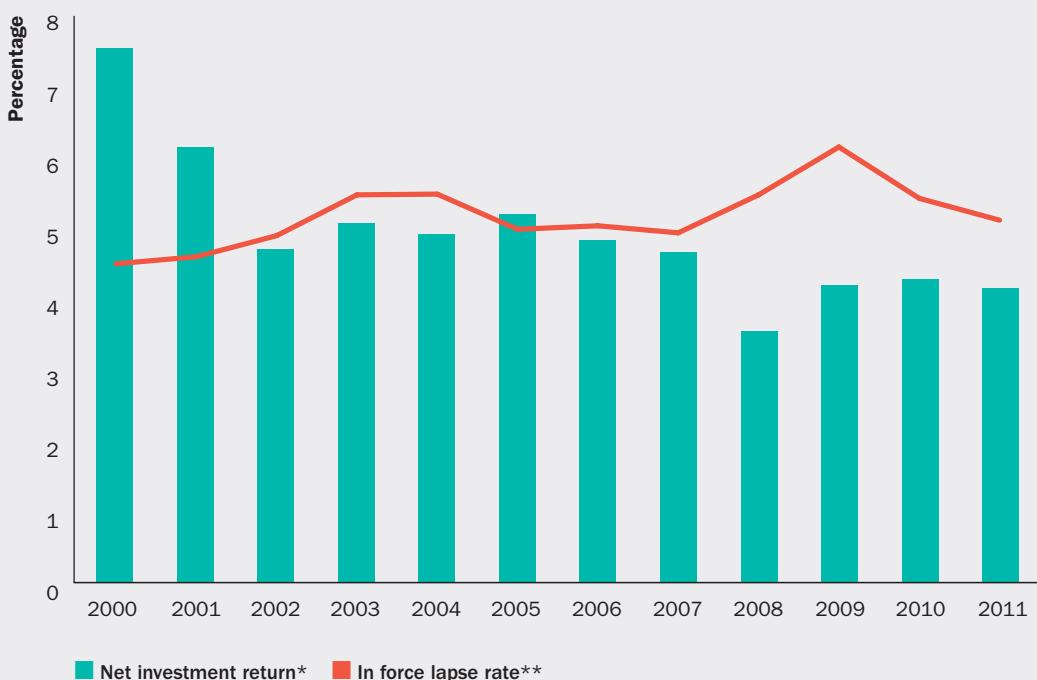
In German life insurance, a book value-based accounting regime is used. The vast majority of liabilities are in with-profit traditional products (mostly endowments), with an increasing share in with-profit deferred and immediate annuities.

For a typical German life insurer, the liabilities of traditional business are backed and managed by one common pool of assets, with the intention to smooth returns to policyholders over time and also across generations. While assets are predominantly held to maturity in fixed income at amortised cost, transfers to policyholders' accounts are channelled through a reserve for bonuses which further levels out interest credited over time. As a result, the total interest credited withstands short-term fluctuations of the assets underlying the contracts.

There also tends to be preferential tax treatment for policies that are held to maturity. In addition, an increasing portion of returns on policies is paid in the form of terminal bonuses which are lost on early termination of the policy. These characteristics lead to relatively low and stable surrender rates, so that a significant proportion of the liabilities can be regarded as highly predictable and stable.

This is illustrated in **Figure 02**, which shows that while investment returns may have varied over time, the lapse rates have remained fairly stable.

Figure 02. Net investment return on assets backing German products and corresponding lapse rates



Source: Gesamtverband der Deutschen Versicherungswirtschaft (GDV)

* Book return on assets, including realised capital gains

** Measured in terms of regular premiums

Does Solvency II align with management of insurance business?

For consumers, the main concern is whether the insurer is able to meet its commitments in the future. Insurers therefore use ALM techniques to help manage their income and promised outgoings to policyholders.

This management means the insurer will be less sensitive to changes in the market conditions provided that the underlying assets that provide the income do not default. This is important as over the last few years we have seen quite volatile movements in spreads and therefore in the market values for corporate and government bonds, but there has not been a material increase in defaults.

There is additional empirical evidence to support this. Some supporting references are cited in the box below.

“Over the long term, credit spreads are roughly twice as large as default losses, resulting in an average credit risk premium of about 80 basis points. We also find that credit spreads do not adjust in response to realized default rates.”

K. Giesecke, F. Longstaff, S. Schaefer, I. Strebulaev, 2011. Corporate Bond Default Risk: A 150-Year Perspective. *Journal of Financial Economics*, 102(2), 233-250

“Compensation for bearing non-credit related illiquidity risk appears to have been a particularly important driver of high-yield spreads.”

Bank of England Quarterly Bulletin, Q4 2007. Decomposing Bond Spreads article.

“Contrary to theory, recent empirical work suggests that changing default expectations can explain only a fraction of the variability in credit spreads.”

M. Manning, 2004. Exploring the Relationship Between Credit Spreads and Default Probabilities. Bank of England Working Paper No. 225

This means that for insurers with fixed interest assets, the spreads are not necessarily a reliable predictor of defaults and hence the amount they would expect to get back from holding the assets to maturity. However, Solvency II builds on a market value framework as a tool to assess the balance sheet of the insurance company. As there is no market for insurance liabilities, a mark-to-model methodology is used. The industry has argued that an adjustment is required to the framework in order to reflect the ALM techniques that they use.

Without such an adjustment, the insurer is exposed to significant balance sheet volatility as market values of corporate and government bond assets can vary widely based on short-term perceptions. However, this volatility is artificial as long as the bonds do not default and the insurer can either hold the assets to maturity or protect itself against loss on early forced sale of assets. We consider this more explicitly in Case study 2.

This debate on the specific nature of insurance liabilities is not new and is well-known within the sector. Insurance companies that report on a Market Consistent Embedded Value basis (MCEV) can make use of a liquidity premium when valuing illiquid liabilities.

This is in line with the European Insurance CFO Forum Market Consistent Embedded Value Principles (MCEV Principles) © (Copyright © Stichting CFO Forum Foundation 2008). The MCEV Principles were updated in 2009 following observations of stressed markets during the financial crisis to allow for a liquidity premium when valuing illiquid liabilities. In effect the proposal to adjust the Solvency II framework is similar to this concept and specific to the portfolio of each individual insurer.

“Without such an adjustment, the insurer is exposed to significant balance sheet volatility as market values of corporate and government bond assets can vary widely based on short-term perceptions.”

Case study 2 – the Italian experience

The Italian ‘segregated funds’ provide a typical example of where Solvency II does not take into account the specialist ALM of insurers. Profit participation in revalorisation products is designed to follow the book returns of the segregated funds. Surrenders are discouraged through surrender penalties, and in some cases disqualification from terminal bonuses. Historically, surrender rates for long-term Italian traditional business have generally been low and stable, particularly for traditional retail business.

The stable liability profile and close matching of the underlying cashflows set the basis for sound Asset Liability Management. In general, these funds have a very high allocation in fixed income assets, with a majority being in Italian government bonds. These are typically duration-matched and often held to maturity.

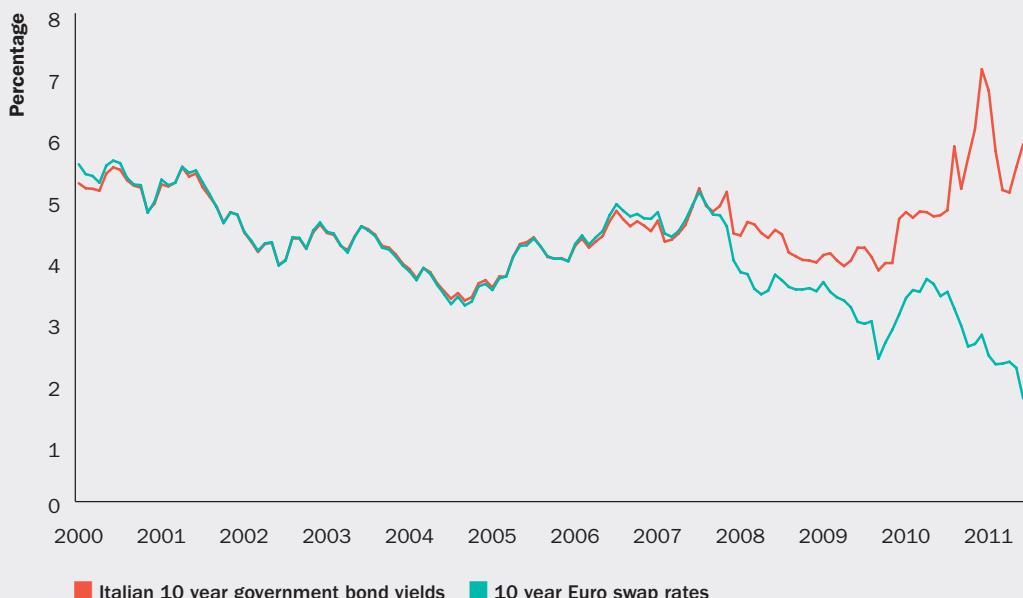
However, under Solvency II proposals, assets are assessed at current market values, while liabilities are valued based on European swap rates. This has recently created a significant mismatch, following the increased spreads on Italian government bonds.

Figure 03 shows the divergence in Italian 10 year government bond yields and 10 year Euro swap rates. For Italian companies, a market value framework using a swap liability discount rate showed a substantial shortfall at the end of 2011, where the difference between government bond yields and the swap rates was 4.3%.

However, not all of the above difference in spreads will be due to credit risk. For insurers who can hold the debt to maturity, an assessment is required as to how much of the spread difference is actually related to defaults. Once this is assessed the insurer can determine the additional value that it can reasonably expect to realise from holding the assets to maturity.

This is not the approach of the current Solvency II framework, which effectively assumes that the government bonds will need to be sold immediately and no additional value can be obtained from holding the assets to maturity. This is one of the arguments as to why an adjustment to the Solvency II framework is necessary to reflect the special characteristics of insurance business.

Figure 03. Italian Government bond yields compared to Euro swaps



What are the proposals to reflect the nature of insurance liabilities?

The volatile market conditions since 2008 have highlighted the ability of insurers to hold assets through the economic cycle. For policymakers, the question arises as how best to reflect these considerations in the proposed Solvency II framework.

A number of solutions have been, and are being, discussed. These involve an adjustment to the balance sheet, either as a separate entry or as an adjustment to the discount rate for the liabilities. A summary of the development of the proposals is shown in **Figure 04** below.

Figure 04. Development of proposals

| | Illiquidity premium | Matching premium/ matching adjustment | Proposed industry refinements to the matching adjustment ⁵ |
|----------------------|---|--|---|
| Introduced in | • QIS5 | • Omnibus II proposals ⁶ / Draft Implementing measures | • Under development |
| Purpose | To reflect the characteristics of insurance business where the insurance undertaking is able to hold assets to maturity | | |
| Methodology | <ul style="list-style-type: none"> Function of the market yield spread from corporate bonds over risk free Based on a reference portfolio Applied as an adjustment to discount rate used to value liabilities | <ul style="list-style-type: none"> Based on current yields less a deduction for defaults based on historic information Based on company specific portfolio Calculated for each individual rating class Applied as an adjustment to discount rate used to value liabilities | <ul style="list-style-type: none"> Based on current yields less a deduction for defaults Based on company specific portfolio Calculated for each individual rating class Can be applied as an adjustment to the balance sheet or as an adjustment to the discount rate used to value liabilities |
| Scope | <ul style="list-style-type: none"> Available on all products but to different extents Can be applied at all times | <ul style="list-style-type: none"> Restrictive application with criteria that excludes most long-term insurance products Can be applied at all times | <ul style="list-style-type: none"> Wider application based on predictability of cashflows Can be applied at all times |
| Strengths | <ul style="list-style-type: none"> Encourages companies to maintain their traditional long-term products Reference portfolio means simpler calculations Objective method Partially responsive to change in spreads | <ul style="list-style-type: none"> Encourages companies to maintain their long-term investment horizon for qualifying products Reflects actual assets held and their matching characteristics to the liabilities Objective method Highly responsive to change in spreads | <ul style="list-style-type: none"> Encourages companies to maintain their traditional long-term products and investment horizon Reflects actual assets held and their matching characteristics to the liabilities Objective method Wider application based on predictability and stability of insurance cashflows |
| Limitations | <ul style="list-style-type: none"> Does not take into account actual assets held which is of particular relevance at times of stress Does not promote good ALM as companies receive illiquidity premium regardless of matching position | <ul style="list-style-type: none"> Restrictive nature means that only certain products will qualify and hence perceived as biased towards certain markets Artificial limits imposed on the benefits that could be recognised Unnecessary restrictions on eligible assets, for example on callable bonds | <ul style="list-style-type: none"> Clarification needed on exact basis for calibration. Will govern responsiveness to spread changes Increased governance (Pillar II) and disclosure (Pillar III) requirements likely as part of supervisory review process |

⁵ Based on discussion with industry representatives.

⁶ Article 308c of the draft European Parliament legislative resolution on Omnibus II published by the European Parliament's Committee on Economic and Monetary Affairs (ECON) on 28 March 2012.

Relationship with counter-cyclical premium

Policymakers are also discussing the use of a separate counter-cyclical premium (CCP). This can serve as a useful tool for supervisors when the markets are no longer functioning rationally. However, the CCP is not a substitute for the matching adjustment as they serve different purposes.

The CCP will only apply in sufficiently extreme market conditions whereas the matching adjustment is intended to cope with both day-to-day spread movements as well as the dislocations that can be experienced in extreme conditions. Hence, we would not expect the CCP and matching adjustment to be applied to the same portfolio.

We do not consider the CCP in detail but we note that in order to function effectively, there must be some mechanism to target the application of the CCP to where it is needed. A single CCP for the Eurozone area will be a very blunt instrument. It will provide too much relief in some markets and not enough in others.

In addition, a broad understanding as to when the CCP will be applied is necessary. However, we will not know in advance what will trigger the next financial crisis so there should be sufficient flexibility around the design so as not to limit the ability of supervisors to employ the CCP.

A proposal to improve the matching adjustment

Many of the current discussions centre on the matching adjustment as a possible refinement to the Solvency II framework. These are described in the draft Omnibus II text. However, we believe that these proposals are unnecessarily restrictive and there are a number of areas where the current proposals could be better designed to reflect the nature of the insurance business.

There are three steps we believe should be considered in the application of the matching adjustment. They are:

Identify the underlying profile of predictable and stable liability payments

The starting point should be an economic analysis taking into account the product features and associated policyholder behaviour. Large portfolios exhibit some degree of predictability and there are techniques to help establish this. For example, actuarial models can be used to derive the necessary profile whilst making conservative assumptions (perhaps based on the 1-in-200 year stresses) about policyholder behaviour such as lapses.

Such an approach allows some of the restrictive requirements currently in Omnibus II to be removed. The matching adjustment could therefore be applied to a wider range of products provided that a stable underlying liability profile could be identified.

Identify the corresponding assets and the associated cashflows

These are assets which can be used to back the stable liability profile and hence may qualify for a matching adjustment. Bonds and assets with similar cashflow characteristics will be eligible for the matching adjustment. If these assets are

insufficient, then only the proportion backing the stable liability profile should be considered. However, in order to do so, it is necessary to show that there are other assets which will be available in stressed circumstances to meet the liability profile. The matching adjustment should not provide companies with an incentive to invest in lower grade assets. This could be done by limiting the potential benefit for lower rated assets (for example, rated BBB or lower) to that which could be recognised on a similar higher quality asset (for example, A-rated). This removes any incentive for companies to use the matching adjustment to invest in lower grade assets.

If this approach were used then there should be no need for additional investment restrictions on the assets to be held by rating class as proposed in the current Omnibus II text. Indeed, such investment restrictions may have unintended consequences. For example, such restrictions could lead to a mass forced sale of assets by insurance companies (resulting in pro-cyclical behaviour) if there was a downgrading of a widely held government debt to BBB.

Determine the matching adjustment

The matching adjustment would be a function of the interaction of the assets and liabilities. The following diagrams demonstrate a few illustrative investment scenarios. Attention is drawn to the matching achieved (in red), and the profile of the unmatched asset payments (in green) and unmatched liability payments (in grey). Such analysis allows the company to identify in each scenario the cashflows eligible for the matching adjustment. This will allow the benefit of the matching adjustment to be tailored to each fund's individual position.

Investment strategy 1

- Asset and liability payments are exactly matched.
- Underlying assets can be held to maturity.
- Full benefit of matching adjustment can be recognised.

In practice, exact matching of liabilities and assets is difficult as assets are often not of sufficiently long durations and there are additional practical issues when cashflows are broken down by month and by day.

However, the matching adjustment does not need to be limited to exactly matched cashflows. We illustrate this in **Figures 06 and 07**.

Investment strategy 2

- Asset and liability payments are not exactly matched.
- However, all assets can be held to maturity and there is no risk of forced asset sales.
- Benefit of matching adjustment can be recognised although methodology needs to consider how to recognise the benefit with regard to excess asset payments (in green).

Figure 05. Cashflow matching – investment strategy 1

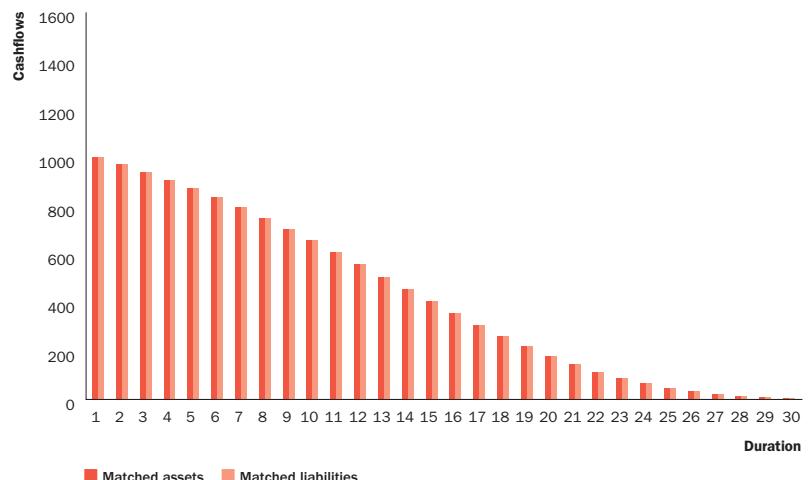


Figure 06. Cashflow matching – investment strategy 2

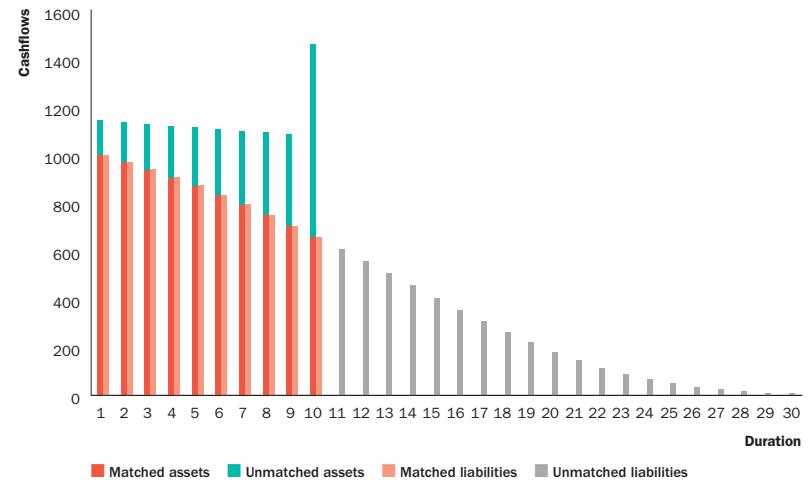
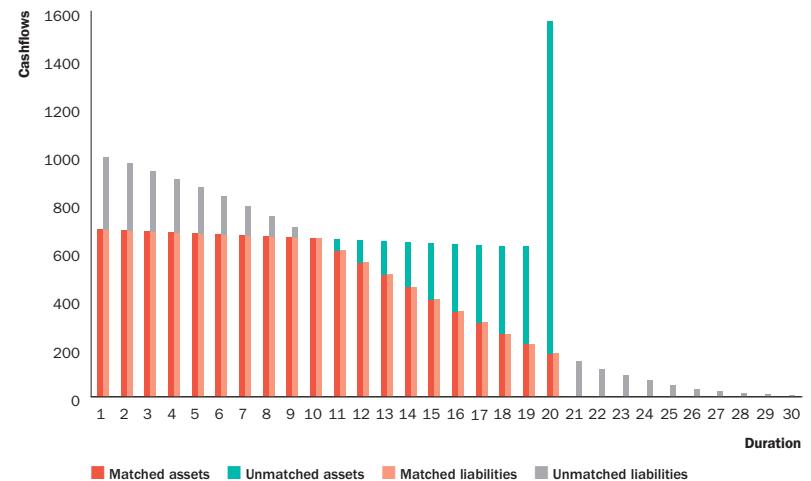


Figure 07. Cashflow matching – investment strategy 3



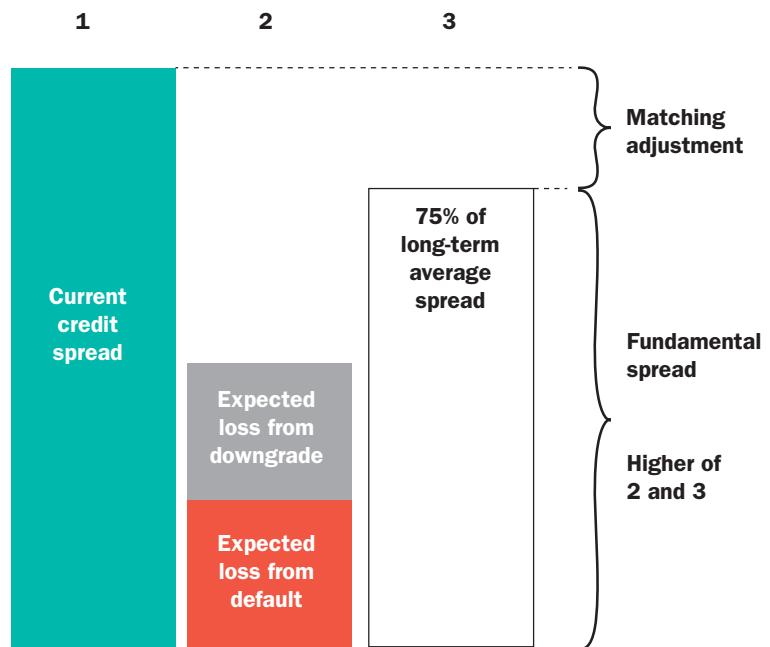
Other aspects of the Omnibus II proposal

For a single cashflow the matching adjustment under the current proposals can be thought of as:

- Matching adjustment = current credit spread – fundamental spread
- Where fundamental spread = (expected loss on defaults + expected loss on downgrade) subject to a floor of 75% of the long-term (30 years) average spread

Graphically, this is expressed in **Figure 08**.

Figure 08. Omnibus II proposal for a matching adjustment



In determining the potential loss from defaults, a balance between historical and prospective information is required. The risk relates to defaults and hence the matching adjustment should make a conservative assumption on defaults.

However, in the Omnibus II proposal there is a minimum assumption for defaults based on 75% of long-term average spreads. It is not clear why such a floor is needed or how it has been derived. Additionally, the Omnibus II proposal makes assumptions about constant rebalancing of the portfolio on downgrades. This means that if an asset is downgraded then it is assumed that it is sold and replaced by a new asset of equivalent rating prior to the downgrade. This is not consistent with a buy-to-hold strategy and, in any case, the cost of downgrades should be based on the company's investment policy as this drives the need to sell assets.

Supervisory controls around the matching adjustment

While noting the areas where the Omnibus II regulations can be improved, it remains important for all stakeholders that the Solvency II framework is robust. This means that there will need to be a set of rules governing the use of the matching adjustment. Supervisors will have the responsibility of reviewing the application of the matching adjustment by companies and may use a number of existing tools to monitor the application of the matching adjustment. For example:

- We expect that the use, methodology and size of any matching adjustment would be disclosed to the regulators as part of the regular supervisory reporting.
- The matching adjustment will not take into account any premium flows associated with new business to pay out unexpected claims.
- Companies would need to justify how the assets supporting the matching adjustment are consistent with the prudent person principle within the Solvency II Directive. This requires company assets to be properly diversified in order to avoid excessive reliance on any particular asset, issuer or geographical area, and excessive accumulation of risk in the portfolio as a whole.
- The insurer must show that they have the ability to hold assets until maturity and there are sufficient mechanisms in place to protect against policyholder surrenders. To do this there needs to be suitable policies, procedures and governance structures in place which could be reviewed by supervisors.
- The ORSA also represents a mechanism whereby supervisors can challenge the progress of the business over time and the use of the matching adjustment in the future. Scenario analysis can be expanded to consider the extent to which changes in areas such as fiscal incentives might change the underlying liability profile.

In order to ease application for smaller companies, supervisors may allow simplifications based on type of product, the structure of the asset portfolio, and average asset and liability durations. This may allow a less demanding derivation of the matching adjustment, while maintaining the core principles of a portfolio specific adjustment.

Consequences of a limited application of the matching adjustment

Insurance companies

The lack of a matching adjustment on long-term savings products means that insurance companies would need to raise additional capital. This may be difficult in the current environment and even if possible, the suppliers of capital will demand a return on the additional support provided. This will increase the cost of providing certain products and perhaps discourage consumers from saving. Ultimately, the cost of any shortfall in retirement savings will fall back on the state.

Longer-term products will be affected the most as these are where insurance companies can provide the maximum benefit via the matching adjustment. With the matching adjustment these products benefit as:

- Writing a new policy will require less capital as the company is able to recognise some initial value from holding any matching assets to maturity.
- The volatility of the balance sheet due to spread movements is reduced as assets and liabilities react similarly to spread movements. This means that the company does not need to hold large additional buffers to protect against artificial volatility.
- The capital requirements will be based on the expected change in default risk rather than potential changes in spread. This is in line with the underlying risk exposure.

Consumers

There are knock-on effects for consumers from the lack of a suitable matching adjustment.

- We indicated previously that companies may need additional capital to support existing products. Such costs will invariably need to be shared with the consumers. This will lead to lower returns on policies and will exacerbate the already low returns policyholders receive due to the current low interest rate environment.
- In order to better understand the impact on consumers, we have built a simple company model. The model assesses the impact on policyholders of the additional capital required if there was no matching adjustment. Assuming a typical risk appetite and target returns for the business, we estimate that premiums paid would have to rise by about 10% to 15% for the same level of policyholder benefits without a matching adjustment. This should be viewed in the context of the over €600 billion of life insurance premiums received annually.

- Alternatively, companies could look to alter their product mix and perhaps focus on products without guarantees, such as unit-linked products. Such a strategy passes all the risks associated with retirement savings and payouts back to the policyholders. Policyholders would be exposed to the day-to-day market fluctuations and this would be contrary to their desire for long-term stability and predictability.

Supervisors

A limited application of the matching adjustment also has implications for supervisors as they are ultimately responsible for monitoring companies' solvency and taking any necessary actions to protect policyholders.

- Without a matching adjustment the balance sheet will be much more volatile meaning that breaches of the Solvency Capital Requirement (SCR) will be more frequent. Companies may need to provide a recovery plan but could argue that the best course of action would be to do nothing other than continue to hold the assets to maturity. Without the matching adjustment, even if supervisors agreed with the view, they may have no other option than forcing the company to sell their assets at an inopportune time. This could result in them being accused of creating an artificial crisis for the company and losses for policyholders.
- The Solvency II regime could face strong criticism if the regulatory regime is unable to adequately allow for the features of insurance contracts. This could undermine the credibility of the supervisor, create a drain on company and supervisor resources, and undo the good progress that has been made to date. It is therefore important that the regulatory regime is aligned with the risk that a company faces.

“...we estimate that premiums paid would have to rise by about 10% to 15% for the same level of policyholder benefits without a matching adjustment.”

Wider economy

The interactions of institutional investors such as insurance companies with the wider economy are complex so it is difficult to assess the long-term impact of having no matching adjustment. However, we do note some of the shorter-term implications:

- Increased prices mean less incentive for individuals to save for their own retirement and thereby provide the necessary capital to help stimulate economic growth.
- Society expects insurance companies to provide a market for long-term savings. The lack of a matching adjustment will decrease the attractiveness of such products for insurers and some will exit the market. These points act to increase as opposed to reduce the pensions gap. Given the political imperative of reducing this gap this would place pressure on future government policy in this area.
- Insurance companies, discouraged from being long-term investors, will increase their focus on shorter-term products. Given that other financial institutions such as banks already offer similar products, this will decrease the diversity of the market. Lower diversity leads to increased systemic risk and encourages pro-cyclical behaviour.
- A lack of a matching adjustment means that companies will need to alter their existing investment strategy. Given the size of the insurance market, this would lead to significant short-term market disruption. This is not desirable, especially given that current market conditions are already volatile and uncertain. In addition, as products change, insurance companies will have no choice but to increasingly shift their investments away from longer-term assets and into shorter-term assets.

A wider application of the matching adjustment will help recognise the extent to which insurance companies are protected against losses from an early forced sale of assets. It will also help maintain the diversity of products currently offered, thus contributing to the overall stability in the financial system.

A Europe-wide solution for the matching adjustment

The current gap in retirement savings is a Europe-wide problem. European demographics and the cost of retirement mean that insurers will continue to play an essential role in wealth accumulation for consumers.

The ability of insurance companies to invest for the long term is valuable and should be recognised. A solution to reduce short-term volatility is required for the Solvency II framework and we believe the matching adjustment is a sound approach to do this. However, to date, it has been viewed as a solution for very specific products in a few markets. The methodology developed in Omnibus II is narrow in application but we have shown how this can be extended more widely. This is done by using a more tailored approach that more accurately reflects the risk characteristics of the business.

If Solvency II achieves its objectives, we will see a more risk-based, well-managed and sustainable insurance industry which will benefit consumers, investors and society as a whole. As long-term investors in industry and government, insurers need to be protected from short-term market volatility. This should be achieved using a tailored solution that properly recognises the risks of insurers. We believe this is the fairest way for Solvency II to achieve its aims. It is therefore important that a solution for the entire insurance industry is implemented.

Common misconceptions about the matching adjustment

- **It is an unsubstantiated concession for insurance companies**
Rather, the matching adjustment is designed to recognise the distinctive nature of insurance contracts and the advantages of long-term investing.
- **It is only relevant for specific products in some countries**
The matching adjustment should be based on an economic analysis, taking into account specific product features and associated policyholder behaviour. It is relevant to a wide range of products.
- **The aim is to allow insurance companies to chase high yields**
The portion of the yield relating to credit risk cannot be recognised. In addition, the matching adjustment can be calibrated to take a prudent view of defaults and limits can be designed to remove any incentive from investing in lower grade assets.
- **It is too complicated for small companies to implement**
The calculation will require an analysis of the ALM which is good business practice. Much of the information should already be available from the models used to produce the cashflows for the technical provisions. In addition, supervisors can explore simplifications if necessary.
- **It will introduce systemic risk**
On the contrary, without a suitable matching adjustment, the diversity of products written will be reduced, increasing systemic risk.

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