[address redacted]

11 January 2021

By email d.e.buckner@eumaeus.org

Solvency II Review SolvencyIIReview@hmtreasury.gov.uk

Dear Sirs,

We write to comment on the Solvency II review, particularly on the use of the regulatory 'Matching Adjustment' (MA), a means of creating artificial capital on the regulatory balance sheet of life insurance companies. Dowd is a professor of finance and economics and Buckner is retired from the Bank of England, where he worked on the valuation of Equity Release Mortgages, and on the Matching Adjustment itself. He now works with Dowd on the Eumaeus project, which is devoted to technical valuation issues.

As you say, MA applies to business in which an insurance firm sells liabilities with fixed duration and cash flows, for example, annuities, and backs these liabilities by buying 'to hold' assets with predictable cash flows and durations that approximately match those of the liabilities. The MA allows firms to use higher yielding, and hence risk bearing assets, and use the supposedly risk-adjusted yield to discount the liability cash flows. This discounting practice decreases the reported present value of the liabilities, hence creates capital on the regulatory balance sheet[1]. Use of MA has to be approved by the PRA.

HMT seeks views on whether the matching adjustment is operating optimally. This begs the question: 'operating optimally' is based on the unsupported assumption (see above) that MA is a good thing, and that we don't have enough of it because of overly restrictive criteria surrounding it. This claim unwisely presupposes that the MA is beneficial. There are better ways to support the provision of long-term finance than putting pensioner savings at risk, as we argue below.

We do not agree that firms using MA are 'exposed to less risk than other firms.' The MA allows firms to recognise some anticipated risky future profits as if they were certain, thereby allowing them to be distributed before being realised. If the risky future profits are not realised – bear in mind that they are called 'risky' for a reason – then the capital created by MA will vanish, and policyholders will be at risk. For the same reason, we do not agree that 'an insurance firm that meets these conditions is less exposed to the risk of asset price movements, because the short-term volatility of asset prices does not affect its ability to make contractual payments on its liabilities as they fall due.' Market movements are the market perception of increased default risk, as we saw in March 2020 when asset markets collapsed

[1] And hence, because International Financial Reporting Standards has a similar mechanism, increases IFRS equity.

on fears that the coronavirus crisis would cause long term damage to the economy. Default on the affected assets would certainly affect the ability of a firm to make contractual payments on its liabilities as they fell due.

Again, and for the same reason, we do not agree that firms can cover default losses 'with a very high level of confidence' and can cover the uncertainty over the cost of replacing assets that default from their own capital. The problem is that the capital of some firms making excessive use of MA has entirely been created through MA, so these firms have no true capital at all.

You say that 'The matching adjustment has a clearly defined rationale.' Again, we disagree. Standard economic theory says there is no rationale for discounting risk-free liabilities at higher than the risk-free rate. According to the Bank of England's Donald Kohn, "While economists are famous for disagreeing with each other on virtually every other conceivable issue, when it comes to this one there is no professional disagreement: *The only appropriate way to calculate the value of a very low-risk liability is to use a very low-risk discount rate.*"[2]

Use of the matching adjustment does not boost the true affordability of annuities. It makes them *appear* affordable by supporting them with higher yielding, but riskier assets. Note that much of the capital artificially created by MA goes into the pockets of hedge funds and private equity managers and does not support long-term funds to pay for future annuity payments.

Nor does MA support the provision of long-term finance to the economy. On the contrary, the MA allows firms to artificially boost reported profits which can then be distributed before true profits have been earned, thereby depleting funds available for long-term investment. Also, our understanding is that relatively few of the assets that received MA regulatory benefit were used to provide long-term finance.

You say that the Government also seeks views as to whether there are barriers in the current processes in the use of MA. Again, this statement presumes without any underlying justification, why a system of what is essentially false accounting could support long-term financing of projects.

Sincerely,

Dean Buckner (EUMAEUS)

Kevin Dowd (University of Durham)

[2] Donald L. Kohn, "Statement at the National Conference on Public Employee Retirement Systems Annual Conference," New Orleans, LA, May 20, 2008.