

# Newsflash

## "PRA Policy Statement on Solvency UK Reform 'Review of Solvency II: Reform of the Matching Adjustment'"

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The Prudential Regulation Authority (PRA) policy statement PS10/24 was published on 6 June 2024, and sets out changes to the Matching Adjustment (MA) framework. In this newsflash, we discuss the final changes to the MA framework, ahead of implementation on 30 June 2024, and their potential impact on insurers. The full policy statement can be found [here](#).

### Executive Summary

This newsflash follows the proposed reforms to the MA framework (set out in the PRA's consultation paper CP19/23), which we discussed in a previous [Newsflash](#). It covers changes to asset eligibility requirements, new eligible liability types, and requirements for an annual Fundamental Spread (FS) and MA attestation.

**Our overall view:** There have been some pragmatic changes and clarifications from the PRA. These are useful to insurers but unlikely to change the overall approaches undertaken by firms to implement changes set out in CP19/23. The policy statement has helped to reduce the potential operational burden of completing the MA Attestation, but they haven't made a significant difference to the assets that would be eligible for the MA compared to the consultation paper. While there is increased flexibility in the investments insurers can make, overall, the new potential asset universe isn't as great as insurers may have preferred. However, these are important steps that have been taken and with discussions ongoing on proposed "sandboxes" to investigate potential new MA assets, there is hope that more potential will be unlocked.

The key changes (and key areas that haven't changed) from the September 2023 consultation paper can be summarised as:

- Deletion of wording that caused confusion as to whether certain assets, such as those with extension clauses already included in firms' MA portfolios, would be reclassified as assets with highly predictable cashflows (HP assets).
- Confirmation that insurers can assume the published FS captures the key risks for "vanilla" corporate bonds and private placements will help to save the industry significant work that was expected to lead to minimal or no impact to MA. Insurers should instead focus on any idiosyncratic risks and concentrations of exposures.
- Recognition that the Effective Value Test (EVT) can be used to demonstrate the FS is sufficient for Equity Release Mortgage (ERM) assets, although insurers will need to assess the sufficiency of the PRA's EVT parameters.
- Allowing insurers to perform an initial top-down assessment of assets at a homogenous risk group (HRG) level – although the factors specified may require a very large number of HRGs, with relatively detailed analysis still needed. The wording remains that states insurers should not assume that prudence in one asset can offset an insufficient FS in another. This still leaves it open for insurers to justify their approach.
- Extending liability eligibility requirements to allow group death in service dependants annuities and confirming that Group Income Protection can be included, which was not immediately clear from the original CP19/23 wording.
- No change to the 10% MA benefit limit on HP assets, although the tolerance for the additional matching tests for HP assets has increased from 3% to 5%. The policy now provides a couple of worked examples to provide some further clarification to the approach of calculating FS add-ons for HP assets.

## Asset eligibility and “HP assets”

### What is changing?

In the consultation paper, the PRA had added wording setting out some specific examples of where assets may not be considered fixed. This had caused confusion within the industry about the treatment of fixed assets under the new reforms. The PRA sought to clarify their position in [a statement on 15 April 2024](#). These examples have been completely removed from the supervisory statement in order to clear up this confusion.

There is also clarification that the PRA expects MA eligible assets (whether fixed or HP assets) to be included without restructuring – but will consider these on a case-by-case basis, with explanation of the reason for the restructure. It also noted that additional value could be created through this restructure, although the insurer will need to explain how this has arisen and that it has been created on an arms-length basis.

In relation to the new matching tests for HP assets, the thresholds for both the matching loss test and modified accumulated cash flow shortfall test have increased to 5% (from 3%). The matching loss test involves comparing the level of MA benefit with the lowest possible MA benefit that could be achieved if cashflows were altered (though consistent with contractual terms). The accumulated cashflow test examines the accumulated shortfall from assuming cashflows from HP assets are received at the latest date possible under the contract.

### What will it mean for insurers?

This removes some doubts created by the consultation paper and insurers will feel more comfortable that their quota of HP assets will not be taken up with assets they view as fixed, and which are already included within MA portfolios. The PRA may well wish to discuss certain assets with insurers on a bi-lateral basis.

An area that has **not changed** is the limit of HP assets to 10% of the value of the MA. Some insurers were seeking to increase (or remove) this limit or to make it more risk sensitive. However, the PRA has determined that 10% is an appropriate limit to achieve the overall aim of ensuring that the vast majority of assets in MA portfolios have fixed cashflows is met. As expected, there have not been any changes made from CP19/23 which will open up a new asset class and so the overall conclusions remain.

## Clarifications to the approach for MA attestation including calculating FS add-ons

### What is changing?

In the policy’s three step process for calculating the level of FS add-on, the PRA has clarified its expectation that the majority of assets with a risk profile consistent with the underlying MA assumptions (ie vanilla corporate bonds and private placements) will not require an FS add-on. The amendment to the policy wording means that, for such assets, insurers can focus on assessing the concentration of exposures and any idiosyncratic risks not captured by the FS calibration data.

For ERM assets, the PRA has updated policy wording to recognise that the EVT can be used for the purposes of MA attestation, noting that firms would be expected to set their own assumptions, which should not fall below PRA published minimum parameters.

Firms will also be able to group assets into HRGs for initial analysis of FS and MA appropriateness, with certain minimum grouping factors, including asset type, sector, sub-sector, rating method and notched rating. However, there is an expectation that specific assets may need to be analysed further, for example to identify idiosyncratic risks, or where the asset contributes significantly to the MA benefit.

For assets with HP cashflows, the policy includes a worked example for a callable bond and for an asset with prepayment features. This shows the PRA’s expectations of how the standard approach for FS add-on could be applied. In relation to reinvestment risk or rebalancing costs, due to changes in the timing or amount of HP cashflows, the PRA has clarified that the 10bps allowance is intended to be a minimum of the FS add-on rather than an addition.

For out-of-cycle MA attestations, the policy sets out a deadline of no later than three months after a material change in risk profile, with Firms expected to engage the PRA to discuss timelines for completing the attestation. The PRA has clarified that out-of-cycle attestations will not be required before 31 December 2024.

### What will it mean for insurers?

These updates will reduce the operational burden of completing the MA attestation for insurers with vanilla corporate bonds and private placements, while providing recognition that the EVT can be used to assess FS sufficiency for ERM assets. Both will be welcome clarifications that should draw a line under uncertainties within insurers' MA reform plans.

The allowance of a top-down assessment of assets at a HRG level will be a welcome change, though the factors specified may lead to a large number of groups, and there will still need to be a detailed level of analysis performed. The wording on not assuming that a prudent level of FS add-on could be used to offset an "insufficient" level of FS add-on in another asset is unchanged, leaving firms with the need to justify whether such offsets may be appropriate.

### Amendments to the use of credit ratings for MA assets

#### What is changing?

The CP19/23 consultation paper proposed a move from the existing credit quality steps (ie AAA, AA, A etc) to a more granular notched level (eg A+, A, A-, BBB+ etc). The policy statement has clarified the requirement to reflect notching effective from 31 December 2024 (though firms have the option to implement from 30 June 2024). In addition, the PRA expects assets to have a notched rating within six months of becoming assigned within the MA portfolio, or for firms to explain where this is not the case.

When determining the investment strategy and limits for assets with a sub-investment grade rating, CP19/23 set out expectations for firms to consider concentration exposure, its work-out capabilities as well as considerations under guidelines in SS1/20 (Prudent Person Principle). The policy statement further adds expectations to consider additional metrics, such as the value of MA benefit and FS, or cashflows adjusted for probability of default. The PRA further expects firms to assess the adequacy of its work-out capabilities, proportionate to the levels of investments into sub-investment grade assets.

In respect of sub-investment grade assets, the PRA has also updated its regulatory guidance on internal models (SS8/18) to state that firms should ensure that the level of MA benefit of a sub-investment grade asset should remain appropriate pre and post a stress event.

Regulatory guidance in SS3/17 (illiquid unrated assets) has also been updated with a requirement for a firm's internal credit rating function to have a responsible individual, with sufficient experience, whose role is approved by the firm's management, and who will have access to management on "an ongoing basis". This is on top of the current requirement for individuals assigning internal credit ratings to have suitable expertise and independence.

#### What will it mean for insurers?

The deferral of the requirement to move to the granular notching of credit ratings for MA assets to the year-end provides firms with more time to implement necessary system changes and to prioritise getting other items of these reforms through governance. However, many firms will have already progressed with these changes and may well choose to implement from 30 June.

The additional risk considerations for sub-investment grade assets may act as another limiting factor when setting investment strategies but are metrics that are likely to already exist. Firms will also have to pay more attention to their work out capabilities if investing significantly into these assets.

We have seen the PRA pay more focus on the capabilities of firms' internal credit rating functions, and the inclusion of the requirement of an experienced individual responsible for internal credit ratings, reinforces this. Our recent survey highlighted internal credit ratings as an area where insurers may seek support, recognising the expectation that the PRA will seek further work in this area.

### Amendment to the PRA's approach to MA applications

#### What is changing?

In a number of areas, the PRA has removed or reduced the requirement for firms to provide documentation or evidence at MA Application stage, for example removing the need to supply a "comprehensive quantitative breakdown" of liabilities, monthly asset and liability cashflows and results of the MA tests.

The six-month target for PRA decisions on MA applications remain unchanged, though there is an expectation of shorter time-periods for a streamlined review, where this is appropriate. The PRA has developed an application readiness assessment process (ARAP), where firms will be expected to submit an ARAP form setting out the reasons for an application and the work done to gain comfort that the new assets or liabilities are MA eligible. Firms may also be able to submit a new MA application whilst waiting for the decision for a prior MA application, though the firm will be required to set out how any interaction of the existing and new MA applications.

### What will it mean for insurers?

The removal of certain requirements within an MA application will, of course, be operationally beneficial to insurers. The introduction of the ARAP essentially formalises the “unofficial” pre-application process that insurers have been going through prior to MA applications being accepted by the PRA. So, there is likely to be limited actual impact from this.

Streamlined reviews will also be welcome and may enable quicker investment in certain asset classes. In particular the addition of safeguards such as exposure limits may assist with this. Again, this is largely a formalisation of these limits, which are often agreed bilaterally between insurer and regulatory already.

There have also been a large number of changes in wording within updated Supervisory Statement 7/18 from “the PRA expects firms to demonstrate” with “the PRA expects firms **to be able** to demonstrate”, which may reduce the burden.

We welcome the PRA’s intention to publish regular reports on the MA framework, which should include updated timelines and information on decision rates (with the first report due in 2025). This should give the industry better insight into the PRA’s expectations as well as the impacts from these reforms.

### Other changes

#### Expanding the types of insurance business to which insurers may apply the MA

MA eligibility requirements are being extended to allow liabilities that are in-payment death in service annuities for dependants under group policies. For these types of liabilities to be eligible, firms must be able to separately identify and manage death in service annuities that are in-payment to the dependant.

It was also clarified that in payment claims under group income protection contracts will be considered eligible, along with individual income protection contracts. The initial CP wording left room for doubt on this point.

#### Matching Adjustment asset and liability returns

The requirement to produce asset and liability cashflows beyond the 50 years has been replaced with the requirement to produce cashflows up to 50 years, with any cashflows beyond this term being discounted back to the 50<sup>th</sup> projection year. There are changes to certain field names to be more consistent with QRTs, and the definition of assets has been refreshed.

#### Treatment of MA breaches in the SCR

It has been clarified that, where the level of an insurer’s MA benefit has decreased due to a breach of MA eligibility conditions, insurers should calculate the SCR as if the reduction in MA benefit had not occurred.

### What next?

This sees the finalisation of the MA reforms – which has been eagerly anticipated for many years. However, this is likely to be just the first step in opening up the potential asset universe for annuity writers with discussions on the use of sandboxes for MA funds already starting, as per the [PRA’s 2024/25 strategy document](#).

For insurers, the next step is to continue the implementation of these new requirements in order to deliver the first MA Attestation as at 31<sup>st</sup> December 2024.

### How Hymans Robertson can support you

We continue to work with a wide range of insurers across the UK and abroad about Solvency UK developments and how this could impact their business. We have recently shared the results of a private MA Attestation Survey with all participants (which included all Bulk Purchase Annuity writers and all but 2 insurers with MA approval). As we approach the second half of the year, we are increasingly supporting insurers with aspects of their MA attestation readiness and all areas of Solvency UK reform.

If you would like to discuss any of these points further, please [get in touch](#) with your usual Hymans Robertson contact or any of the authors of this Newsflash.

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