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Dive into pensions de-risking

The insurance regulator finalises Solvency UK Matching Adjustment reforms



On 6 June, the Prudential Regulatory Authority (PRA) published its policy statement finally concluding its review of the Matching Adjustment (“MA”) framework.

Recap of proposals to date

In November 2022, the Government published its response to a consultation regarding UK insurance reforms following Brexit. It announced a new “Solvency UK” regime, with:

- A reduction in the **risk margin**, a component of insurance capital that was introduced with Solvency II and is prominent for annuity business – this was incorporated into statute at the end of 2023 and was reflected by insurers in their 2023 year-end solvency calculations for the first time.
- Reform of the **matching adjustment** requirements, in particular increased flexibility for eligible assets – the subject of this policy statement, the majority of which will be effective as at 30 June 2024.
- Simplifications and **reduced reporting requirements** to ease cost and burden on insurers. Proposals on this were finalised in a policy statement in early 2024 and are due to come into force from the end of this year.

The final piece of the Solvency II reform puzzle is largely administrative, moving obligations away from legislation and into the PRA Rulebook to facilitate future policy updates. This process itself is currently under consultation and is expected to be largely uncontroversial, with the final rules expected by year end – this should then draw to a close the long process of Solvency II conversion to Solvency UK.

What’s in this policy statement?

Highly predictable cashflows

The change: The “matching adjustment” is a fundamental component of pricing in the bulk annuity market. Without it, the cost of a buy-in or buy-out would be prohibitive to pension schemes. It allows insurers to discount their liabilities using the asset yield of the investments that back these liabilities, less an allowance for credit risk known as the “fundamental spread”.

Whilst offering greater clarity in some areas, the final proposals are broadly unchanged since 2023’s consultation. Insurers are now able to match liabilities with assets having “highly predictable” cashflows (having previously been restricted to only investing in assets with fixed and certain cashflows) as proposed, albeit the definition of ‘highly predictable’ has been widened slightly since the consultation. The proposal to cap the benefit an insurer derives from these new assets to 10% of the benefit they derive from their overall MA portfolio has been retained.

The impact on bulk annuities: Insurers have welcomed the additional flexibility offered by the proposals. The 10% allowance will apply not just to new assets but to insurers' existing portfolios, so its impact may be greater than at first glance. While we expect the changes to create a modest amount of additional insurer capacity, they do not fundamentally move the dial on the types of investments insurers are permitted to make. In particular, it is not expected that many illiquid assets held by pension schemes would fall into the 'highly predictable' category so alternative solutions for managing these will still be required in order to proceed with a bulk annuity transaction.

Attestation requirements

The change: Under the current legislation, insurers use a fundamental spread that the PRA provides monthly. This is the adjustment made to asset yields to reflect the risk of future defaults and downgrades. An attestation requirement for a designated senior manager at the insurer (likely to be the chief finance officer) has been introduced. The designated senior manager will be required to attest that the fundamental spread covers all retained risks and the matching adjustment can be earned with a high degree of confidence and increase the fundamental spread accordingly if it's not. The policy statement has clarified that an increase to fundamental spread will not be required for 'vanilla' corporate bonds and private placements. The attestation is required annually or whenever the insurer's risk profile changes materially. The PRA will also have the power to apply a capital add-on for particular asset classes if it deemed the risk adjustment was not appropriate.

The impact on bulk annuities: From a pension scheme perspective, the policy statement is largely unchanged compared to the September 2023 consultation. The required attestation is set at a level of being materially more certain than best estimate. In effect, it raises the bar for policyholder security, with corresponding upward pressure on annuity pricing. Furthermore, a significant or complex bulk annuity transaction could create a material change in risk profile for an insurer, and so might require an ad hoc attestation.

Increased granularity of credit quality and removal of the BBB cliff

The change: Under Solvency II, assets are assessed based on credit quality steps such as AAA, AA, A, and no further spread is available for sub-investment grade assets (below BBB). The PRA has confirmed the introduction of notches to the credit quality steps (such as A+ and A-) for Solvency UK, as well as an extension to sub-investment grade but has permitted an implementation deferral to 31 December 2024 (originally proposed as 30 June 2024). The extra credit steps will better reflect the underlying risk profile of the portfolio, while the expansion to sub-investment grade assets may enable insurers to broaden their investment strategies, for example in green and digital assets.

The impact on bulk annuities: The expansion to sub-investment grade shouldn't lead to any material watering down of credit quality in investment portfolios, as a sliding scale of increased capital would continue to apply. Insurers will still be required to invest with the prudent person principle, which will probably mean most of their portfolio will remain investment grade.

Next steps

The publication of this policy statement is the last of those expected detailing technical changes to insurer solvency regulations. A 'final' consultation is currently underway in respect of the implementation of the new rules into the PRA Rulebook, the conclusion of which is expected in July with a policy statement due to be issued in Q4 2024. This should conclude the reforms to this regulation following Brexit and finally move insurers into the long-awaited era of Solvency UK.

Solvency UK will of course evolve, and the PRA has already highlighted one area it intends to consider further in 2024, namely so-called "sandboxes", which would allow insurers to explore bringing new assets into the Matching Adjustment universe.

In summary

The PRA policy statement is broadly consistent with the proposals originally outlined in its consultation in September 2023. Whilst the majority of the changes are effective from as soon as 30 June 2024, it is likely to take some time before we see the impact as insurers adjust their portfolios to reflect the updated flexibility.

In our view the changes confirmed by the PRA in this statement are likely to give rise to a modest increase in policyholder security and cost. However, in combination with the risk margin reduction that came into effect at year-end 2023, the overall impact on both pricing and on policyholder security is unlikely to be significant. The 10% limit relating to new assets may seem low but could still be significant, as it also applies to existing portfolios. The proposed asset flexibilities may help some pension schemes with illiquid assets in certain instances within the context of buy-in or buy-out, although for most schemes with illiquid assets we don't expect this to solve the issue.

Get in touch

If you have any questions about anything covered, please don't hesitate to get in touch.



Michael Abramson

Partner and Risk Transfer Specialist

020 7082 6155

michael.abramson@hymans.co.uk



Lara Desay

Partner and Risk Transfer Specialist

020 7082 6180

lara.desay@hymans.co.uk