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DELIVERING SOLVENCY UK: FINAL MATCHING ADJUSTMENT REFORMS PUBLISHED

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On 6 June 2024, the Prudential Regulation Authority (PRA) issued Policy Statement PS10/24 providing feedback on responses to its Consultation Paper CP19/23, which proposed reforms to the Solvency II Matching Adjustment (MA). PS10/24 includes the PRA's final policy, which encompasses a new MA Part of the PRA Rulebook, amendments to other parts of the Rulebook, updated supervisory statements, a new Statement of Policy (SoP) on MA permissions, and minor amendments to the PRA's existing SoP on the publication of Solvency II technical information.

The PRA has made pragmatic changes and clarifications in PS10/24 that are useful for insurers regarding the use of the MA. These changes should help reduce the operational burden of completing the MA attestation, and a new SOP provides helpful guidance on MA applications, which should in turn reduce documentation requirements. However, the eligibility requirements for MA assets have not materially changed from CP19/23 and are not as expansive as had been hoped. That said, ongoing discussions with the PRA about proposed "sandboxes" to explore potential new MA assets could offer future opportunities for insurers. For more information on CP19/23 proposals, please refer to our briefing "Solvency UK - Reforming the matching adjustment to support investment and growth' - 24 November 2023."

PS10/24 applies to all UK Solvency II firms, including Lloyd's of London and third-country branch undertakings that utilise the MA. The new PRA rules and policies took effect on 30 June 2024, unless stated otherwise. Firms employing the MA can therefore begin to benefit from these reforms before the full suite of Solvency UK reforms comes into effect on 31 December 2024. The PRA has also provided further details on practical implementation, including an Application Readiness Assessment Process to assist firms in preparing for the reforms. This briefing outlines steps that firms may wish to undertake to capitalise on the changes.

1. Background

The first half of 2024 has been marked by considerable progress in advancing the Solvency UK reforms within the UK. The PRA has published a sequence of policy statements and consultations, complemented by HM Treasury's legislative actions to establish the new "Solvency UK" statutory framework. In February 2024, the PRA released its conclusive Solvency UK reform policy statements, PS2/24 and PS3/24. These documents are instrumental in reducing burdensome reporting obligations, enhancing the flexibility surrounding internal model approvals, and promoting new entrants to the UK insurance sector. For a detailed analysis of these reforms, please refer to our briefing "Solvency UK reforms: analysis of key policy statements and consultations - 22 May 2024".

The Government's November 2022 statement outlined those the areas of MA reform that it would implement directly through legislation, and those that would be implemented through PRA rules. Using powers under the Financial Services and Markets Act 2023 (FSMA 2023), the Government issued the Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations 2023 (IRPR Regulations) to implement the statutory aspects of the MA reforms.

The IRPR Regulations maintain the existing Fundamental Spread (FS) methodology and calibration and broaden the MA eligibility criteria to include assets with highly predictable (HP) cash flows. Additionally, the IRPR Regulations reform the PRA's powers in respect of breaches of MA eligibility conditions and empower the PRA to make rules on other MA policy aspects. For more information on an earlier draft of the IRPR Regulations, please refer to our briefing "Solvency UK Draft Regulations Published – June 2023".

The IRPR provides that an MA approval granted under Regulation 42 of the Solvency 2 Regulations 2015 prior to 30 June 2024 will become a permission granted by the PRA under section 138BA, ensuring that firms with existing MA approvals can continue to apply the MA after 30 June 2024. The PRA therefore does not expect firms to reapply for permission to apply the MA when such permission has been provided prior to 30 June 2024, unless due to changes to their MA portfolios, it is required to document compliance with the new regime at the point of implementation. Firms with in-flight MA applications should discuss these bilaterally with their usual PRA supervisory contact.

The enactment of FSMA 2023 also has granted the PRA expanded powers to establish comprehensive rules governing the MA and bring into effect most of the MA reforms envisioned under Solvency UK which were consulted on in CP19/23. PS10/24 delivers the final Solvency UK reforms and works alongside the IRPR to come into force for firms on 30 June 2024, with the rules on credit rating notching coming into force at the end of this year.

2. Feedback and material changes

The PRA received a total of 24 responses to CP19/23, with the consensus among respondents being supportive of the proposed changes. On the topic of investment flexibility, there was a favourable view towards the proposal to expand MA asset eligibility and introduce additional matching tests. However, there was opposition to the idea of imposing overly burdensome controls on certain assets, and a call for broader eligibility criteria was made. Concerns were also raised about the potential for existing assets to become ineligible, which could hinder investment in new assets. Regarding liability eligibility for the MA, the expansion was met with approval, but there was disappointment over the exclusion of group policies, and a case was made for the inclusion of group-dependent annuities.

Further responses addressed several other key areas of the consultation. The removal of the MA benefit cap for sub-investment grade (SIG) assets was generally supported, but there was a clear demand for further clarification on risk management and the use of internal models. The support for internal credit assessments was evident, with calls for proportionality in their application and detailed guidance on external assurance. The proposed changes concerning MA permissions, breaches, and consequential rule changes were also welcomed, but respondents sought clarification on the repercussions of breaches and advocated for a simplified application process.

While some aspects of MA attestations were supported, there was a preference for a less burdensome approach, particularly for corporate bonds, and a desire for offsets in Financial Statements. The publication of MA assumptions was seen as a positive step towards transparency, yet there were reservations about its application to non-bond assets and the need for consistency. The formalisation of Matching Adjustment Asset and Liability Information Return (MALIR) data collection was supported, but the reporting burden it entailed was a concern, with suggestions made to alleviate it. The proposed changes to notching of credit ratings were also welcomed, but respondents were keen to receive clarification on the timings for implementation.

In response to the feedback received, the PRA has made significant revisions to the final policy as follows:

- The PRA has amended the wording in Supervisory Statement SS7/18 to safeguard the eligibility of existing assets with "fixed" cash flows for the MA, thereby protecting insurers' current investments.
- To enhance investment flexibility, the PRA has recalibrated the additional matching tests in SS7/18, allowing insurers greater scope to invest in assets that offer HP cash flows.
- The final rules have been revised to expand liability eligibility, making all in-payment income protection and group-dependent annuity policies eligible for the MA.
- A new chapter has been added to the MA SoP detailing the PRA's approach to monitoring the MA permissions framework. This includes a commitment to regularly publish reports on the framework, which will cover aspects such as application review and approval rates.
- The PRA has streamlined the permission process by reducing the documentation required from firms when applying for MA permissions, as specified in the amendments to the MA SoP.
- For the inclusion of corporate bonds in the MA, the PRA has revised SS7/18 to reflect that firms are only required to consider risks that are evident in historical credit data. This change means firms will not be expected to account for risks not captured by the historical credit performance data used to calibrate the Fundamental Spread (FS).
- The process for MA attestations has been made more efficient. SS7/18 now clarifies that firms may conduct an initial top-down analysis of assets by homogenous risk groups, followed by a targeted examination of specific assets where necessary. This approach balances practicality with the need for detail.
- To reduce the reporting burden, the PRA has eliminated the requirement for firms to provide detailed cash flow data beyond 50 years in the MALIR reporting.
- The implementation date for the notching rules has been postponed by six months, with the new date set for 31 December 2024.

3. Finalised policy and implications for firms

Asset eligibility

The IRPR Regulations have widened the scope of assets eligible for the MA to include a controlled proportion of assets with cash flows that issuers or third parties can change, known as highly predictable (HP) cash flows. The PRA has updated the PRA Rulebook and supervisory statements to provide guidance on what constitute HP cash flows and to define the characteristics of 'fixed' cash flows.

To address confusion within the industry about how to categorise fixed assets, particularly following the inclusion of certain examples in SS7/18 in the CP19/23 proposals, the PRA has taken the step to remove these specific examples. The PRA's statement, published on 15 April 2024, aims to eliminate any lingering ambiguity, and ensure a clear understanding of the asset categorisation under the MA framework. Furthermore, the PRA has provided assurance that assets with fixed cash flows will retain their classification and will not be reclassified as HP assets. This measure prevents firms from having to re-evaluate the eligibility of assets already held in their MA portfolios. The PRA found that firms were taking a variety of approaches to interpretation of the existing provisions of SS7/18. To address this, the PRA will engage bilaterally with firms to better understand their approaches and ensure consistent interpretation of the PRA's expectations regarding assets with fixed cash flows.

To qualify as HP assets, the cash flows must be subject to contractual limitations (or "bounded" in the PRA's terms), with any failure to adhere to the contractual terms constituting a default event. The contractual requirements must cover both the timing and the amount of the cash flows. Firms are also required to demonstrate that these assets are managed in accordance with the Prudent Person Principle (PPP). This means that in the case of HP assets, firms must carefully assess whether an asset, despite meeting the eligibility criteria due to its contractually bound cash flows, is appropriate for matching annuity liabilities, particularly if the contract allows for significant variations in those cash flows.

Despite some insurers' calls for an increase in the 10% cap on HP assets (the proportion of the portfolio with HP cash flows is limited to assets in aggregate creating 10% of the MA benefit) or for a more risk-sensitive framework, the PRA has decided to uphold this threshold. The PRA underscores the necessity for MA portfolios to be composed primarily of fixed cash flows and has provided strategies for firms to manage their MA portfolios within this constraint. Furthermore, the PRA has issued guidance in Supervisory Statement 7/18 (SS7/18) on how firms should recognise and account for the risks associated with HP assets. This includes making specific adjustments to the FS to reflect these risks.

The PRA has identified that assets with variable HP cash flows introduce two distinct risks that could affect the quality of matching: reinvestment risk and liquidity risk. In response to these concerns, the PRA has decided to raise the thresholds for the proposed new Matching Tests 4 and 5 for UPA study from 3% to 5% (detailed in Appendix 1 of Supervisory Statement 7/18). The purpose of these tests is to safeguard against any significant mismatch risks that could adversely impact the insurance business to which the MA is applied.

Regarding asset restructuring, the PRA expects that firms will include MA eligible assets (whether with fixed or HP cash flows) in MA portfolios without restructuring. If a firm does restructure MA eligible assets and then applies to include the restructured notes in a MA portfolio the PRA will consider the restructured assets on a case-by-case basis and expects firms to justify the restructuring and demonstrate that any additional value created is on an arm's-length basis. Special Purpose Vehicles (SPVs) used for internal restructures must have sufficient assets to meet future commitments.

For the determination of best estimate cash flows for assets with HP cash flows, the PRA allows firms to use a deterministic approach and expects the cash flow profile to be consistent with fair valuation under IFRS 17. Firms have discretion over the methodologies they apply, but the PRA may review and challenge these. The PRA has also confirmed that there is no change in the process for assessing the ongoing adequacy of the internal model in relation to assets with HP cash flows. Firms will need to consider the materiality of the additional risks and update their models accordingly.

Firms interested in the ability to include HP assets in their MA portfolios should now:

- Review and consider the timing for the inclusion of HP assets considering the PRA updates in PS10/24. This includes understanding the implications of the increased thresholds for the new matching tests, ensuring that existing fixed assets remain unaffected, and consider how to manage the portfolio within the 10% HP asset limit.

- Develop and implement robust processes for determining the required additions to the FS for different asset classes. Additionally, design and conduct the two new matching tests, incorporating the PRA's threshold revisions to the tests, to ensure compliance with the updated requirements.
- Engage with the PRA at an early stage if planning to apply for approval to include HP assets. Discuss and seek feedback on the proposed methodology for calculating the mandatory additions to the FS to ensure accuracy and adherence to regulatory expectations.

Liability eligibility

The PRA has made amendments to the PRA Rulebook and supervisory statements to expand the types of liabilities that may benefit from MA eligibility, specifically allowing the inclusion in MA portfolios of in-payment Guaranteed Dependants' Annuities (GDAs) and in-payment individual and group income protection liabilities, with the latter added due to the inclusion of recovery time risk, and the guaranteed element of with-profits annuities within MA portfolios, which the PRA outlines is similar to the risk on standard non-profit annuities. However, the MA eligibility is not extended to periodic payment orders (PPOs) or liabilities that assume future premium payments. There is also no change in eligibility criteria for contracts which include policyholder options.

Firms should now:

- Schedule a strategic review to assess the potential benefits and firm-specific implications of including GDAs and guaranteed benefits components of with-profits annuities in the MA portfolios.
- If choosing to seek approval, prepare the necessary documentation and develop an application plan for firms, ensuring compliance with the regulatory requirements and alignment with the firm's investment strategy.

Credit ratings

The PRA's final policy includes the introduction of new expectations for the prudent management of assets backing policyholder liabilities. The reforms remove the amount of MA benefits denied from investment in SIG assets in the MA portfolio statements. This change is particularly relevant for assets that are close to and below the boundary between investment grade and SIG assets (this boundary is sometimes referred to as the 'BBB cliff'). The PRA expects firms to be able to monitor, measure and report on the additional risks of holding these assets compared to holding investment grade assets.

Respondents requested further clarification on points specific to internal models and internal credit assessments. In response, the PRA has updated Supervisory Statement SS3/17 to reflect a wider range of metrics for determining the contribution of SIG assets to MA portfolios and clarified expectations for the individual responsible for the internal credit assessment function.

Given the critical role of the internal credit assessment function, the PRA has set out its expectations and criteria for the individual who is responsible for the function, including them having appropriate experience for the role and having access to the management body. In addition to the internal credit assessment, firms will have to include extensive assurance. The extent of these expectations will depend on the nature, scale and complexity of the assets held that are held by the firm.

Firms may now want to consider:

- Conducting a comprehensive review of their current internal rating framework to evaluate its robustness, capability, and maturity, ensuring it meets the PRA's expectations outlined in SS3/17 and can be adapted to produce notched credit ratings by the 31 December 2024 deadline.
- Developing and documenting a validation strategy (which is an important part of the firm's internal rating framework) in line with PS10/24, determining the appropriate frequency of validation, sample size, and whether external assurance will be required, as well as establishing a clear process for this validation.
- Ensuring that the leader of the internal credit assessment function meets the PRA's remits and define the governance structure, ensuring that this function has direct access to the management body to maintain compliance with PRA requirements.

MA permissions (incl. approval process), breaches and consequential rule changes

The PRA's final policy on MA permissions, breaches, and rule changes includes amendments to the PRA Rulebook and updates to supervisory statements and statements of policy. The PRA has responded to industry feedback by making several changes to its draft policy, such as removing the requirement for 'new risks' to trigger variations of MA permissions, clarifying the PRA's approach to public reporting on MA review frameworks, and reducing the scope of required documentation for MA applications.

Responses to the consultation indicated support for the restatement of existing regulations into PRA rules and the new MA Statement of Policy (SoP), with requests for further commitments to improve the speed of MA applications. The PRA has reduced the extent of documentary evidence required for applications and will not provide a list of pre-approved asset features or classes, as eligibility also covers asset management.

The PRA has decided not to extend the two-month window for rectifying breaches of MA eligibility conditions, maintaining the proposed staggered reduction in MA for non-compliance. The PRA has also clarified that firms will not be expected to recalculate the Solvency Capital Requirement (SCR) to reflect a reduction in MA due to breaches of eligibility conditions and that firms can continue to allow for management actions to restore compliance within internal models.

Regular reports on the MA framework will be published, with the first due in 2025. The PRA has set a target of six months for decisions on MA applications.

The PRA's approach to streamlined MA applications will remain selective, and it will not allow for minor changes to MA permissions without formal application. The PRA is open to considering how the MA application process may evolve to support long-term investments that align with its objectives. The PRA has also confirmed that it will provide reasons for refusing MA applications and clarified that the board of a firm can delegate authority for submitting new MA applications or modifying existing permissions.

Firms considering a new MA application should now:

- Review and update internal processes and documentation to align with the PRA's clarified expectations on MA applications, ensuring readiness to meet the six-month decision timeframe and to engage with the PRA's Application Readiness Assessment Process (ARAP) for a more efficient pre-application process.
- Assess and, if necessary, adjust the firm's approach to managing MA portfolios considering the PRA's policy on breaches of MA eligibility conditions, including the implementation of management actions within the specified two-month rectification window, and understanding the implications of staggered MA reductions for extended non-compliance.

MA attestation

The PRA will require an annual attestation for each MA portfolio, timed to coincide with the Solvency and Financial Condition Report (SFCR). Additionally, attestations are required when there are significant changes to the firm's risk profile. These attestations are to be managed by a senior manager responsible for the firm's financial reporting.

Firms will also be required to develop and uphold a policy for these attestations, which should be backed by robust internal processes and controls. The senior manager must certify to the PRA that the firm's financial statements and MA are both adequate and of high quality.

The PRA confirm that it important crucial for firms to evaluate the financial spread (FS) and MA separately, and that firms may choose to voluntarily increase the FS if it is found to be lacking. However, it is critical to understand that excess prudence in one asset does not make up for a deficiency in the FS of another asset. When submitting attestations, firms must include a report to the PRA and note the occurrence of the attestation in their SFCR, but they are not required to disclose the details of the attestation. Neither the attestation report nor any supporting evidence, including voluntary FS additions, will be disclosed, or audited externally.

The PRA has updated its guidelines for analysing corporate bond portfolios, allowing firms to initially categorise assets into homogenous risk groups (HRGs) to assess if FS additions are necessary. This should be followed by a more granular review of specific assets that significantly contribute to the MA. Firms must also consider rebalancing costs and the method by which downgrade losses are incorporated into the FS. For the initial attestation, firms should leverage existing

analysis methods and concentrate on the most significant MA-contributing assets. The PRA clarifies that FS additions are not anticipated to directly influence the SCR.

For Equity Release Mortgages (ERMs), firms are expected to apply their own assumptions in the Effective Value Test (EVT), which must meet or exceed the PRA's minimum standards. Additionally, firms should consider any risks not assessed by the EVT.

The PRA has introduced a six-month transitional period, allowing firms to postpone their first attestation until after 31 December 2024. This period is intended to give firms sufficient time to establish their attestation policy and processes. After this period, firms are expected to conduct a thorough review of their MA contributors and submit their first attestation using a well-documented and rigorous approach.

Firms may wish to:

- Develop and implement robust MA attestation policies, ensuring the integration of necessary systems and governance structures to meet the PRA requirements. Allocate appropriate senior management resources from various disciplines to oversee this comprehensive process and ensure compliance with the reporting obligations.
- Create trigger frameworks for ad-hoc attestations, incorporating the PRA's guidance and revisions as detailed in Policy Statement PS10/24.

Data reporting

In response to firm's feedback, the PRA has made changes to the MALIR instructions and template, such as removing the requirement for firms to submit cash flows extending beyond 50 years and making clarifications to asset type definitions. The PRA has decided not to change the draft policy regarding the annual reporting requirement for the MALIR, the deadline for submission, or the Excel-based template format. However, the PRA has made minor changes to the MALIR template to improve clarity and consistency with the Quantitative Reporting Templates (QRTs).

A waiver process for the MALIR has been proposed, allowing firms to apply for an exemption from the reporting requirements on a case-by-case basis. The PRA will consider waiver applications based on factors such as the materiality of the portfolio and the size of the firm, without predefining all circumstances where a waiver may be granted.

Firms should consider the following actions:

- Review and update internal reporting processes to align with the revised MALIR instructions and template. This includes adjusting the scope of cash flow projections to a 50-year horizon and ensuring that asset classifications are consistent with the latest PRA clarifications.
- Assess the eligibility and potential benefits of applying for a waiver from the MALIR reporting requirements. Firms should consider the materiality of their portfolio and the size of their operations to determine if a waiver application is appropriate.

Notching

The PRA has decided to implement notching, which requires firms to adjust the FS to reflect differences in credit quality by rating notch when calculating their Technical Provisions (TPs). The PRA proposed that firms with MA permission must adjust the FS in their TPs calculations to reflect the credit quality of assets by rating notch, where possible. If not possible, this should be considered in the MA attestation process. The PRA will require firms to interpolate the Transition Independent (TI) for each Credit Quality Step (CQS) to derive a more granular FS by rating notch. Firms must also justify any granularity differences in credit quality reflection between their TPs and internal models used for SCR calculations.

Feedback indicated general support for the proposals, with requests for clarity on implementation timelines. In response, the PRA has clarified that notching requirements will take effect from 31 December 2024, with voluntary implementation possible from 30 June 2024. The PRA has decided to maintain its approach of linear interpolation for notching, despite some concerns raised about its suitability.

The PRA expects firms to justify any differences in credit quality granularity between TPs and internal models. It has not mandated a specific method for reflecting notching in internal models, allowing firms to choose an appropriate method, such as linear interpolation, provided it meets internal model requirements.

The PRA has also addressed operational considerations for increasing credit quality granularity in internal models, suggesting interim remedies if model development is challenging. It has not set a specific timeline for including notching in internal models, allowing firms flexibility based on their priorities and development plans.

Regarding internal ratings and validation, the PRA has updated its expectations, giving firms six months from when an asset becomes an 'assigned asset' to have a notched rating available. The PRA has also addressed concerns about the complexity and feasibility of implementing notching in internal models by maintaining flexibility in the approach firms can use.

Firms should consider the following actions:

- Implement the necessary updates to the MA calculation process to incorporate the increased granularity required by the PRA.
- Prepare for the implementation of the notching requirement by 31 December 2024, with the option to adopt these changes as early as 30 June 2024. Furthermore, align with the PRA's updated guidance in PS10/24, which allows a six-month timeframe for a notched rating to be assigned to an asset once it is included in the MA portfolio.

4. Next steps

PS10/24 is a significant step in the evolution of the MA framework and should offer insurers a more nuanced approach to asset management under the Solvency UK. The policy statement not only addresses industry feedback but allows a pragmatic application of the MA, particularly through the introduction of notching and the expansion of asset eligibility. Firms will have to now deal with the substantial PRA supervisory material to adapt their strategies and operations in line with the regulatory changes.

We anticipate that insurers will want to thoroughly evaluate their portfolios to capitalise on the new opportunities presented by the MA reforms. This includes a strategic assessment of the inclusion of HP assets within the regulatory cap and the integration of GDAs and income protection policies into MA portfolios.

The extended timeline for implementing notching should also provide firms with the necessary leeway to refine their internal credit assessment processes. Insurers should now continue the implementation of these new requirements in order to deliver the first MA attestation as at 31st December 2024.

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