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SOLVENCY UK - REFORMING THE MATCHING ADJUSTMENT TO SUPPORT INVESTMENT AND GROWTH.

On September 28 2023, the UK's Prudential Regulation Authority (PRA) released its second consultation paper on Solvency UK, a set of reforms to the Solvency II framework for the UK insurance market. These reforms aim to relax some of the requirements relating to the use of the Matching Adjustment (MA) by insurers.

The MA is a mechanism under Solvency II that enables insurers to discount their long-term liabilities at a rate lower than the standard risk-free rate. The MA is calculated by subtracting a fundamental spread (FS) from the risk-free rate, representing the additional risk insurers assume by investing in non-risk-free assets. In order to be eligible for the MA, assets must satisfy stringent eligibility criteria such as fixed cash flows and alignment with the insurer's liabilities.

With the enactment of the Financial Services and Markets Act 2023, the PRA now has the authority to establish comprehensive rules for the MA, allowing changes to the MA and FS calculations. The PRA envisages that these changes will stimulate investments by life insurers in the UK economy while ensuring policyholder protection.

The consultation period ends on Friday 5 January 2024. The final rules and guidance are planned to be published in Q2 2024 and to come into effect on 30 June 2024.

REFORMS

The PRA's proposals in the consultation paper largely implement HM Treasury's proposals set out in its Solvency II review consultation in November 2022 and build on the draft MA Regulations published in June 2023. The PRA expects to be granted the necessary powers to implement those aspects of the Solvency UK MA reforms that are not implemented directly by legislation, as set out in the consultation paper. These reforms include:

- widening the MA asset eligibility criteria to include assets with highly predictable cashflows,
- removal of the effective cap on sub-investment grade assets,
- the introduction of an annual MA appropriateness attestation,
- the inclusion of a streamlined MA application process, and
- the removal of automatic revocation of MA permissions following a two-month compliance breach.

The PRA plans to establish a dedicated Matching Adjustment Part within the PRA Rulebook, consolidating all relevant requirements, as well as changes to other parts of the Rulebook and several Supervisory Statements (including SS 7/18 on Matching Adjustment).

The PRA will also release a Statement of Policy (SoP) explaining how it will grant change, or revoke regulatory permissions related to the MA and detailing the application process, scope modifications, and PRA's authority to revoke permissions when necessary.

These changes will make it easier to insurers and other stakeholders to identify and comply with all relevant requirements.

KEY PROPOSALS

1. Asset Eligibility

The proposed reforms will broaden the existing asset eligibility criteria. Solvency II legislation presently requires asset cash flows to be fixed and unalterable. The reforms propose allowing a limited portion of asset cash flows to be subject to alteration by issuers or third parties, provided they exhibit a high degree of predictability. The PRA is empowered to set limits for such assets to ensure they do not unduly jeopardise matching quality. The reforms encompass criteria for inclusion, a robust control framework, adjustments for additional risks, and a cash flow estimation method that aligns with the Prudent Person Principle (PPP). Whilst the relaxation of the fixity requirement was flagged in the HMT's response to consultation, these protective features go beyond what was perhaps anticipated.

- The PRA proposes expanding the control framework for MA portfolios so, while "highly predictable" (HP) cash flow assets will be MA eligible, such assets will be limited to a maximum of 10% of the total MA benefit per portfolio, accompanied by additional safeguards as necessary to maintain matching quality.
- The PRA will distinguish circumstances in which specific asset types are more likely to align with "fixed" term than HP cash flows. Assets meeting these criteria will be designated as "fixed," potentially enabling inclusion in MA portfolios without further restructuring and leaving the 10% allowance available for other HP assets. An updated MA application will need to be submitted so that such assets can be included in a firm's MA portfolio, and early engagement with the PRA will be necessary.
- The proposals also include the removal of constraints on recognizing MA benefits for sub-investment grade (SIG) assets, subject to overarching exposure limits on additional risks.
- These reforms are expected to ease financial burdens related to asset restructuring and incentivise investments in HP cash flow assets, such as mezzanine notes.
- The newly introduced Matching Adjustment Part of the PRA Rulebook, along with amendments to SS7/18, will explicitly outline the criteria for incorporating HP cash flow assets into MA portfolios.

The removal of the "fixity of cash flows" requirement marks a significant shift in response to longstanding industry preferences, and the introduction of the "highly predictable" feature potentially opens the doors to investments in new asset classes.

Where assets have previously been re-structured to allow inclusion in MA portfolios, the PRA envisages that such assets will be "un restructured" and flags a preference for them to be included directly.

While there is a limitation on the allocation to 10% of MA benefit, this provision should still facilitate investments by larger firms in new asset classes, subject to the PRA's valuation requirements and supplementary safeguards.

2. MA Eligibility and Prudent Person Principle (PPP)

The PRA seeks to formalise the link between MA eligibility and compliance with the PPP. It proposes to require firms to provide evidence in their MA applications that assets can be managed in accordance with the PPP at both portfolio and individual asset levels. This requirement aligns with the expectation that MA assets will be held over the life of the relevant obligations, necessitating firms' ability to manage associated risks effectively over this period.

3. Streamlined MA Application Process

To expedite the inclusion of new investments into MA portfolios while ensuring insurer stability, a streamlined MA application process will be established. The PRA aims to provide decisions within six months from the receipt of applications, with even quicker responses for streamlined applications. These streamlined applications are aimed to give a quicker assessment on the threshold question of eligibility, with other aspects such as ratings and valuations deferred until after MA authorisation has been given.

- This approach will be available for applications that clearly satisfy the MA eligibility conditions, propose fewer complex changes, or incorporate suitable risk mitigation measures.
- The streamlined process should facilitate swift responses to emerging investment opportunities.

4. Enhanced Asset Credit Quality Assessment

The PRA proposes modifying the MA calculation to incorporate a notched rating system, departing from use of broad credit categories like AAA. Firms will be required to use notched FS and probability of default in the MA calculation, determined through linear interpolation based on PRA-published data.

- Firms must use the most current credit risk information available, particularly for rating notches, or use the FS corresponding to the mapped Credit Quality Step (CQS) if notched ratings are unavailable.
- In instances where the CQS is used, the appropriateness of the resulting FS would be scrutinised as part of the attestation process (see para 6 below).

This more granular approach is intended to simplify implementation and reduce operational efforts. It is not expected to have a substantial impact on the MA calculation. However, it may discourage the practice of holding assets at the lower end of the CQS rating.

5. Removal of Disincentives for Investment in Sub-Investment Grade (SIG) Assets

The PRA aims to eliminate disincentives for investing in SIG assets, potentially leading to increased investment in assets close to SIG.

Firms are expected to maintain prudent levels of SIG asset investments, considering potential downgrades of investment-grade assets to SIG during market downturns.

Effective risk management systems are crucial for firms to identify, measure, monitor, manage, and report on additional risks associated with SIG assets.

6. Annual FS and MA Appropriateness Attestation

Firms will be required to provide an annual attestation to the PRA, affirming the sufficiency of the FS and the quality of the resulting MA generated by their MA portfolios. This attestation must be made by a senior manager, such as the Chief Finance Officer.

- The attestation process introduces several requirements, including standardised language (to be outlined in the PRA Rulebook) and annual submissions for each MA portfolio.
- Firms must establish policies and internal processes for FS analysis and justification in line with the attestation requirements.

The proposed attestation requirements could prove challenging. There is a requirement to provide an ad-hoc attestation in response to material changes in risk profile, which could make it more difficult, for example, for insurers to offer innovative solutions for large pension schemes coming to market with unusual features such as high proportions of illiquid assets.

While the financial impact will vary by firm depending on the specific assets held, the process of designing a methodology for evaluating the FS and the MA benefit for new assets is likely to be challenging to most firms, as it could require significant expert opinion and judgement, given the relative lack of available data for newer MA assets.

7. Expansion of Eligible Insurance Business

Eligibility for MA treatment will extend to include (i) liabilities exposed to "recovery time risk" (that is, the risk that income protection policyholders take longer to recover from serious illness) than had been assumed in an insurer's best estimate projections and (ii) the guaranteed elements of with-profits annuities (but not provision for other benefits which would remain outside the MA portfolio). Proposal (i) will appeal to firms primarily focused on income protection that could not use MA before, potentially leading to new MA applications from them.

For (ii), with-profits annuities, are just a part of the with-profits business held by UK firms. Many firms with with-profits funds closed to new business may not benefit much from this change. However, some firms might want to consider taking advantage of the higher discount rate, if it is cost-effective to include these liabilities.

8. Revised Treatment of MA Breaches

The automatic cliff edge revocation of all MA permissions 2 months after a MA compliance breach will be removed. Instead, non-compliance beyond two months will result in a progressive reduction of the MA benefit, with full revocation retained as an option for severe or persistent breaches.

NEXT STEPS

The proposed reforms to Solvency UK's MA represent a significant step towards encouraging investment, easing operational burdens, and improving regulatory clarity within the UK insurance sector.

Insurers are generally expected to welcome these changes, which broaden the scope of eligible assets and simplify application procedures. However, the proposals include significant additional controls and safeguards, so we anticipate insurers being relatively cautious in taking advantage of the reforms.

Insurers are urged to share their feedback on these reforms by the January 5 2024 deadline, as these alterations have the potential to reshape the landscape of insurance investment strategies and regulatory compliance in the UK.

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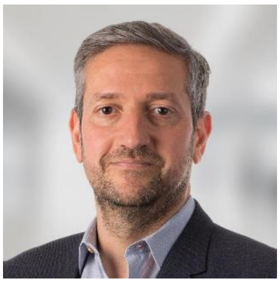

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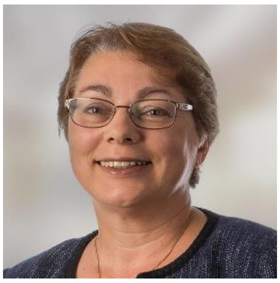

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