Solvency UK: PRA shares final Matching Adjustment rules

07 August 2024

The PRA has published the finalised Matching Adjustment (MA) rules. Simon Perry explains the regulator's clarifications and the impacts insurance firms should consider.

Understanding the new MA rules should be a priority for insurers. They can already leverage some of them, but compliance is required at year-end, which leaves time to bring reporting plans and procedures in line.

The MA is a mechanism that allows insurers to adjust the discount rate used to value their insurance liabilities. It has been a topic of debate and review within the insurance industry, as it represents a departure from market-consistent valuation principles and has raised concerns about its potential impact on risk management and financial stability.

The PRA updated SS7/18 in June 2024, providing welcome changes and clarifications for MA within the Solvency UK regime.

Key changes and clarifications

There have been some changes since the consultation paper released in September 2023, mainly in the form of clarifications and amendments to the wording in places to aid understanding and respond to feedback.

The key changes and clarifications since the draft policy are as follows:

- Clarification for firms that have permission to treat assets as having highly predictable (HP) cashflows that they can switch between treating assets as HP or guaranteed provided that the assets meet the criteria of both
- An increase in the limits for the two new tests proposed to allow for greater flexibility when assessing the impact on the MA from HP assets
- Extension of the liability eligibility criteria to allow inclusion of both in-payment income protection liabilities and group dependent annuities, also known as contingent annuities which provide guaranteed income for the policyholder and potential income for a named dependent, in the MA portfolio
- Expansion of the new Statement of Policy (SoP) on MA permissions outlining the PRA's intended monitoring of the MA permissions framework, including the commitment to publish regular reports on the MA framework covering application review and approval rates

- Clarification of the triggers for variations of MA permissions by removing the references to 'new risks'
- Reduced documentation requirements for firms submitting MA applications
- Clarification of expectations for firms’ analysis of corporate bond portfolios with firms generally expected to rely on the basic fundamental spread (FS)
- Clarification of the analysis firms are expected to perform when determining if FS additions are needed and the degree of confidence firms need in their ability to earn the MA on the assets included
- Pushing back the implementation date for notching rules to 31 December 2024
- Some alterations to the Matching Adjustment Asset and Liability Information Return (MALIR)

How will the final rules affect firms?

Fundamentally, the finalised policy is no great leap away from the draft policy, which firms will have been considering since the September 2023 consultation paper, but it does make some helpful clarifications and changes.

We believe that the core impacts to all firms with, or seeking, MA permissions are:

- the expansion of the universe of MA eligible assets to include HP assets and the suggested PRA consideration of asset sandboxing in the future which would permit assets to be included up to a limited proportion of an MA portfolio without (or prior to) receiving permission from the PRA
- the increase in the role and control requirements of investment teams, through the new internal ratings, notching requirements, and full risk analysis

- the new reporting requirements including annual attestations and MALIR data submissions
- removed the limit of the MA benefit that can be claimed from Sub-investment Grade (SIG) assets to facilitate more diverse investments

Beyond these core impacts, other changes will have some impact and are worth noting. The PRA has:

- stated they will adopt a more proportionate response to breaches in the MA eligibility conditions, instead of fully revoking the benefits, they'll be reduced by 10% each month beginning after a two-month period of ineligibility
- committed to reaching a decision within six months for all applications and the introduction of an increased streamlined application process for certain types of application
- proposed that all firms with MA approval must submit the MALIR to aid the PRA in collecting data in a way that minimises the resource burden on firms and the PRA
- stated that as firms are already subject to the Prudent Person Principle (PPP), they should be expected to provide evidence that any new assets are capable of being managed in line with this principle.

Minor change to MA attestation

The PRA hasn't made drastic changes from the initially proposed legislation for the attestation as the feedback was largely positive. There were some clarifications in response to some points of confusion or

contention in the consultation paper. The most important clarification is that where a firm has a corporate bond portfolio that has accurate and up-to-date credit ratings, the basic FS can be used with no additions. Firms should ensure that assets are grouped together to form homogeneous risk groups, when determining if FS additions are needed, potentially examining specific assets if necessary. Other helpful clarifications of detail were also made here.

The fact that the initial consultation paper has largely been left unchanged means that the attestation will work as initially proposed. The firms' senior management function holder who holds the prescribed responsibility for the production and integrity of the firm's financial information and its regulatory reporting (PR Q) should have responsibility for attesting that:

> "The fundamental spread used by the firm in calculating the matching adjustment reflects compensation for all retained risks, and the matching adjustment can be earned with a high degree of confidence from the assets held in the relevant portfolio."

For this, firms should have an attestation policy in place as well as appropriate internal processes, systems and controls supporting the attestation. A firm must submit to the PRA, the attestation document, plus a report, including a list of evidence used in making the attestation, which should be readily available if asked for.

The attestation should be completed annually with any out of cycle attestation performed if a material change in the firm's risk profile occurs. It should be noted that insurers won't have to disclose the information that they are attesting to in any public disclosures and will only simply have to state in their SFCR that they have completed the attestation. The attestation isn't required to be audited.

The final policy statement includes a six-month transitional period so firms may, but won't be required to, provide any annual or out-of-cycle attestations prior to the end of 2024. The first formal attestations will be required to be completed in respect of the first financial year from 31 December.

Key clarification on HP assets

The PRA has made one main clarification from the initial consultation paper with regards to HP assets, which was included in the April statement titled Solvency II Review – Matching adjustment reform implementation considerations for 30 June 2024. The statement was published to support firms in their preparations for the MA reform. The statement provided clarification around the HP assets, particularly that there will be no requirement to reclassify assets in pre-existing MA portfolios as HP should they fit the definition of both guaranteed and HP.

The inclusion of up to 10% HP assets should encourage insurers to invest in a wider range of assets, including long-term productive assets. This should benefit both the insurers and the market in general with the PRA having stated that they will ensure this doesn't come at the detriment to consumers. To protect consumers the PRA reserve the right to add in additional safeguards, and potential additions to the FS.

The application process for new insurers will require the applicant to evidence the risks associated with the new HP assets they wish to include and would require a robust process in the asset management team including evidencing that the MA eligibility criteria has been considered throughout the asset

acquisition and management process. Those insurers who already have a MA portfolio wouldn't be expected to submit new MA applications to reflect the new regime at the point of implementation.

The policy statement mentions the topic of 'sandboxes', which would permit assets to be included up to a limited proportion of an MA portfolio without (or prior to) receiving permission from the PRA, with a full application to follow. This wasn't within the scope of CP19/23 and although a subject expert group (SEG) has been set up to examine the issue it would need to be subject to a further consultation. Currently there's nothing suggesting a change will be made anytime soon.

Notching remains unchanged

The PRA have chosen not to make any material changes from the detail of the initial consultation paper, with market feedback largely positive. This means that the use of notching will be unchanged from the initial consultation paper.

The notching is designed to increase the granularity seen in the FS which should result in better risk allocation, however, firms with a reasonably diversified portfolio will see little impact. The idea is to linearly interpolate the FS between the different letter credit ratings of the various assets used in the MA portfolio. This would mean that the FS would be more accurately tailored to the portfolio of assets and liabilities.

The PRA did change the timing of the requirement for the MA calculation to reflect notching so that it won't apply until 31 December 2024, although firms will be able to voluntarily include notching in their MA calculations from 30 June 2024.

SIG assets

The removal of the cap on the MA benefit for SIG asset may allow firms to have an increased portion of their investments in assets near the SIG boundary. Though the PRA has made its expectations clear that any investment in SIG assets should be kept at prudent levels. The removal of the cap presents some interesting issues for consideration for firms, eg, the calibration of internal model stresses for SIG assets. Now the cap has been removed it's for firms to demonstrate that their internal model adequately reflects the risk profile for SIG assets held.

What’s next for in-scope firms?

The upcoming changes to the MA requirements are poised to have a tangible impact on insurance and reinsurance companies.

It's essential that firms are aware of the potential benefits they can realise either with their existing portfolios or the opportunities for new ones, especially given that these benefits can be realised from the 30 June.

The transitional period will give firms a welcome period for getting their attestations and processes prepared ahead of the 31 December 2024 deadline.

To learn more about the Matching Adjustment, key changes to rules or on the other rules being brought in as part of the Solvency UK reforms, contact Simon Perry**.**