HMT outlines changes to risk margin and matching adjustment

AT A GLANCE

July 2023

What's new?

- HMT published two draft statutory instruments (SIs) on 22 June 2023, for implementing changes to the UK's prudential regime for insurers. The SIs outline changes to the risk margin (RM), matching adjustment (MA) and fundamental spread (FS) calculations in line with the Review of Solvency II: Consultation – Response published in November 2022 (see our At a glance for further details).
- HMT notes that draft SIs outlines proposed changes to Solvency II regulations that will be implemented under the powers in the Financial Services Markets Act 2023 which received Royal Assent on 29 June 2023. The Government expects that the package of reforms will enable insurers to increase investment in long-term productive assets and ensure that the UK maintains an internationally competitive insurance sector without compromising policyholder protection.

What does this mean?

- **RM** - The draft SIs propose a new methodology for calculating the risk margin using a 'risk tapering' (also known as the 'lambda') approach. The new methodology introduces a risk tapering factor (lambda (λ)) raised to the power of years (t); (λ) has been set at 0.9 for long-term insurance obligations, and at 1.0 for general insurance obligations with a floor of 0.25. The lambda approach reduces the sensitivity of the risk margin to interest rate changes. In addition, the cost-of-capital rate for calculating the RM has been reduced from the current rate of 6% to 4%.
- **MA** - The Government proposes to replace the requirement that all MA eligible assets have fixed cash flows with a more flexible requirement. The draft SIs state that the insurer applying for MA must assign a portfolio of assets with similar cash flow characteristics, to cover the best estimate of the portfolio of insurance or reinsurance obligations. The cash flows of the assigned portfolio of assets must not be capable of being changed by the issuer of the asset except where the quality of matching is not material and where only a limited proportion (as determined by the PRA) is affected. In addition, the credit quality of the assets in the MA portfolio must be capable of being assessed either by an external rating agency or by the firm using an internal credit assessment. The Government proposes to remove the severe treatment of assets whose ratings fall below BBB and remove the clause on ring-fencing of assets. The requirement that the MA applies only to contracts without future premiums and underwriting risks connected to the portfolios of longevity risk, expense risk, revision risk and mortality risk has been removed.
- The draft SI allows the PRA to make rules and set out conditions,

Contacts

Neil Farmer
Director

T: +44 (0) 7841 495506
E: neil.farmer@pwc.com

Anirvan Choudhury
Senior Manager

T: +44 (0) 7483 423721
E: anirvan.choudhury@pwc.com

AT A GLANCE

July 2023

in addition to those set out in the MA application section of the SI, under which an insurer is eligible to apply a MA. The draft SIs removes the requirement to re-establish compliance with MA approval within two months after a breach is confirmed or risk losing the MA for 24 months but instead states that PRA can vary/revoke, or reduce the MA benefit being claimed if a firm fails to comply with the conditions set out in its MA approval.

- **FS** - The draft SIs introduce the option for an insurer to increase the fundamental spread where necessary to ensure that it covers all the risks retained by the undertaking. The Government has decided to leave the overall design and calibration of the FS unchanged. The SIs note that the calculation of the "credit spread" must be based on the assumption that in case of default 30% of the market value of the assets can be recovered. For exposures to Gilts and other assets, where the FS would otherwise be lower than 30% and 35% respectively of the long-term average of the spread over the risk-free interest rate of similar assets (the "average spread"), the FS must be 30% and 35% respectively of the average spread.
- **Disclosure of information** - The draft SIs grant the PRA powers to disclose confidential information if it is necessary to do so in order to publish the outcome of an insurance stress testing exercise.

What do firms need to do?

- Firms will need to review their asset strategies in the light of greater eligibility and investment freedom and whether to expand the scope of their MA or submit new applications to cover other liability classes. They will also need to consider the new risks introduced and how these will be mitigated.
- Internal ratings, already a focus of the PRA, are likely to come under even more scrutiny and assurance may be required. Therefore, firms holding internally-rated assets should assess the robustness, capability and maturity of their internal rating frameworks.
- With the reduction in the RM, reinsurance and capital management strategies will need to be reviewed along with hedging levels. Life insurers may wish to model the changes to the risk margin, and the MA as these are likely to impact their reinsurance, capital management and investment strategies going forward.
- The draft SI provides the ability to increase the FS where necessary. Firms may wish to set up robust validation and governance arrangements around evaluating the adequacy of their FS to mitigate the possibility of regulatory add-ons.

Next steps

The Government expects that reform of the RM will be in force by year end 2023. It is also considering options to enable reforms to the MA to come into force by the end of June 2024, and the remainder of the new Solvency II regime will come into force by year end 2024.

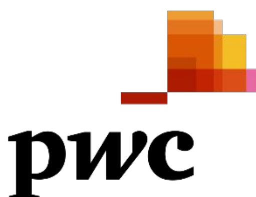
Contacts

Neil Farmer
Director

T: +44 (0) 7841 495506
E: neil.farmer@pwc.com

Anirvan Choudhury
Senior Manager

T: +44 (0) 7483 423721
E: anirvan.choudhury@pwc.com



www.pwc.co.uk/regdevelopments

This content is for general information purposes only, and should not be used as a substitute for consultation with professional advisors.

© 2023 PricewaterhouseCoopers LLP. All rights reserved. PwC refers to the UK member firm, and may sometimes refer to the PwC network. Each member firm is a separate legal entity. Please see www.pwc.com/structure for further details.