Financial Services Regulatory Insights

PRA consults on Matching Adjustment reforms

HOT TOPIC

October 2023

Highlights

The PRA is consulting on changes to the solvency regime for MA Portfolios. The changes are far-reaching with significant implications for balance sheets, governance and asset strategies.

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Summary

Consultation paper CP19/23 is the long-awaited PRA paper on reforms to the **solvency** regime for **Matching Adjustment (MA) portfolios.** It accompanies CP12/23 released in June 2023 and these two CPs aim to enact HMT's November 2022 statement.

CP19/23 is wide ranging with significant impacts on insurers' balance sheets, reporting requirements and the responsibilities of senior management.

It covers critical areas such as the new **MA attestation** process, the **expansion of MA permissible assets and liabilities**, reforms to the **granularity and validation of credit rating processes**, **internal model changes**, and the introduction of a **regular detailed data template** that needs to be provided to the PRA. The combination of these proposals could impact the level of the MA that firms currently achieve.

The consultation ends on 5 January 2024 with some elements due to be implemented by 30 June 2024 putting time pressure on firms to comply.

Background

The UK Government has been working closely with regulators following the UK's withdrawal from the European Union (EU) in order to adapt the UK's financial services regulatory framework to the UK's new position outside of the EU. The Financial Services & Markets Act 2023 enables the revocation of retained EU law, including legislation which incorporated the Solvency II Directive into UK law. This year the PRA has proposed its UK prudential regime for insurers, to be referred to as Solvency UK.

In the Government's November 2022 statement, the Government outlined the areas of MA reform that it would implement directly through legislation, and those that would be implemented through PRA rules (see our At a Glance summary here on the November 2022 statement). The PRA's proposals operate within the constraints of the Government's anticipated MA regulations. The draft regulations were published on 22 June 2023 (see our At a Glance summary on the draft regulations here).

The PRA issued its second major Solvency II review consultation, CP19/23, on 28 September 2023. This CP follows the PRA's June 2023 CP12/23, where it consulted on changes to remove onerous reporting requirements, allow improved flexibility for internal model approvals, and to encourage entry into the UK insurance market (see our Hot Topic on CP12/23 here).

CP19/23 is focused on the design and operation of the MA framework, and it covers a range of topics including: the new MA attestation process, the expansion of MA permissible assets and liabilities, reforms to the granularity and validation of credit rating processes, internal model changes and the introduction of a regular detailed data template that needs to be provided to the PRA.

The PRA claims that its proposed MA rule changes are in line with the unique characteristics of the UK insurance sector, as well as the financing demands of the wider economy. It claims its proposals will enable life insurers to play a significant role in productive investment in the UK economy, but also continue to ensure safety and soundness of firms along with maintaining a high degree of policyholder security.

Overall, the PRA's proposals aim to: improve business flexibility by widening the range of eligible assets in MA portfolios; be more responsive to the level of risk, for example by introducing notched credit ratings and Fundamental Spread (FS) add ons for assets with highly predictable cash flows; and enhance firms' responsibility for risk management, for example by introducing an attestation for the level of MA benefit claimed.

The PRA's proposals apply to UK Solvency II firms; the Society of Lloyd's, its members and managing agents; and the UK branches of overseas insurers and reinsurers.

From an operational perspective, the PRA proposes to introduce a new MA section in the PRA rulebook (and update several Supervisory Statements), which would act to consolidate existing requirements from other relevant parts of the existing PRA rulebook, as well as requirements from the anticipated MA regulations.

Introduction of MA attestation

The PRA states that the senior manager who holds responsibility for the production and integrity of the firm's financial information will be required to attest to the PRA on the sufficiency of the FS and the quality of the resulting MA generated by the assets in the MA Portfolio. The responsible senior manager function (SMF) holder will usually be the Chief Financial Officer (CFO).

The PRA proposes to use standardised wording for the attestation which is: *"The FS used by the firm in calculating the MA 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 of assets."* A 'high degree of confidence' means the MA should be materially more certain than the best estimate.

The PRA would require particular focus on assets that have different risk profiles from those used in the existing FS calibration (i.e. assets other than corporate bonds) and more focus would be required for those assets with a comparatively high level of MA.

The PRA expects firms to review the size of the FS and MA separately from each other, and not attest to the MA as the residual spread having first determined the FS. A firm will be able to include a voluntary addition to the FS and reflect this in their attestation where it considers the FS is insufficient. The PRA is not expecting this to automatically reduce the solvency capital requirement.

The PRA requires an attestation for each MA portfolio within a firm, annually at the effective date of the Solvency and Financial Condition Report (SFCR) and additionally upon any material change in the firm's risk profile.

The PRA proposes that firms implement a formal attestation policy, and for each attestation, submit an attestation document and accompanying report to the PRA. Neither the attestation report nor the underlying evidence would be within the scope of external audit. In addition, firms would have to disclose within their SFCR whether or not an attestation has been made.

The PRA states it will require firms to consider the assumptions underlying the FS when determining an appropriate FS add-on and the safeguards in respect of assets with highly predictable (HP) cash flows to ensure that the FS reflects risks retained by the firm.

The PRA states that the Solvency II framework already includes a provision for it to apply a capital add-on in circumstances where there is 'significant deviation from the assumptions underlying the MA', and that it is not proposing to change its policy or practice about the potential use of capital add-ons for the MA. It intends to consult in due course on reflecting this proposal in its rules.

Widening MA asset eligibility

The proposed MA regulations will widen the MA asset eligibility conditions to go beyond the current requirement for fixed cash flows, and will allow a limited proportion of asset cash flows that can be changed by the issuers of the assets or any third parties, so-called assets with highly predictable cash flows (HP assets). The PRA proposes that no more than 10% of the aggregate MA benefit can be derived from HP assets.

The PRA sets out the following criteria for HP assets: the cash flows are contractually bound, and failure to meet the contractual terms is a default event; and the contractual bounding applies to the timing and the amount of cash flows. The PRA further states that firms must be able to demonstrate that all assets can be managed in line with the Prudent Person Principle (PPP) by, amongst other things, determining internal quantitative investment limits for the assets they are proposing to invest in, reflecting the firms investment expertise.

The PRA notes that assets with HP cash flows introduce two new risks to the quality of matching: reinvestment risk and liquidity risk. Therefore, the PRA proposes two additional matching tests, including an assessment of the risks from HP assets in firms' liquidity plans.

Further, the PRA proposes that firms must be able to identify all sources of cash flow uncertainty (both in timing and amount) and be able to make adequate allowance for these risks via an addition to the FS for HP assets.

Firms can employ either a probability-weighted approach to model the addition to the FS, or use a deterministic approach (e.g. where suitable data is not available). Under a deterministic approach, the PRA states an expectation that the FS addition will be no lower than one quarter of the difference between the MA under a best estimate scenario and the MA under the worst case scenario.

The PRA states that cash flow variability arising due to economic factors is more likely to be more amenable to a probability-weighted approach.

Regardless of the approach adopted, the PRA proposes a minimum FS addition for HP assets of 10 basis points as an estimate for reinvestment and/or rebalancing costs.

In addition, where asset classes have previously needed to be restructured in order to meet the 'fixity' requirement, the PRA states that insurers may now choose to include these in MA portfolios without restructuring where they meet the proposed new MA eligibility conditions. The PRA says that this would require a new MA application.

There may also be opportunities to include further cash flows from internally restructured assets through the creation of mezzanine notes, for example where those notes have HP cash flows, or where they are sub-investment grade (SIG) through the lifting of MA restrictions on SIG assets.

Focus on credit ratings under the MA and removal of 'BBB cliff'

The PRA proposes to remove the limit on the amount of MA that may be claimed from SIG assets to allow more investments close to and below the boundary between investment grade and SIG assets (sometimes referred to as the 'BBB cliff').

In line with the PPP, the PRA expects firms to only invest in SIG assets where they have an effective risk management system in place to enable them to identify, measure, monitor, manage, and report on the additional risks associated with these assets compared to those for investment grade exposures.

CP19/23 highlights that firms will need to give consideration to the reliability of expected cash flows emerging on SIG assets for the purpose of cash flow matching within the MA portfolio.

The proposal to remove the SIG cap within the technical provisions (TPs) will also require firms to be able to demonstrate that the risk profile of SIG assets is adequately reflected within their internal model.

The anticipated MA regulations will require that the credit quality of MA assets must be determined by a credit rating issued by an external credit rating agency (CRA) or the firm's internal credit assessment. The PRA expects that the MA regulations will require a firm's internal credit assessment to be of a comparable standard to a credit rating issued by a CRA.

As a result, the PRA proposes to implement rules which are based on the existing expectations set out within SS3/17. In order to improve consistency between the risk identification and internal credit rating, the rules will require firms to consider all risks to which assets are exposed as part of their assessment.

In addition, firms will be required to undertake appropriate independent external assurance alongside the validation and assessment of the ongoing appropriateness of the internal credit assessment process.

Finally, 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.

Notching

The PRA proposes to make changes to the MA calculation to increase the granularity of the FS, where appropriate, to reflect differences in the credit quality of assets by credit rating notch.

Firms will be required to calculate the FS for each rating notch by linearly interpolating the information produced by the PRA for each credit quality step (CQS). A notched FS will be required for assets of CQS 1 to CQS 5 (inclusive). If notching is not possible for a certain asset then firms must use the FS for the CQS to which the exposure is mapped and this limitation should be considered as part of the FS attestation process.

The PRA considers its proposals will increase the risk sensitivity of the FS, by reflecting the relative credit quality of exposures within each rating category. Further, as all firms will be required to adjust the FS to reflect differences in credit quality by rating notch, the PRA also considers the approach will promote consistency between firms.

The PRA anticipates that TPs could increase slightly as firms may historically have chosen to invest proportionately more in assets towards the lower end of each current rating band.

The PRA notes that some firms will need to develop their current internal credit assessment processes so that they can produce internal ratings on a notched basis.

In addition, CP19/23 outlines an expectation that any differences in the level of granularity of FS adopted within internal models and TPs should be justified.

If it is considered that notched ratings should also be included within the calculation of the SCR, then methodology should be developed in line with relevant internal model requirements. Given developing and implementing such changes may not be straightforward, the PRA states that firms should consider other possible remedies in the interim, including an increase in the capital requirement calculated by the internal model to ensure the SCR is not understated.

New annual data reporting - MA Asset and Liability Information Return (MALIR)

The PRA proposes introducing a new annual reporting requirement for firms with permission to apply the MA. The data would be collected in a new return called the MALIR. A separate MALIR will be required for each MA portfolio, with the first set of returns being due in 2025 for the year ending 2024. The MALIR would be due 130 business days after a firm's financial year end.

The PRA proposes collecting data in the following areas:

- Asset features, including sector of exposure, issuer country and currency, and individual asset characteristics;
- Asset ratings, including whether each asset is internally or externally rated;
- Asset-level metrics, including the yield, spread, FS and MA in respect of each asset;
- Asset and liability cash flows; and
- Portfolio metrics, including the results of the PRA matching tests where relevant.

In certain circumstances firms will have the option to apply for a waiver (it can also be a partial waiver) from the requirement to submit a MALIR. When assessing a waiver application the PRA will consider the materiality of the portfolio, as well as the proportionality of the requirement which would include looking at the size of the firm and the nature of the asset holdings in the portfolio.

The PRA notes that MA portfolios will be subject to significant change over the next few years due to the growing Bulk Purchase Annuity market. The PRA therefore considers regular structured reporting in this area will enable effective supervision. It will also allow the PRA to gauge the nature of the assets that firms are investing in, including how much firms are investing in assets that contribute to UK economic growth.

Widening MA liability eligibility

The PRA proposes to expand the types of insurance business that may benefit from the MA.

The permissible underwriting risks in MA portfolios will be expanded to include recovery time risk (which is the recovery period on income protection claims in payment). This will be in addition to longevity, expense, revision, and (limited) mortality risks, which are allowed under the current MA portfolio rules.

In CP19/23, the PRA proposes to allow the inclusion of in-payment income protection liabilities, 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, it is not proposed that MA eligibility is extended to periodic payment orders (PPOs) or liabilities that assume future premium payments. There is also no proposed change in eligibility criteria for contracts which include policyholder options.

Streamlining MA approvals and revised approach to breaches

The PRA proposes a new streamlined MA application approach for certain types of applications. The PRA expects decisions will be made in a much shorter time frame than the six months it might take for non-streamlined applications.

The PRA intends to inform firms if their MA application will be suitable for a streamlined approach once they engage with the PRA. It states a streamlined application will be suitable where it is clearly in accordance with the MA eligibility conditions, proposes less complex changes, where the firm suggests appropriate safeguards or where limited variations are requested to existing permissions.

The PRA considers that the current consequences for breaching the MA eligibility are unduly punitive, and may risk the stability of a firm's balance sheet.

Where firms are in breach, the PRA proposes to retain the two months rule within which firms must restore compliance with MA conditions. However, instead of facing immediate termination of the MA permission where compliance is not restored within two months, firms will be required to gradually reduce their MA. This means the MA will need to be reduced by a minimum of 10% of the unadjusted MA for each month of non-compliance. (For example, if the unadjusted MA is 100 bps it will be reduced to 90 bps in the first month, 80 bps in the second month, and so on).

The board may delegate authority for approval and submission of MA applications to a suitable sub-committee of the board or to approved senior managers.

What do firms need to do?

Firms have three months to respond to CP19/23 and the PRA encourages respondents to provide relevant data and evidence wherever possible to support any feedback provided. Given the technical nature, tight timescales and scope of CP19/23, firms will need to consider resourcing and capacity of their actuarial and finance teams to respond to CP19/23 while balancing BAU activities.

The proposals require significant change and firms will need to plan now in order to assess the implications and implement the operational changes required.

MA attestation

Firms should consider which SMF is best suited to attest to the quality of the MA to the PRA. The PRA has indicated that this will usually be the CFO.

Firms will need to develop an FS attestation policy and build the capabilities needed (including systems and governance) to apply a FS add-on and report on this. This is a demanding requirement from the PRA which will require significant senior manager time across multiple disciplines. The limited time for implementation, if introduced on 30 June 2024, will make this challenging to achieve.

Firms may consider developing scenario analysis in order to understand the potential impact that the FS attestation could have on their balance sheet.

There could also be a knock-on impact to the internal model, which may require an internal model change.

Widening of asset and liability eligibility

Firms may choose to review their asset strategies in the light of greater investment freedom, in particular from the introduction of HP assets. This may include a cost benefit analysis of the additional modelling, operational and governance requirements.

For HP assets, firms will need to design and build processes for determining the addition to the FS, which may vary by asset class. There may also be knock-on impacts for internal models, as to how the FS is modelled under stress.

Firms will also need to design, assess and implement the two new matching tests, and make the PRA's adjustments to the existing tests.

Where changes are made to the MA portfolio, new MA applications may be required.

Firms may also want to consider the scope of their MA to cover other liability classes.

Credit ratings

Internal ratings, already a focus of the PRA, are likely to come under even more scrutiny. Firms holding internally-rated assets should assess the robustness, capability and maturity of their internal rating framework.

The framework will need to be extended to produce notched credit ratings.

In addition, firms should consider where they would need independent external assurance to test for bias in internal ratings and to ensure they are in line with those issued by CRAs.

Firms also need to consider who will lead the internal credit assessment function and the governance requirements, including for them to have access to the management body.

Changes to systems, tests and models

Significant changes will be required to systems to allow for notched ratings, FS add-ons and the removal of the BBB-cliff. Additional reporting at asset level will also be required for the MA attestation process.

There are knock-on impacts to the calculations required for the PRA matching tests and risk appetites.

Changes to the internal model may also be required and it is not yet clear if this will require model change approval from the PRA.

Firms should consider what additional processes, governance and technology investment they might need to put in palace to prepare for the submission of the MALIR.

Timelines

The PRA's CP closes on 5 January 2024.

The PRA plans to publish its final rules on the MA in Q2 2024, with an effective date of 30 June 2024.