HYMANS ROBERTSON

Newsflash

PRA Consultation on Solvency UK Reform
'Review of Solvency II: Reform of the Matching Adjustment'

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The much-anticipated second PRA consultation paper which sets out proposed changes to the Matching Adjustment ("MA") framework was published on 28 September 2023. In this newsflash, we discuss the key changes being proposed and their potential impact on insurers. The full consultation paper can be found here.

Executive Summary

The first of the PRA's Solvency UK consultation papers was published in June and focussed on simplifying some of the existing regulations, reducing barriers to entry and increasing competition. We discussed these in a previous Newsflash.

This second consultation paper proposes a number of reforms aiming to enable broader and quicker investment by insurers in their MA portfolios, while improving responsiveness to risk and enhancing firms' responsibility for risk management.

The key changes can be summarised as:

- Extending asset eligibility requirements to allow assets with "highly predictable" cash flows
- Increasing the granularity at which the credit quality of assets is assessed
- Removing features of the existing regime that disincentivise investment in sub-investment grade assets
- Introducing an annual Fundamental Spread ("FS") and MA appropriateness attestation requirement
- Expanding the types of insurance business to which insurers may apply the MA.

In keeping with the general objective of improving efficiency, there are also proposed changes to the MA application process, including a new "streamlined" application process and less stringent treatment of unintended MA compliance breaches.

Overall, the changes proposed are largely in line with previous publications from HM Treasury and the UK Government, although some of the details may be disappointing, if not surprising, to the industry.

Our initial reaction to the consultation paper

In the sections below, we discuss the key changes and set out some potential impacts on insurers. Our initial reaction to the consultation paper is summarised by following points:

1. **The proposals open up a significant opportunity to invest in new assets, but the hurdles to do so are onerous and may limit the extent to which insurers take advantage of the changes**
   - A cap of 10% of MA benefit on assets with highly-predictable ("HP") cash flows is perhaps higher than might have been expected, given previous indications that assets with fixed cash flows would remain in the vast majority
   - Restrictions on the types of assets with HP cash flows that will be eligible and how they are to be valued are extensive, and significant modelling will be required to fully realise potential benefits.
2. **We expect most firms will see an increase in overall FS**
   - This will likely occur regardless of new asset classes given the MA attestation requirements, FS add-ons, imposition of notching and approach to credit ratings more generally. The removal of the cap on the MA of sub-investment grade assets may provide some relief.

- For the new asset classes with HP cash flows the FS will also need to cover the risks associated with the lack of fixity including re-investment and rebalancing costs.

3. The attestation process will be onerous, and appears designed to lead to a reduction in MA benefit achieved

- Firms must be able to attest that the likelihood of the MA benefit being realised is materially more certain than best estimate, and that the FS covers all risks retained
- Out-of-cycle attestation will be required for material changes in risk profile, including, for example, large bulk purchase annuity transactions
- The attestation process will be supported by a significant annual data gathering exercise.

Extending asset eligibility to allow assets with "highly predictable" cash flows

What is changing?

The existing requirement for MA assets to have fixed cash flows will be removed, and insurers will be allowed to hold assets which have highly predictable cash flows. Eligible assets must have contractual bounds on both the cash flow timing and amount, and must also meet all other existing MA eligibility requirements.

Holdings of such assets will be limited to providing no more than 10% of the overall portfolio MA benefit, and there will be new cash flow tests for insurers that choose to hold assets with HP cash flows – one covering reinvestment risk and one covering liquidity risk. Insurers will also have to include assets with HP cash flows in their liquidity plans.

The consultation paper also sets out guidance on how firms should model HP cash flows in both base and stressed conditions, including how they should be allowed for in existing PRA matching tests. It also notes that such assets will require additions to the PRA-published FSs to reflect the specific risks associated with non-fixed cash flows. The PRA believes that the non-fixity feature should not give rise to an MA benefit because its value cannot be relied upon.

What will it mean for insurers?

The removal of the "fixity of cash flows" requirement was one of the main changes that the industry has long been in favour of, and the "highly predictable" feature should allow investment into new asset classes – including assets with initial construction phases. While there is a limitation of 10% of MA benefit, this should still allow the larger firms to invest many hundreds of millions (or even billions) of pounds into these new asset classes.

The consultation paper suggests that some existing MA eligible structures which include mezzanine may qualify as HP assets. Firms may have the option of keeping these types of structures in their existing form, or classifying them as HP assets and treating them in line with the new regulations. However for Equity Release Mortgages ("ERMs"), for example, given the material holdings of some firms, we'd question whether they would want to use up much of the 10% limit on ERMs.

The new cash flow tests are unlikely to be overly burdensome as they are similar in nature to existing tests. However, the requirement for FS add-ons (see later section on attestation requirements) may well dampen the expected increase in MA that these potentially higher-yielding assets may bring. While the contractual bounds on cash flow timing and amount will limit the range of assets that become eligible, widening the asset universe should bring non-financial benefits. These benefits may include increasing the volume of long-dated assets available to match long-dated liabilities, and allowing investment in assets that align with insurers' environmental, social and governance objectives. Modelling HP assets under stress is also likely to bring additional complexity.

Increasing the granularity at which the credit quality of assets is assessed

What is changing?

The assessment of an asset's credit quality will move from the existing credit quality steps (i.e. AAA, AA, A etc) to a more granular notched level (e.g. A+, A, A-, BBB+ etc). Where firms are not able to assign a notched rating to an asset, the existing approach will be retained, but they will need to consider this in the annual attestation (see later section).

Firms will then apply a notched FS and probability of default in the MA calculation. Notched FS and probability of default will be determined by linear interpolation of the information published by the PRA at the existing credit quality step level.

To the extent possible, firms should align the granularity of credit assessment within their models to that used within the MA calculation. Where not possible, firms will be expected to justify any differences to the PRA.

What will it mean for insurers?

This is another change that insurers were expecting and many firms will already have notched credit ratings for the assets that they hold within their portfolios which may make it challenging to justify retaining the current approach. The change should smooth the differences between FS values and reduce the impact of a downgrade from one credit quality step to another.

The linear interpolation approach is a simple one that should reduce the operational effort required to implement this change. It should also mean that there is no material impact on the MA, although it will penalise the practice of holding assets at the lower end of the credit quality step rating, which is a practice rewarded under the current regime.

Removing features that disincentivise investment in sub-investment grade assets

What is changing?

The cap on sub-investment grade assets, which limits the MA to the level that could be achieved on a similar BBB-rated asset with equivalent duration, will be removed. This will allow firms to benefit from any additional premia available on sub-investment grade assets.

Additional expectations will be introduced for assessing the appropriateness of holding sub-investment grade assets and for how they are treated within internal models. It also sets out additional expectations for internal credit assessment processes which firms will be expected to demonstrate to the PRA on request.

What will it mean for insurers?

The so-called “BBB cliff-edge” has long been noted as a feature of the MA framework that disincentivised investment in assets that have a credit rating of BBB or lower. The UK Government sees the removal of this feature as key in encouraging investment in new and innovative asset classes. Given that many such asset classes will have credit ratings of BBB or below (particularly when in construction phase), we’d be inclined to agree. We’d also expect the operational effort of moving to the more granular ratings to vary by firm, as many will already use notched ratings for other purposes (e.g. in Internal Models). For those that do not already use notched ratings, implementing these into Internal Models may be challenging.

While we wouldn’t expect to see a material increase of sub-investment grade assets within MA portfolios, this change may present an opportunity for better risk management of sub-investment grade assets after models and investment strategies have been developed. Improved capabilities may result in more economic investment strategies and the removal of the cliff-edge also reduces the imperative to rebalance back to investment grade assets under stress.

Attestation requirements

What is changing?

The proposed attestation requirement is one that has been met with the most challenge from the industry in the process so far. The consultation paper confirms that a particular senior manager (likely to be the Chief Finance Officer) will have to provide a standardised attestation on an annual basis that the FSs used within the MA calculation reflect all risks retained by the firm and that the firm should be able to earn the MA from assets held with a high degree of certainty.

The attestation will be provided annually in line with the publication of the Solvency & Financial Condition Report, but will also be required on an ad-hoc basis in the event of a material change to the firm’s risk profile, such as a large or complex bulk purchase annuity transaction.

As part of the FS attestation, firms will be expected to assess the appropriateness of PRA-published FSs for all assets held including publicly-traded assets. Firms will also have to consider whether any element of excess credit spread could be indicative of additional unidentified risks. Firms should increase the FS for any asset classes where the published FS is not sufficient to capture all risks retained.

The PRA will also have the power to apply an FS add-on for particular asset classes should it feel it appropriate to do so.

What will it mean for insurers?

While concerns have been raised by many in the industry, the PRA feels strongly that this additional feature will result in firms taking “greater ownership and accountability for the calculation of the FS and MA”. The requirement for the appropriateness of the published FS to be assessed for all asset classes will bring significantly increased operational effort. Insurers may be disappointed to learn that they will have to do this even for assets that are similar to those used to calibrate published FSs. Firms will have to enhance modelling capabilities to be able to determine what an appropriate level of FS might be for a given asset class, and any FS add-ons applied to specific asset classes will ultimately reduce the MA benefit.

The requirement to provide an ad-hoc attestation in response to material in changes in risk profile could make it more difficult 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, we’d expect the process of designing a methodology for evaluating the FS and the MA benefit from an asset to be one that is new to the majority of firms, and one that requires significant expert opinion and judgement given the relative lack of available data.

The requirement to consider the prevalence of any unidentified risks appears to be particularly challenging and could be another general driver of increased FS.

Expanding the types of insurance business to which insurers may apply the MA

What is changing?

MA eligibility requirements are being extended to allow liabilities that are exposed to "recovery time risk" (the risk that income protection policyholders take longer than expected to recover from sickness) and the guaranteed elements of with-profits annuities to be included within MA portfolios.

Only the guaranteed element of with-profits annuities will be eligible, and firms must have a policy on how additional future bonuses are allowed for on these liabilities. The non-guaranteed element of with-profits annuities and other types of with-profits business will remain ineligible.

What will it mean for insurers?

Only a handful of the firms that currently have MA approval have material volumes of income protection business. These firms may well seek permission to apply the MA to income protection business, given that many of the required processes and methodologies will already exist. However, we'd expect that this change may well be most attractive to firms that have a greater focus on income protection business and would not previously have been able to benefit from the MA, and so we might see new MA applications from income protection writers.

Given that with-profits annuities are only a subset of the with-profits business held by UK firms, and that many with-profits funds are closed to new business, we wouldn't expect that many firms will benefit from this change. That said, if these liabilities can be added to the portfolios at relatively low cost/ effort, we may see some firms choosing to do this to benefit from the increased discount rate.

Other changes

Streamlining the application process

Certain elements of the existing MA application requirements will be removed and a "streamlined application" process will be introduced, which should facilitate quicker approvals for less complicated applications. However, this will be limited to specific types of application such as those that clearly meet eligibility requirements, new safeguards and (potentially) variations on existing approvals.

PPP compliance

A new requirement to demonstrate how the firm ensures that it can manage its MA assets in line with the Prudent Person Principle ("PPP") will be introduced. MA firms are already required to comply with the PPP, however this requirement will formalise the link between MA eligibility and PPP requirements.

Treatment of MA breaches

The current automatic revocation of all MA permissions that occurs following 2 months of an MA compliance breach will be removed. Where compliance is not restored within 2 months, the MA will be reduced by 10% for each month that the issue remains (in addition to the initial 2 months). The PRA will retain the ability to fully revoke permissions if appropriate (e.g. for repeated breaches or failure to address issues in a timely manner).

What next?

Insurers are invited to provide feedback on the proposed changes by 5 January 2024. The final MA policy and rules will be published in Q2 2024, with an effective date of 30 June 2024. Other changes (i.e. those covered by the first consultation paper) will take effect from 31 December 2024.

We continue to work with a wide range of insurers across the UK and abroad about Solvency UK developments and how this could impact their business. If you would like to discuss any of these points further, please get in touch with your usual Hymans Robertson contact or any of the authors of this Newsflash.

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