PRA Publishes Its Proposals for Reforms to the Matching Adjustment

4 October 2023

Background. On 28 September 2023, the PRA published its long-awaited consultation paper CP19/23 on its proposals for reforms to the matching adjustment (the "MA"). The MA is a Solvency II mechanism under which insurers can match long-term returns on their investment assets with long-term liabilities to get capital credit up front for the investment return they expect to earn over the lifetime of their assets.

Changes to the MA are a key element of reforms being considered and implemented to the Solvency II framework in the United Kingdom. The new regime, known as "Solvency UK", seeks to release up to £100 billion of capital held by (re)insurers. It is hoped that this capital will be invested in long-term productive assets in the United Kingdom, particularly in the infrastructure space, while prudential standards and policyholder protection are maintained.

These proposals follow on from the changes to the MA proposed in draft regulations published by HM Treasury in June this year.

Expanding the Pool of Assets and Liabilities That Are Eligible for the MA. Under the existing Solvency II framework only assets with fixed cash flows may be included by insurers in their MA portfolios. Under the proposed reforms, assets with "highly predictable" ("HP") cash flows (meaning some degree of uncertainty as to the timing and amount of cash flows) can be included. CP19/23 offers further detail on which assets are eligible for inclusion.

Under the draft HM Treasury regulations, for assets with HP cash flows to be included in MA portfolios, the risks to the quality of matching with liabilities must not be "material" (which was left for the PRA to define). CP19/23 provides that for assets not to give rise to material risks, they must satisfy the following criteria:

- the cash flows are contractually bound, and failure to meet the contractual terms is a default event; and

- the contractual binding applies to (i) the timing of cash flows and (ii) the amount of the cash flows.

The assets themselves must also meet a two-part test of being "*bonds or other assets with similar cash flow characteristics*"; and having a credit quality that is capable of being assessed through a credit rating or an internal credit assessment. The capital treatment of bond-like assets has also been a recent area of focus for the NAIC, and clarity from the PRA on its approach is welcome.

The PRA also proposes to create an explicit, all-encompassing MA eligibility condition requiring re(insurers) to demonstrate that their portfolio of assets, and each individual asset, can be managed in line with the prudent person principle (the "PPP").

A greater range of liabilities will benefit from the MA. In particular, the guaranteed benefits component of with-profits annuities can be included in MA portfolios. It remains to be seen if other longer-tail liabilities will also benefit from inclusion when the reforms are finalised, as many in the industry hope.

Addressing Additional Risks from Assets with HP Cashflows. CP19/23 also explains how additional risks in an MA portfolio generated by including assets with HP cash flows will be accounted for. The aggregate MA benefit claimed from assets with HP cash flows will be capped at 10% of an insurer's overall MA benefit, and two asset-liability matching tests will be introduced exclusively for firms investing in assets with HP cash flows, assessing reinvestment and additional liquidity risk.

The PRA also proposes that firms should consider whether further safeguards are appropriate to ensure that the risks of quality matching are not material, including quantitative investment limits for assets in which they propose to invest. Self-imposed safeguards are also likely to demonstrate compliance with the PPP.

Changes to the Fundamental Spread. The fundamental spread (the "FS") is the allowance in the MA calculation for risks that insurers retain during the life of their investments. To accommodate assets with HP cash flows, firms must be able to identify all sources of uncertainty in cash flow timing and/or amount, make adequate allowances for these additional risks and be able to justify such allowances.

Treatment of Assets Based on Credit Rating. The disproportionately harsh treatment of sub-investment grade ("SIG") assets in the MA framework (also known as the "BBB cliff") will be mitigated by the removal of the SIG MA cap from the MA calculation. However, despite this headline change, the PRA expects investment in SIG assets to be at "prudent" levels (with no expansion on what is "prudent"). The PRA also considers

that firms should invest in SIG assets only to the extent that they have effective risk-management systems to handle risks associated with this exposure.

Attestation by Senior Managers. Senior managers will take responsibility for (re)insurer's MA adjustments. A PRA senior management function holder will be expected to justify the amount of MA benefit claimed and explain why their FS is sufficient for the risks in the firm's portfolio. Attestations will be made in standardised wording and must be given annually, on a date aligned with publication of the firm's SFCR, for each MA portfolio within a firm and upon any material change in a firm's risk profile.

Streamlined Reporting and Application Systems. The data firms submit on their MA portfolios will be regularised by a new Matching Adjustment Asset and Liability Information Return (the "MALIR") to be submitted annually from the end of 2024. The MALIR is intended to reduce the reporting burden on firms by removing the need for ad hoc data requests. Firms may apply for a MALIR waiver on an MA portfolio basis if the requirement to complete a MALIR is disproportionate given the portfolio's size and materiality.

Applications to include assets in an MA portfolio will also be reformed. The PRA proposes to remove the current requirement for it to formally undertake a completeness assessment for every MA adjustment. The PRA does not expect to take longer than six months to provide a decision. Certain applications will be assessed under a "streamlined" approach, with a much shorter timeframe. The PRA expects that the streamlined approach will be suitable where "*applications are clearly in line with the MA eligibility conditions, propose less complex changes, or where firms propose appropriate safeguards*."

Enforcement. The PRA will have the power to vary or revoke a (re)insurer's MA approval, or impose a limit on the value of the MA benefit, if a firm fails to meet approval conditions. This will replace the current automatic obligation to revoke a firm's MA permission if eligibility conditions are breached and not restored within two months (at which point a firm may not re-apply for MA permission for two years). Despite these changes, the PRA is clear that where a firm commits significant or frequent breaches of MA eligibility conditions, the firm's permission may be revoked, at which point the firm must re-apply for MA permission (albeit with no time limit before this application can be made).

Next steps. Consultation on CP19/23 closes on 5 January 2024. Further data and evidence will be gathered by the PRA before it makes its final policy decisions. The PRA plans to publish its final policy on the MA in Q2 2024. 30 June 2024 is the latest targeted date for these changes to come into force.

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Please do not hesitate to contact us with any questions.

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