

PRA finalises Matching Adjustment reforms

HOT TOPIC

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Highlights

The PRA has finalised changes to the solvency regime for MA portfolios.

It has implemented a number of changes and provided several clarifications in response to feedback on its draft policy.

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Summary

The PRA published its long-awaited policy statement [PS10/24](#), following [CP19/23](#), on reforms to the Solvency II (SII) regime for Matching Adjustment (MA) portfolios on 6 June 2024. PS10/24 accompanies other key SII reforms confirmed by the PRA in [PS2/24](#) and [PS3/24](#) in February 2024.

The December 2023 [Insurance and Reinsurance Undertakings \(Prudential Requirements\) Regulations 2023](#) (IRPR Regulations) align with the PRA's proposals in CP19/23. The IRPR Regulations maintain most of the existing methodology and calibration of the fundamental spread (FS), and broaden the MA eligibility criteria to allow assets with highly predictable (HP) cash flows. The IRPR Regulations also reform the PRA's powers for breaches of MA eligibility conditions, and enable the PRA to make rules on other MA policy aspects.

PS10/24 implements and works alongside the IRPR Regulations. It is wide-ranging with significant impacts on insurers' balance sheets, reporting requirements and the responsibilities of senior management.

The PRA states that respondents to CP19/23 were generally supportive of its proposals. However, in line with the feedback received, the PRA confirms it identified several areas where changes were needed to the draft policy.

PS10/24 comes into force on 30 June 2024, allowing firms to take advantage of the reforms from this date. Some of the new requirements will become effective on 31 December 2024 or the first financial year end from 31 December 2024.

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 SII Directive into UK law. Going forward, the UK prudential regime for insurers will 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 final policy operates within the constraints of the Government's IRPR Regulations (see our At a Glance summary on the draft regulations [here](#)).

The PRA issued its first major final SII review policy statements, PS2/24 and PS3/24, in February 2024. These policy statements act to remove onerous reporting requirements, allow improved flexibility for internal model approvals, and encourage entry into the UK insurance market (see our Hot Topic on PS2/24 and PS3/24 [here](#)).

PS10/24 is focused on the design and operation of the MA framework and 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 states that its final policy is expected to improve the way that the MA supports investment, and to maintain a high level of prudential standards for the insurance sector and protection of insurance policyholders.

Responding to feedback on CP19/23

The PRA states that respondents to CP19/23 were generally supportive of its proposals. However, in line with the feedback received, the PRA provides a number of clarifications and makes a number of changes to the final policy. These include:

- Clarification on implementation timelines.
- Firms will not have to reclassify any assets currently classified as fixed assets in MA portfolios as being assets with HP cash flows.
- Higher thresholds for the additional matching tests (in [SS7/18](#)) for assets with HP cash flows.
- For MA attestation, the PRA generally expects firms to rely on the basic FS for corporate bonds, where these broadly reflect the calibration data and have up-to-date accurate credit ratings.
- Also for MA attestation, firms are expected to be able to group assets into homogeneous risk groups (HRGs) when determining whether FS additions are needed as part of their initial top-down analysis.
- A new MA Statement of Policy (SoP), which includes changes to permit concurrent applications and implement reduced documentation requirements.
- Clarifying the scope of external audit in relation to the new requirements for FS additions.

Overall, the purpose of the PRA's reforms to the MA remain the same; these are 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 FS additions for assets with HP 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 reforms apply to UK SII firms; the Society of Lloyd's, its members and managing agents; and the UK branches of overseas insurers and reinsurers.

From an operational perspective (see the appendices to PS10/24), the PRA introduces a new MA section in the PRA rulebook (and updates several Supervisory Statements), which acts to consolidate existing requirements from other relevant parts of the existing PRA rulebook, as well as requirements from the IRPR Regulations.

MA attestation

The senior manager who holds the prescribed responsibility for the production and integrity of the firm's financial information and its regulatory reporting 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.

The PRA confirms the 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 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 reminds firms in PS10/24 that they should not assume that prudence for one asset can be offset against an insufficient FS for another.

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 ("out-of-cycle attestation").

The PRA expects firms to implement a formal attestation policy and, for each attestation, to submit an attestation document and accompanying report to the PRA. Firms have to disclose within their SFCR whether or not an attestation has been made, however there is no requirement to disclose the contents of the attestation.

PS10/24 confirms that neither the attestation report nor the underlying evidence would be within the scope of external audit, and a new paragraph has been added to [SS11/16](#) to clarify that voluntary additions to the FS are outside the scope of external audit.

The attestation is expected to focus on assets that have different risk profiles from those used in the existing FS calibration (i.e. assets other than corporate bonds).

For corporate bonds, the PRA states in PS10/24 that it generally expects firms to rely on the basic FS where their corporate bonds broadly reflect the calibration data and have up-to-date accurate credit ratings.

For Equity Release Mortgages (ERMs), the PRA has included a new paragraph in [SS3/17](#) regarding the use of the Effective Value Test (EVT) for attestation. The PRA says that it expects firms to use their own assumptions that are judged to be appropriate for the high degree of confidence requirement, and these should not fall below the PRA's published minimum parameters for the EVT. Additionally, the PRA has clarified that firms should consider any retained risks other than the No Negative Equity Guarantee (NNEG) that are not assessed by the EVT.

A notable change in PS10/24 from the previous draft policy is that when firms are performing an initial top-down analysis, they are now permitted to group assets into HRGs when determining whether FS additions are needed. Where necessary, this should be followed up by examination of specific assets (in respect of idiosyncratic risks) and those assets that are material MA contributors.

The PRA also emphasises the importance of considering rebalancing costs that may arise from other retained risks when determining the need for FS additions, and it has clarified how downgrade losses within the basic FS are derived.

For the first attestation, the PRA states in PS10/24 that it expects firms will leverage existing analysis and processes and perform a focused and thorough review of at least the material MA contributors.

The PRA is not expecting the inclusion of FS additions to automatically reduce the solvency capital requirement (SCR), nor does the PRA have an expectation that the FS additions must increase in stress.

Widening MA asset eligibility

The IRPR Regulations widen the MA asset eligibility conditions to go beyond the current requirement for fixed cash flows, and 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 HP cash flows.

In PS10/24, the PRA has maintained the limit from the draft policy that no more than 10% of the aggregate MA benefit can be derived from HP assets. The PRA has clarified that the 10% limit applies to the amount of MA benefit for which credit is taken, rather than it placing an absolute limit on the permitted holdings of HP assets.

The PRA sets out the following criteria for HP assets: the cash flows are contractually bound, 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 firm's 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 confirms two additional matching tests, including an assessment of the risks from HP assets in firms' liquidity plans. The PRA clarifies that these tests do not apply to portfolios of assets with only fixed cash flows. The thresholds for these two additional matching tests have been increased (from 3% to 5%), following feedback from respondents to CP19/23.

Further, the PRA states 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. PS10/24 clarifies that these mandatory FS additions for HP assets, as distinct from any voluntary additions for assets with fixed cash flows, are within the scope of external audit.

Firms can either employ 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. However, the PRA also permits firms to use a sophisticated approach to modelling the FS addition, provided this allows for an appropriate range of stresses to the changes in repayment behaviour on the underlying assets.

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. The PRA clarifies that it expects the 10 basis points to act as a floor rather than a specific increase to the FS addition.

Existing fixed assets in MA portfolios

Several respondents to CP19/23 raised concerns that the proposed changes in SS7/18 would lead to a re-evaluation of certain assets that are currently considered to have fixed cash flows. This might then lead to a material volume of existing MA portfolio assets needing to be reclassified as assets with HP cash flows, significantly reducing the capacity that firms had to invest in assets with HP cash flows.

The PRA agrees that the draft policy should not act as a trigger for firms to reclassify assets previously considered to be 'fixed' assets, and therefore changes have been made to SS7/18 to rectify this.

It has also been noted that some assets could be considered to have either HP cash flows or fixed cash flows (where firms apply the relevant expectations of SS7/18). The PRA has clarified in PS10/24 that firms have the option to move assets between the two categories, where permissions exist to hold assets with HP cash flows.

Increased focus on internal credit ratings under the MA and removal of 'BBB cliff'

The MA reforms remove the limit on the amount of MA that may be claimed from sub investment grade (SIG) assets. This change is relevant for assets that are close to and below the boundary between investment grade and SIG assets (this boundary is 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.

The PRA has updated [SS8/18](#) to clarify that firms should ensure the MA on SIG assets is appropriate post-stress, including for those assets that downgrade to SIG as a result of the stress. The PRA emphasises that internal models should result in appropriate capital being held given the firm's risk profile and that this should remain the case if the SIG MA cap is removed. The PRA goes on to say that it is open to firms potentially reducing the stressed FS for SIG assets.

The IRPR Regulations require the credit quality of MA assets to be determined either by a credit rating issued by an external credit rating agency (CRA) or by the firm's internal credit assessment. A firm's internal credit assessment must be of a comparable standard to a credit rating issued by a CRA.

In order to improve consistency between the risk identification and internal credit rating, the PRA has updated SS3/17 to 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. PS10/24 states that a firm should select the validation frequency and coverage sample size according to the complexity and materiality of its internally rated assets.

The PRA has clarified in PS10/24 that there is no intention to change the scope of existing external audit work in respect of internal credit assessments.

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. Again, the extent of these expectations will depend on the nature, scale and complexity of the assets held that are held by the firm.

Notching

The PRA confirms 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 that 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 that the approach will promote consistency between firms.

The PRA confirms that it expects any differences in the level of granularity of FS adopted within internal models and technical provision (TPs) to be justified. Additionally, 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.

The PRA notes that firms will need to develop their current internal credit assessment systems and processes so that they can produce internal ratings on a notched basis. Taking feedback from CP19/23 into account, the PRA has made changes to the implementation date of the requirement for the MA calculation to reflect notching. The requirement will apply from 31 December 2024, although firms can choose to include notching in their MA calculations from 30 June 2024.

The PRA has also updated its expectations in PS10/24 to state that firms have six months from the date at which an asset is assigned to the MA portfolio for a notched rating to become available.

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

The PRA confirms that it will introduce a new annual reporting requirement for firms with permission to apply the MA. The data will 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 on or after 31 December 2024. The MALIR would be due 130 business days after a firm's financial year-end. The PRA has set out the asset data submission requirements within the MALIR instructions and template, which has now been finalised.

Following feedback received on CP19/23, the PRA has made a number of changes to the final MALIR instructions and template. These include:

- Removing the requirement for firms to submit cash flows extending beyond 50 years.
- Changes to certain asset type definitions.
- Two new asset type definitions.
- Splitting the 'Other/Unknown' option in the 'Capacity Enhancing Assets' field.
- Merging certain sections of the template.
- Minor changes for clarity and referencing.

In certain circumstances, firms will have the option to apply for a full or 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.

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.

The PRA clarifies that its rules 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.

Following consideration of feedback from respondents to CP19/23, the PRA has made changes to the PRA Rulebook to allow the inclusion of in-payment group death in service dependants annuities (GDAs) in MA portfolios, and to ensure that the policy intent of allowing in-payment individual and group income protection liabilities in MA portfolios was achieved.

However, the MA eligibility is not extended to periodic payment orders (PPOs) or liabilities that assume future premium payments. There is also no change in eligibility criteria for contracts which include policyholder options.

Streamlining MA approvals

The PRA confirms a new streamlined MA application process for a range of suitable assets, proportionate to risk.

The PRA has six months to reach decisions on non-streamlined reviews, but it has not yet provided a target timeline for reaching decisions on streamlined reviews. The PRA states that it will develop this shorter target timeline after reflecting on experience of the new regime. It has also clarified that it will publish regular reports on the MA framework alongside the PRA Annual Report, covering application review timelines and decision rates, with the first report to be published in 2025.

To encourage a more consistent and efficient approach to pre-MA application submission with firms, the PRA has developed an Application Readiness Assessment Process (ARAP). The PRA intends to encourage firms to use this process and submit the related ARAP form. The ARAP form is expected to assist the PRA in understanding a firm's readiness to submit a formal application, as well as to determine resourcing needs.

Additional measures to be introduced to support a more streamlined and transparent application process include:

- A triage process, to enable an initial assessment of the scope and completeness of applications.
- A reduction in the documentary evidence that the PRA expects a firm to submit within its application.
- Updated supplementary information forms published on the PRA website to ensure that applications contain appropriate evidence to enable PRA review.
- Firms are not required to await the determination of one MA application before the submission of another.

The PRA reiterates in PS10/24 that it does not consider that speculative applications from firms would be appropriate.

Some respondents to CP19/23 raised a suggestion that limited investments could be made in assets that a firm considers to meet the MA eligibility conditions, prior to PRA approval being granted. However, the PRA considers it would not be appropriate to implement this approach at the current time.

Revised approach to breaches

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 confirms it will 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 PRA clarifies that it may not always be necessary for a firm to reflect the breach in its SCR calculation, depending on the nature of the breach.

What do firms need to do?

Revisit current implementation plans

As described in this Hot Topic publication, the PRA has provided several clarifications and made a number of changes to the draft policy consulted on previously.

Firms should perform a detailed review of these clarifications and changes, and assess whether any amendments are required to current implementation plans and timetables.

MA attestation

Firms are in the process of developing MA attestation policies and building the capabilities needed (including systems and governance) to apply FS additions and report on this. This is a demanding requirement from the PRA which requires significant senior management time across multiple disciplines.

Firms will need to define the HRGs to be used for the initial top-down analysis, taking into consideration the factors which the PRA has listed in paragraph 5.36 of SS7/18.

Trigger frameworks will also need to be developed for out-of-cycle attestations, reflecting the PRA's clarifications and amendments to the final rules in PS10/24.

Widening of asset eligibility

Firms may want to revisit their decisions on whether to apply for inclusion of HP assets (and the timing of when to do so) following the clarifications and changes provided by the PRA in PS10/24, in particular:

- Higher thresholds for the two new matching tests.
- Existing fixed assets will not be reclassified as HP.
- Methods for managing against the 10% limit.

Where applications are being considered, firms will need to design and build processes for determining the addition to the FS, which may vary by asset class. 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 a firm proposes to apply for approval to include HP assets, we would encourage early engagement with external auditors on the proposed methodology for the calculation of the mandatory additions to the FS.

Widening of liability eligibility

Firms will be able to apply from 30 June 2024 for approval to include in-payment income protection policies and the guaranteed benefits components of with-profits annuities in their MA portfolios.

The decision on whether to apply for approval and the benefits of doing so will be firm-specific.

Internal credit ratings

Internal ratings, already a focus of the PRA, will 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, although the PRA has clarified that firms have until 31 December 2024 to implement this.

An important part of the internal rating framework is a firm's approach to validation. As laid out in PS10/24, firms will need to decide the frequency of validation, the sample size, and the providers of any external assurance.

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, processes and internal models

Significant changes will be required to systems and processes to allow for notched ratings, FS additions, the removal of the BBB-cliff, and reporting (including MALIR).

Firms are in the process of evaluating the extent of any changes that may be required to internal models and beginning to formulate proposals for how to implement these. There have been no significant changes introduced by PS10/24.

The PRA has not proposed a particular approach for notching, nor has the PRA set a timescale for reflecting notching in the internal model. Firms will need to decide on the most appropriate approach and formalise plans for implementation.

For SIG assets, firms may decide to remove the MA cap in stress, or they may choose to make other changes. Whatever changes are made, the firm must be able to demonstrate that the internal model results in appropriate capital being held, given the firm's risk profile.

Firms will also need to consider if implementing any of the changes would trigger the need for an internal model change approval in line with their existing model change policy.

Timelines

Firms will be able to take advantage of the MA reforms from 30 June 2024. Rules relating to notching in the calculation of the TPs will come into effect on 31 December 2024. The first required attestation for any firm with MA permission prior to 31 December 2024 will be in respect of its first financial year-end from 31 December 2024.

List of updated Supervisory Statements published alongside PS10/24

- [Supervisory Statement 7/18](#) – Solvency II: Matching adjustment
- [Supervisory Statement 8/18](#) – Solvency II: Internal models – modelling of the matching adjustment
- [Supervisory Statement 3/17](#) – Solvency II: Illiquid unrated assets
- [Supervisory Statement 1/20](#) – Solvency II: Prudent Person Principle
- [Supervisory Statement 11/16](#) – Solvency II: External audit of, and responsibilities of the governing body in relation to, the public disclosure requirement

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