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The Standard Formula

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The PRA Outlines New Details of Solvency UK: Matching Adjustment and Other Reforms

As discussed in our November 2022 and July 2023 newsletters,[1] the UK government is implementing a comprehensive set of proposals for regulation of financial services in the UK, including for insurers. This follows the UK's withdrawal from the European Union on 31 December 2020, with the UK now exercising its freedom to move away from key EU insurance prudential regulatory standards, to develop a regime known as "Solvency UK".

This article focuses on the new regime of the Prudential Regulation Authority (PRA) for the matching adjustment. It also summarises some other recent related developments, including proposals for enhanced stress-testing protocols for life insurers, and its response to its newly acquired secondary objective to support the UK's economic growth.

1. Matching Adjustment (MA) Reform

On 27 September 2023, the PRA issued its first substantive consultation, CP 19/23, on the detail of its proposed changes to the matching adjustment (MA). As a recap, the MA benefits insurers that hold long-term assets that match the cash flows of similarly long-term insurance liabilities, by allowing the insurer to recognise upfront as capital part of as-yet-unearned future cashflows with the application of an illiquidity premium. The MA is a particularly material benefit for insurers writing annuity business, which are thereby incentivised to invest in a wide range of long-term, illiquid, fixed-interest assets.

These wide-ranging proposals can be seen as a substantial relaxation of the Solvency II requirements around which fixed assets are eligible for inclusion in an MA portfolio, and the (narrow) scope of liabilities that they can be held against. This is tempered, however, by an enhanced governance framework for insurers, including principles-based judgements, as well as a hard attestation from the insurer's CFO or other officer that they have a "high degree of confidence" that the MA assets will deliver the intended result.

Although each of these components was set out in the HM Government's statement in November 2022 and the PRA's subsequent consultation papers, the additional detail is a welcome assertion of the PRA's overall direction and intent.

The consultation closes on 5 January 2024. Subject to the UK government's legislative timetable and responses to this consultation, the PRA plans to publish final policy and

[1] "From Solvency II to Solvency UK: The UK Government Announces Its Post-Brexit Solvency II Reforms" and "From Solvency II to Solvency UK: The PRA Provides Further Details of Its Post-Brexit Solvency II Reforms".

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rules on the MA during Q2 2024 with an effective date of 30 June 2024, with all other changes relating to the Solvency II review taking effect on 31 December 2024. Implementation of the MA provisions in June 2024 will mean that firms that use the MA will be able to take advantage of these MA reforms before 31 December 2024.

We summarise below the key elements of the proposed regime, focusing on those areas that are most likely to attract scrutiny from the industry.

MA asset eligibility for assets that are "highly predictable'. The new framework moves away from a requirement for fixed income to allow for the inclusion of assets with "highly predictable" (HP) cash flows — *i.e.*, with cash flows that are capable of being changed by the issuers of the assets or third parties) — provided they do not represent more than 10% of the total MA benefit claimed. Such HP assets must:

- Be contractually bound as to timing and amount of cash flows (with failure to pay constituting a default event.
- Be "bonds or other assets with similar cash flow characteristics".
- Have a credit quality capable of assessment through a credit rating or internal credit assessment of comparable standard.

Where the relevant contract does not specify an upper limit on the cash flow amounts — *e.g.*, leases with "upward only rent increases" — the upper bound of cash flow amounts may be determined using appropriate assumptions for the rate of any future escalation.

The PRA's previous statements in PRA Supervisory Statement SS7/18 will continue to permit certain non-fixed cash flows to be treated as "fixed" (rather then HP), and hence will continue to allow changes related to inflation indices and changes to cash flows for which suitable compensation is paid, *i.e.*, leaving available the 10% allowance for HP assets. The PRA does, however, foresee that assets that were restructured to meet current MA requirements may be "unrestructured" to fall within the looser HP regime (albeit still requiring approval), and indeed reiterates its expectation in SS7/18 that such assets should be included "directly" where possible. Even if the assets remain in "securitised" form, the value of any residual interest should not be greater than would have applied to the underlying assets in "unsecuritised" form.

For HP assets, the PRA also proposes to build on the matching tests set out in SS7/18 to deal with the new risks introduced by inclusion of HP assets, such as:

- Cash flows being received earlier (or later) than expected; for example where a callable bond is redeemed earlier (or later) than expected).
- Cash flows of a different amount being received than expected; for example where coupons are linked to the achievement of environmental impact targets.
- Future contractual payments to the borrower being of different amounts and/or timing than expected; for example from a lease related to the completion of a construction project.

The decision on which approach to take may not always be clear-cut, and the PRA gives examples of scenarios where it could be appropriate to take a deterministic approach:

- An infrastructure project where the project sponsor can prepay in the event of construction failure.
- Limited holdings of callable bonds where the option is significantly in (or out of) the money and a "yield to worst" approach has been taken.

The PRA will expect firms to make proposals for management of these risks in their MA applications to the PRA, including providing ideally modelled distributions of losses arising from HP assets. The authority will provide substantial guidance to assist firms in this. The PRA will launch a verification process for MA applications ensuring firms are held responsible for their MA, backed by a "fundamental spread" (FS) that aligns with their portfolio's inherent risks.

For HP assets, the PRA proposes a "yield to worst" projection. Where the asset can be repaid early, the typical worst-case outcome will be a minimum MA benefit of zero, but subject to a consideration of the prevailing operating conditions.

The FS should reflect all risks retained by firms under the MA — principally credit risk but also the repayment, reinvestment and liquidity risk that results from an HP approach, for which the PRA proposes a minimum level of 10 basis points. It also makes clear that the additional risks due to a lack of "fixity" should not give rise to an MA benefit; rather that part of the spread that arises from lack of fixity should be part of the FS.

The PRA will also be incorporating a criterion for MA eligibility that mandates firms to demonstrate their adherence to the prudent person principle (PPP). Compliance with the PPP means that insurers will need to set internal quantitative investment limits for types of assets in which they propose to invest.

Sub-investment grade (SIG) assets. The PRA proposes to increase the allowance of SIG assets in an MA portfolio by removing the current cap and modifying expectations about the management and modelling of SIG assets. This adjustment aims to promote investments that hover around the threshold between investment and SIG. That said, the PRA expects that any investment in SIG assets will remain limited given that annuity policyholders

do not necessarily benefit from the higher yield on these products, and it states that these should, in any event, remain at prudent levels. When assessing this, insurers will be required to account for the risk of investment grade asset holdings being downgraded to SIG. In line with the PPP, the PRA also considers that insurers should only invest in SIG assets to the extent that they have an effective risk management system for the particular assets.

Extension of the categories of insurance liabilities eligible for MA. The PRA's proposals also expand the scope of liability portfolios that may benefit from the MA. These would include in-payment income protection claims, including recovery time risk (the risk that income protection policyholders take longer to recover from sickness than the firm's best estimate projection), perhaps a nod to the trend for long-term illness that has accelerated since the COVID-19 pandemic. This is a noteworthy extension of the MA, which will produce significant capital benefits in the market concerned. The extension will also permit inclusion in an MA portfolio of the guaranteed components of with-profits annuities, but with the non-guaranteed elements remaining outside. Although this is unlikely to have a significant impact on the market overall, it is likely to assist the limited number of providers of these specialised products.

Implementing a more efficient MA application procedure tailored to specific assets. The PRA will also optimise its MA application processes to help insurers respond to investment opportunities more swiftly. It expects to reach a decision on all MA applications within six months of receipt.

A more balanced approach to MA condition breaches. Currently, insurers must cease to apply the MA if eligibility conditions are breached and compliance is not restored within two months, and insurers cannot apply for its restoration before a further 24 months (a truly draconian sanction). The PRA proposes to retain the two-month remediation period, noting that minor breaches should not necessarily impose a restriction on the MA's application. However, to promote flexibility, where compliance is not remediated within this window, firms would be allowed to reduce the MA in a staggered fashion, rather than face immediate termination of their MA permission.

The PRA proposes that this reduction would be at least 10% of the unadjusted MA, increasing by 10% for each month of non-compliance following the two-month window. Where the MA has been reduced to zero, the PRA would expect to revoke the permission to apply the MA, but if the firm remediates during the reduction period, the restriction would be rescinded (subject to PRA confirmation).

Matching adjustment attestation. The PRA proposes the following formal statement be made on an annual basis by the CFO (or other relevant senior manager) of an insurer:

> "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".

The attestation must be given annually for each MA portfolio within the firm (with the effective date aligned to the firm's Solvency and Financial Condition Report) and upon any material change in the firm's risk profile. The PRA notes that the reference to "compensation" refers not just to the illiquidity premium, but also higher spread related to barriers to entry, or specialist skills in sourcing and developing a relevant asset. The PRA considers that the reference to "high degree of confidence" requires the MA to be materially more certain than a 50th percentile or best-estimate basis.

The firm will designate a senior management function-holder to be responsible for the firm's financial information and regulatory reporting, and who will make the attestation. A policy on providing the attestation must be established and maintained by firms, as well as appropriate internal processes.

We expect this requirement to generate a lot of attention within firms, with the relevant individuals looking to bolster their position, likely with the support of external actuarial advisers. This will lead to interesting discussions as to whether the related liability provisions operate to mitigate impact of potential regulatory sanctions. The PRA does, however, acknowledge that responsibility for different elements of the statement may be delegated, and that ultimate responsibility for the attestation may be shared by two or more senior individuals. In its proposed amendments to SS7/18, the PRA sets out a possible approach that firms could use to systematically review the evidence for the attestation.

Matching adjustment asset and liability information return (MALIR). The PRA proposes a new annual reporting requirement obliging firms to provide portfolio metrics and detailed information on the assets and liabilities held in their MA portfolios, standardising the data that firms provide to the PRA concerning their MA portfolio's assets and liabilities.

2. Solvency UK: Stress Tests

In a speech on 19 September 2023, the Bank of England's Director of Prudential Policy Gareth Truran revealed proposals around individual insurers' stress test results under Solvency UK, with a view to fortifying market transparency and discipline.

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For life insurers, the PRA proposes to transition to publishing individual firm stress test results. This is a significant departure from the current approach, where insurers privately submit their stress test results to the PRA, followed by the release of an aggregate summary. This shift aligns with the modifications previously implemented for banks. The PRA is set to unveil more details about this approach in the coming year, and will consult on technical issues to refine the mechanics of the new stress testing methodology.

The PRA's envisages initiating the revised stress tests in the first quarter of 2025 and publishing the results in the final quarter of 2025.

For the time being, general insurers can expect a continuation of the existing methodology of aggregated publication of stress test outcomes, with further evaluations planned after implementation of the reforms for life insurers. More extensive reforms following the establishment of Solvency UK, are expected, as the PRA is poised to conduct an in-depth evaluation of the standard formula for calculation of the solvency capital requirement.

The PRA expects to release its final policy on the majority of these reforms in the first half of 2024, with implementation by the end of 2024.

3. The PRA's New Secondary Objective To Promote Economic Growth

On 29 August 2023, as part of the Financial Services and Markets Act 2023, the PRA acquired a secondary objective: to foster the UK's economic growth.

In Director Truran's 19 September 2023 speech, he noted that the links between prudential regulation, growth and competitiveness have not been a major focus of external research. In a second speech on 27 September 2023, the PRA's Executive Director of Prudential Policy Victoria Saporta further elaborated the PRA's approach to policymaking in light of the new secondary objective, including the following changes:

- A specialised, independent PRA panel will provide oversight of the cost-benefit analyses of the PRA's prospective policies.
- The introduction of new approval processes and the unveiling of critical data on authorisation timeframes, reflecting a broader trend towards openness in regulatory processes. The PRA has also been working to streamline processes for authorising ventures in the wholesale insurance and reinsurance sector, introducing a mobilisation process for new insurers.
- Use of international ratings as a barometer to assess the congruence between the implementation of growth objectives and international standards, ensuring the UK's regulatory framework remains in harmony with global norms. The PRA is aiming to adapt or remove unnecessary rules and restrictions, focusing on tailoring prudential rules to the circumstances of the UK.

4. In Summary

It is exciting to see the PRA starting to deliver the detail of Solvency UK. While we are only seeing the early stages of that reform, the initial moves are encouraging. Nonetheless, the actual effect of the reforms will hinge on the manner in which the PRA implements the new rules on individual firms, especially given that, in the case of the MA reforms, significant judgement is involved. We will continue to monitor the reform programme and its implementation closely and keep you informed.