

## SOLVENCY UK - REFORMS TO THE MATCHING ADJUSTMENT

On 28 September the PRA published a [consultation](#) (CP19/23) on proposed reforms to the matching adjustment (MA). These follow on from the publications in June of draft statutory instruments by HMT and a PRA consultation on other aspects of Solvency II reforms. Please see our briefings on the [HMT SIs](#) and the [PRA consultation](#) for more details.

CP19/23 sets out changes to the PRA's rules and guidance to transpose onshored MA requirements and to effect those MA reforms which will not be captured in legislation. This will result in:

- a new Matching Adjustment Part within the PRA Rulebook
- amendments to other Parts of the Rulebook (e.g. Reporting)
- amendments to a number of supervisory statements
- a new Statement of Policy on MA permissions.

The PRA plans to publish final policy and rules on the MA during Q2 2024 with an **effective date of 30 June 2024**.

### Key themes

Much of the consultation concerns technical matters implementing HMT's proposed reforms. As discussed below, however, some of the PRA's proposals go beyond what was set out in HMT's November 2022 response document on the Solvency II review.

The draft SI published by HMT in June gives the PRA the power to make additional rules governing the MA and it had been expected that additional controls would be introduced to counter-balance some of the loosening of restrictions. This has indeed been the case, in particular in the context of limits on the use of assets with non-fixed cash flows, expectations in respect of the use of sub-investment grade assets and the new matching adjustment attestation.

Reforms to the matching adjustment are not going to be entirely a one way street.

### Assets with non-fixed cash flows

HMT confirmed in its response document that MA asset eligibility would be loosened to allow assets with highly predictable cash flows to be included in the MA portfolio. The draft SI published in June allows assets with non-fixed cash flows to be included where the risks to the quality of matching are not material and subject to a limit to be determined by the PRA.

The PRA has elaborated on the SI drafting by proposing that assets with non-fixed cash flows only pose non-material risks to the quality of matching if the cash flows that are not fixed are "highly predictable" (as per the response document). This requirement will only be satisfied if the contractual terms of the asset provide for a bounded range of variability in respect of the timing and amount of the cash flows, and breach of those terms is a default.

No more than 10% of the overall MA benefit can be attributable to assets with highly predictable cash flows. In addition:

- firms are encouraged to consider whether additional safeguards should be applied, such as exposure limits to particular assets or groups of assets. In practice these may be required in order to obtain permission for an MA application;
- an addition to the fundamental spread for these assets will be required to reflect the additional uncertainty attaching to them. This should be a minimum of 10 basis points but firms will be required to model their own risks, which could result in a higher figure; and
- additional tests will apply under PRA guidance (SS7/18) to assess the quality of matching in the MA portfolio.

These restrictions will potentially make investment in assets with non-fixed cash flows a less attractive prospect than may have been anticipated from the HMT response document.

### Sub-investment grade assets

The HMT response document confirmed that the effective cap on sub-investment grade (“SIG”) assets would be removed as part of the Solvency II reforms. Currently, the fundamental spread is increased where necessary to ensure that the MA for assets with SIG credit quality does not exceed the MA for assets of investment grade quality, of the same duration and asset class. This is hoped to, among other things, increase investment in green and digital assets.

The PRA considers, however, that SIG assets should play a limited role only within the MA portfolio and proposes introducing some additional expectations in respect of the use of SIG assets. It specifies that:

- “any investment in SIG assets should be at prudent levels” - taking into account the risk of investment grade asset holdings downgrading to SIG in deteriorating market conditions;
- firms should invest in SIG assets only to the extent they have appropriate risk management processes in place;
- the nature of SIG assets should be taken into account when setting investment strategy and limits and assessing compliance with the prudent person principle; and
- firms must consider whether the expected cash flows on their SIG exposures can be sufficiently relied on for the purposes of cash flow matching (given higher and more uncertain default rates).

### The MA attestation

HMT suggested in its November 2022 response document that additional risk management tools to be deployed by the PRA in respect of the MA might include requiring a formal attestation as to whether or not the level of the fundamental spread reflects all retained risks on matching adjustment assets. This is part of a compromise solution following HMT’s rejection of the [PRA’s proposed reform of the fundamental spread methodology](#).

In this CP the PRA proposes that firms will be required to attest that:

- the fundamental spread used by the firm in calculating the matching adjustment 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 - meaning that the MA should be “materially more certain than a 50<sup>th</sup> percentile or best estimate basis”.

Further guidance is given on how the PRA expects firms to carry out the relevant analysis.

Responsibility for the attestation must be taken by the senior management function holder with responsibility for the production and integrity of the firm’s financial information and its regulatory reporting (usually the CFO). Where a firm judges the fundamental spread to be insufficient or the derived MA inconsistent with the attestation then the firm can apply a **voluntary addition** to the fundamental spread and reflect this in the attestation.

In a [speech](#) given in February, Sam Woods stated clearly that the PRA had no intention to use regulatory tools, including the proposed attestation, to try to reverse-engineer its proposed fundamental spread reform. The attestation

requirement is, however, a sufficiently significant departure from current MA processes that it may have an impact on overall MA benefit claimed. The PRA would presumably take the view that, should this be the case, it is having its desired effect of ensuring the level of MA benefit is appropriate.

### Liability eligibility

We noted in our [briefing](#) on the HMT statutory instruments that the new draft SI does not include all of the conditions relating to liability eligibility which are part of the current regime. These include requirements as to future premium payments and restrictions on policyholder options. The PRA has confirmed that these conditions will be included in its Rulebook and the status quo will therefore largely be preserved. Exceptions relate to income protection policies and with-profits annuities, as previously trailed in the HMT response document. These exceptions will provide that:

- in addition to longevity risk, expense risk, revision risk and (limited) mortality risk, “recovery time risk” will be eligible for MA treatment - this is the risk that income protection policyholders take longer to recover from sickness than is assumed in a firm’s best estimate projection; and
- as a limited exception to the requirement that obligations of a (re)insurance contract should not be split into different parts, the guaranteed element of a with-profits annuity can be included where the other MA requirements are satisfied. The residual provision for future additional benefits would remain outside the MA portfolio.

### Notched ratings

As per the HMT November 2022 response document, the PRA proposes to increase the sensitivity of the fundamental spread to credit risk by introducing a requirement to take into account different ratings notches in the MA calculation. The PRA will continue to publish technical information in respect of the fundamental spread at the level of credit quality step in the same way as currently - **firms will therefore need to source or derive the notched ratings themselves for all relevant exposures**. Where notched ratings are not available, the fundamental spread for the CQS to which the exposure is mapped should be used but the appropriateness of the resulting fundamental spread would need to be considered as part of the attestation process.

A method for applying the notched fundamental spread, involving linear interpolation, is proposed by the PRA and worked examples are included in the consultation.

### MA approvals (permissions)

Some relaxations of processes relating to MA approvals - now referred to as MA permissions - are proposed.

A streamlined application process is proposed in respect of less complex assets, under which some factors relating to the ongoing operation of the MA may be assessed after permission has been granted. The PRA proposes that the streamlined approach might also be available for more complex assets (e.g. assets with highly predictable cash flows) if safeguards or mitigants for the relevant risks are proposed.

The PRA also proposes the removal of the current cliff-edge withdrawal of MA approval where a breach of conditions is not rectified within two months. Instead, there will be an automatic reduction of the amount of MA in a staggered fashion, starting with 10% of the MA and increasing by an additional 10% for each further month when the firm is not in compliance. Once the MA has been reduced to 0% the expectation is that MA permission will be revoked. If a firm commits a significant breach of MA conditions or repeatedly breaches MA conditions the PRA will retain the ability to revoke the MA permission even where the MA has not yet been reduced to zero.

### Other proposals

As well as key points mentioned above, the consultation covers a number of other proposed reforms, largely implementing points already mentioned in the HMT response document or reflecting aspects of the draft SI. These include:

- new requirements for internal credit assessments, largely consistent with current expectations as set out in PRA guidance;

- some reduction in evidential requirements for MA permissions;
- a removal of the six month deadline for the PRA to consider an MA application;
- a requirement that firms include in their MA applications evidence that the assets they wish to invest in are capable of being managed in line with the prudent person principle, both at the level of the portfolio and individual assets; and
- a new formal reporting requirement for firms with permission to apply the MA - the “Matching Adjustment Asset and Liability Information Return” (MALIR).

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