

# PS10/24 - REVIEW OF SOLVENCY II: REFORM OF THE MATCHING ADJUSTMENT

## Overview

PS10/24 - Review of Solvency II: Reform of the Matching Adjustment confirms the final policy being implemented by the PRA in respect of the matching adjustment and includes feedback on CP19/23. This will result in a new Matching Adjustment Part of the PRA Rulebook, changes to a number of supervisory statements and a new Statement of Policy. The new rules and guidance will come into effect from 30 June 2024, with two exceptions - in respect of MA attestations and notched ratings (discussed below).

Key changes from the policy consulted on are set out in this briefing. For a discussion of CP19/23 please see our earlier [briefing](#).

## Investment flexibility

The Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations 2023 (the IPRR) provide for assets with non-fixed cash-flows to be included in the matching adjustment portfolio from 30 June 2024, subject to provisos. In CP19/23 the PRA consulted on a number of safeguards around this relaxation, including a requirement that the cash-flows from these assets must be “highly predictable”, and a cap of 10% of the overall MA benefit attributable to these assets.

In PS10/24 the PRA confirms that it is going ahead with the majority of the policy proposals consulted on but with some amendments reflecting feedback to the consultation. The key changes are:

- The PRA has decided not to implement proposed changes to SS7/18 which had introduced new paragraphs 2.21A, 2.21B and 2.23A and amended paragraph 2.21. This is in response to feedback from firms expressing concerns that the changes might mean they had to reclassify assets currently treated as fixed assets as HP assets. The PRA confirms that this is not the policy intent.
- Paragraph 2.12D of SS7/18 has been amended to reflect the fact that firms can switch between a fixed and HP cash flow treatment on MA portfolio assets where the particular circumstances could allow for either treatment.
- The PRA reports that six respondents asked the PRA to clarify that the ability to restructure assets will not be curtailed by the proposed reforms. The PRA comments in the policy statement that “*The PRA expects that firms will generally include MA eligible assets, whether with fixed or HP cash flows, in MA portfolios without restructuring*”. Nevertheless, SS7/18 continues to contemplate asset restructurings to achieve compliance with the MA requirements, subject to firms being able to explain the reasons for the restructuring.
- Queries were raised by firms over the 10% limit for HP assets. The PRA does not intend to change this limit but acknowledges that it could be reviewed in the future. It does confirm that the 10% limit will apply to the amount of MA benefit being taken credit for, rather than that which could be generated by the assets (if different). To assist firms in managing the 10% limit, the PRA has added possible approaches which firms could take to manage their portfolio against the limit in paragraph 8.4 of SS7/18.
- The PRA has revisited the calibration of the two new matching tests for firms holding HP assets and increased the applicable thresholds from 3% to 5%.

- In response to feedback, the PRA has included in paragraph 5.24C of SS7/18 worked examples of using the “standard approach” for calculating fundamental spread additions for HP assets.
- Some other minor changes have also been included in SS7/18 in relation to the calculation of fundamental spread additions.

### Liability eligibility

The provisions of the IPPR, together with the rules and guidance consulted on by the PRA in CP19/23, replicate the liability eligibility requirements under the onshored Solvency II regime - with changes to allow for the inclusion of income protection policies and the guaranteed element of with-profits annuities as eligible liabilities for the matching adjustment.

In response to feedback, the PRA has made a number of changes to the policy consulted on:

- to permit the splitting of income protection policies into different parts, so that only parts relating to in-payment claims are included in the MA portfolio. This allows the in-payment element of a group policy to be included
- to provide that future premiums on group income protection policies would not exclude the in-payment part of the policy from the MA portfolio
- to permit the splitting of liabilities into different parts in respect of group death in service dependants annuities (GDAs), so that the in-payment annuities can be included in the MA portfolio, and to allow for future premiums under the group policy.

The PRA notes that a number of responses to the consultation raised the issue of potential deferrals of premium payments in the context of bulk purchase annuities. Where a BPA agreement between a pension scheme and an insurer includes a deferral of premium, this potentially conflicts with the requirement that there are no future premium payments under MA eligible liabilities. The PRA has decided not to change the draft policy to relax this rule for BPA agreements. It does comment, however, that “*in some cases an agreed partial deferral of the payment of a premium may not constitute a future premium on a liability*” and that “*a partial deferral of a premium payment may not necessarily cause a liability to be ineligible for inclusion in MA portfolios*”. The PRA does not expand on these comments.

### Sub-investment grade (SIG) assets

The effective cap on SIG assets under the onshored Solvency II regime is not being replicated in the new matching adjustment requirements. In CP19/23, however, the PRA consulted on a number of safeguards around the use of SIG assets, including an expectation that investment in SIG assets should be at prudent levels. The PRA has made only minor changes to its proposals in this area in response to feedback:

- It has included reference to a wider range of metrics in SS7/18 where firms are monitoring sub-investment grade (SIG) assets in their MA portfolios.
- It has made a minor amendment to SS8/18 regarding the modelling of SIG assets under stress in a firm’s internal model, and confirms that it is for firms to decide how to achieve appropriate calibration of the internal model following the removal of the SIG assets cap.

### Internal credit assessments

Despite quite a lot of feedback on the proposals regarding external assurance on internal credit assessments, the PRA is not changing its draft policy in this area. It does confirm in response to feedback that assurances can in principle be obtained from non-Credit Rating Agency providers, if they have the correct level of expertise.

Some changes have been made to SS3/17 regarding the expected criteria for the individual with responsibility for the internal credit assessment function.

## MA permissions and breaches

In CP19/23 the PRA proposed some relaxations of processes relating to MA permissions, including a streamlined process for less complex assets and a removal of the cliff-edge withdrawal of MA approval where a breach of conditions is not rectified within two months. A number of amendments have been made to the policy proposals following feedback:

- The extent of documentary evidence which firms will generally be expected to submit to support an MA application has been reduced. The PRA will rely more on confirmatory statements from the firm in some areas, e.g. regarding compliance with the prudent person principle. Further information should still be available upon request where required by the PRA.
- The PRA will publish an annual report on application review timelines and decision rates.
- A new provision has been added to the MA Statement of Policy clarifying that the PRA will communicate to the firm the reasons for a refusal for permission to apply an MA or to vary a permission.
- A number of amendments have been made to SS7/18 and the MA Statement of Policy to remove references to “new risks” triggering a requirement to apply to vary an MA permission.
- A minor change to the MA Statement of Policy has been made to clarify that firms are not necessarily required to await the decision on one MA application before submitting a further application.
- In response to feedback suggesting additional changes to the MA permissions process, the PRA comments that it has “*commenced engagement with the life insurance industry to obtain an appropriate range of ideas and views in this area, and will monitor the effectiveness of the new regime*”. Further changes in future may, therefore, be contemplated once the new regime beds in.
- The PRA has updated SS7/18 to clarify that it does not expect that firms should have to recalculate the SCR to recognise a reduction in MA following a breach of the MA eligibility criteria. It also confirms that firms using internal models can continue to allow for management actions to restore compliance with MA conditions (in calculating the SCR).

## Matching adjustment attestation

In CP19/23 the PRA set out its proposals to require a formal attestation regarding the appropriateness of the level of the fundamental spread used in the matching adjustment calculation. The PRA received fairly high levels of feedback on these proposals but has only made relatively minor changes to the policy consulted on. Changes include:

- Amendments to SS7/18 to include a simplified analysis process for corporate bond portfolios when considering the need for any fundamental spread additions.
- Amendments to SS7/18 to clarify the extent to which assets can be assessed at the level of homogenous risk groups when considering the need for fundamental spread additions.
- A new paragraph in SS7/18 to clarify the relationship of the Effective Value Test used for Equity Release Mortgage restructurings with the MA attestation requirements. The PRA confirms that it expects firms to use their own assumptions when considering the MA attestation (and whether any fundamental spread addition is required), but that these should not fall below the PRA’s published minimum parameters where the Effective Value Test is used.
- Amendments to clarify points around the timing of out-of-cycle attestations (i.e. ones triggered by a material change).
- Changes to the Rulebook to introduce a transitional period for the MA attestation. This means that the first required attestation will be in respect of the first financial year end from 31 December 2024, or where there is a material change in risk profile with an attestation reference date after 31 December

2024. Prior to 31 December 2024 firms may, but will not be required to, provide any annual or out-of-cycle attestations. Similarly, firms may at their own discretion start to apply voluntary fundamental spread additions with effect from 30 June 2024.

## Assumptions underlying the MA

Following feedback, very minor changes have been made to the new chapter in SS7/18 setting out key conceptual and technical assumptions underlying the MA. These include:

- additional commentary on the impact of the MA on insurers
- changes to improve clarity on the cost of downgrade calculation.

## Matching adjustment asset and liability information return (MALIR) data collection

In CP19/23 the PRA consulted on the introduction of a new formal annual reporting requirement for firms with permission to apply the MA - the MALIR. In PS10/24, limited changes have been made to the MALIR requirements, the most substantive of which is the removal of the proposed increase in the period for reporting asset cash flows from 50 to 100 years (compared with previous ad hoc data collections). Only detailed cash flows up to 50 years will be required, with discounted cash flows beyond that point to be reported at the last month of the 50<sup>th</sup> year.

Other changes include:

- merging some fields in the proposed MALIR template
- clarifying definitions of a number of asset types, including “Corporate Bonds”, “Covered Bonds” and “Sale and Leaseback Loans on Commercial Properties”
- introducing new asset types of “Other Loans” and “Other sovereign, Sub-sovereign, Quasi-government/Supranationals”
- some amendments to the instructions for the template to improve clarity.

## Notching

A proposal to increase the sensitivity of the fundamental spread to credit risk by introducing a notching requirement was included in the HM Treasury November 2022 response document and set out in CP19/23. The main change in PS10/24 from the proposals consulted on is that the requirement to reflect notching in the calculation of technical provisions will now be effective from 31 December 2024 rather than 30 June 2024. Firms can implement notching earlier if they wish to.

In addition, the PRA has updated its expectations to state that firms have six months from the date at which an asset first becomes an “assigned asset” - i.e., an asset in the MA portfolio used in the MA calculation - for a notched rating to become available. For assets which are assigned assets as at 30 June 2024, a notched rating is expected to be available from 31 December 2024.

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