Bank of England PRA

CP19/23 – Review of Solvency II: Reform of the Matching Adjustment

Consultation paper 19/23

Published on 28 September 2023

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Responses are requested by Friday 5 January 2024.

Consent to publication

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Responses can be sent by email to: CP19_23@bankofengland.co.uk.

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1: Overview

1.1 This Prudential Regulation Authority (PRA) consultation paper (CP) is the second PRA consultation needed to implement the conclusions of the **Solvency II Review**. It sets out the PRA's proposed reforms that will enable broader and quicker investment by insurers in their matching adjustment (MA) portfolios, while improving responsiveness to risk and enhancing firms' responsibility for risk management. The PRA considers that by adapting the MA rules for the features of insurance business in the UK and the financing demands of the wider economy, the proposals will allow the life insurance sector to play a bigger role in productive investment in the UK economy, while continuing to offer their policyholders the level of security determined by legislation.

1.2 This CP should be read in conjunction with CP12/23 – **Review of Solvency II: Adapting to the UK insurance market**, published on Thursday 29 June 2023. In particular, CP12/23 sets out details of the PRA's overall consultation plans for reforms to Solvency II, the background to the Solvency II Review and the structure of the reformed regime.

1.3 This CP has been prepared in accordance with the Government's **response** to its Solvency II review consultation in November 2022 (November 2022 statement), its accompanying draft **MA regulations** on reforms to Solvency II, and its planned delivery of the **Smarter Regulatory Framework** (SRF). This CP should be read in conjunction with these documents. The Government has also confirmed its intention to legislate to ensure that the PRA has the powers to implement the reforms in this CP in line with its November statement. The PRA has prepared this CP on that basis and the PRA will continue to work closely with the Government to implement the reforms announced in the November 2022 statement.

1.4 The Government outlined in its November 2022 statement the areas of MA reform that it would implement directly through legislation, (using the powers granted in the Financial Services and Markets Act 2023 (FSMA 2023)), and the areas of MA reform that would be implemented by the PRA. This CP sets out proposals for the areas of MA reform allocated to the PRA, and which have been designed in accordance with the anticipated legislation (ie the anticipated MA regulations that will be laid by the Government).

1.5 The proposals in this CP will both implement and work alongside reforms that the Government has chosen to legislate for directly. The PRA's reforms set out in this CP are intended 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 within the constraints of the Government's anticipated legislation. The PRA is grateful for the

constructive **input** from industry subject expert groups which helped inform the proposals, and is also grateful for the input from the Insurance sub-committee of the PRA Practitioner Panel, who were consulted on the development of these proposals during 2023. Building on this engagement, the PRA welcomes further data and evidence from stakeholders in response to this consultation to help inform its final policy decisions. The PRA judges that the reforms in this CP will advance its primary objectives of safety and soundness and policyholder protection while also advancing its secondary competition objective and its new secondary competitiveness and growth objective. The proposed reforms, and the key benefits that the PRA considers will arise from them are set out below.

The PRA's proposals and the key benefits

1.6 The proposed reforms included in this CP consist of the following:

Improving business flexibility

- **Widening the range of investments that firms may hold in MA portfolios**, by providing a clear framework to permit the inclusion of assets that do not have fixed cash flows. The reforms are made possible by safeguards over the resulting risks to policyholders. The reforms will increase the incentives for insurers to invest in a wider range of long-term, productive assets, including assets with construction phases. These changes include a proposal to allow firms to invest in assets with highly predictable (HP) cash flows (rather than fixed cash flows) subject to an allowance for the additional risks in these assets, and subject to the aggregate MA benefit from assets with HP cash flows being a maximum of 10% of the overall MA benefit claimed. The PRA considers this will ensure MA asset and liability cash flows will remain closely matched, and is in line with the November 2022 statement, including that the vast majority of assets in MA portfolios should continue to have fixed cash flows.

- **Expanding the types of insurance business that may claim MA**, to permit more insurance liabilities to benefit from the MA. This reform will increase incentives for good risk management practices such as close matching of asset and liability cash flows, thereby promoting the safety and soundness of firms, as well as facilitating competitiveness and growth.

- **Removing the limit on the amount of MA that may be claimed from sub-investment grade (SIG) assets,** to facilitate more investments close to and below the boundary between investment and SIG assets.

Being more responsive to the level of risk

- **Establishing a streamlined MA application process for a range of suitable assets**, which will be proportionate to risk. This will improve the efficiency of some MA

applications, allow firms to move more quickly when investment opportunities arise, and reduce the regulatory burden.

- **Making the regulatory treatment of breaches of MA conditions more proportionate**, which will provide for more flexible and proportionate consequences. The reforms will remove the cliff-edge effect of total loss of MA benefit[1], but will still incentivise timely management and rectification of breaches by reducing the MA benefit available to firms in breach of eligibility conditions.

- **Increasing the granularity of the fundamental spread (FS), where appropriate, to reflect differences in credit quality of firms' assets by rating notch**, to improve the risk sensitivity of the FS used to calculate technical provisions (TPs) while being pragmatic and proportionate by giving firms some flexibility of approach.

Enhancing firms' responsibility for risk management

- **Introducing an attestation process for the amount of MA benefit being claimed**, to ensure that firms own and are accountable for the MA, with an FS that is sufficient for the risks in their own portfolio of assets. This will reduce the systemic risk due to the existing FS being determined by a single, sector-wide regulatory model, and the potential mismatch between this single model and the wide range of investments that firms are, and will be, making. The proposals provide transparency on the PRA's expectations for attestation, outlining a proportionate process that firms could follow and clarifying its view of the key assumptions underlying the MA.
- **Clarifying expectations around the risk-management of SIG assets**, to promote good risk management and facilitate greater investment freedom. These expectations cover due consideration of the nature of the cash flows, continued compliance with the Prudent Person Principle (PPP) and appropriateness of any relevant internal model calibrations.

- **Formalising the data submitted to the PRA by firms on the assets and liabilities in their MA portfolios**, to gather more structured regular information on the type of assets and the quantum of the MA benefit arising from them, through a new Matching Adjustment Asset and Liability Information Return (MALIR). This will support the PRA's ability to focus supervisory activity towards areas that pose the greatest risk to its primary objectives while enabling a greater understanding of changes in the size and nature of MA portfolios over time, provide certainty for firms, and reduce any potential burden related to ad hoc MA data requests.

- **Converting expectations on internal credit assessments to requirements,** to complement and reflect the new structure of the Government's anticipated legislation in

[1]The cliff-edge effect within the existing framework may encourage firms that lose MA approval to sell assets in a disruptive manner.

this area. Specifically, certain existing expectations on internal credit assessments in SS3/17 will become PRA rules. This is not intended or expected to lead to a change in the PRA's supervisory approach, or to additional burden on firms.

- **Introducing an MA eligibility condition for firms to be able to demonstrate compliance with the Prudent Person Principle (PPP)**, to show how firms have assessed the suitability and the risks within the assets held in MA portfolios.

1.7 In addition, the PRA has taken the opportunity to make clarifications to existing policy by implementing minor changes to PRA guidance to bring this up to date with firms' current practices.

Chart 1: Impact of the proposals in this CP

End

Scope

1.8 This CP is relevant to all UK Solvency II firms, the Society of Lloyd's and its members and managing agents, and insurance and reinsurance undertakings that have a UK branch (third-country branch undertakings) where they are applying or have applied to use the MA. This CP will refer to these collectively as 'insurers' or 'firms' unless otherwise specified.

Background to the matching adjustment

1.9 The MA is a mechanism that allows insurers to recognise upfront as capital resources a proportion of the investment return (in excess of the risk-free rate) that they project to earn over the future lifetime on the assets matching their MA liabilities. The MA also provides a strong incentive for life insurers to closely match their asset and liability cash flows, which reduces prudential risks. The MA calculation relies on assumptions about how much of the investment return on those matching investments can be earned with a high degree of confidence, and how much risk insurers retain during the life of these investments.

1.10 Under Solvency II, the MA is applied as an increase to the liability discount rate; it is calculated by deducting an FS from the credit spread on the assets backing MA liabilities. The FS is intended to provide policyholder protection by covering the risks retained by an insurer on the assets matching its liabilities, predominantly credit risk. The MA impacts both the base valuation of an insurer's liabilities and those liabilities under stress (ie when determining solvency capital requirements).

1.11 The current Solvency II design of the FS is calculated as the sum of:

- the expected cost of losses from defaults (the Probability of Default, PD); and
- the expected cost of losses from downgrades (the Cost of Downgrade, CoD).

The FS is also subject to a floor based on a percentage of long-term average spreads (LTAS). For SIG exposures there is a further addition to the FS under Solvency II in order to limit the MA on those assets to that achievable on an equivalent investment grade asset.

Anticipated legislation on the matching adjustment

1.12 The November 2022 statement announced that the Government will legislate for certain reforms to the MA. In June 2023, the Government published draft MA regulations containing

provisions covering the MA framework and calculation.[2] The PRA anticipates that an updated version of these regulations will be laid in Parliament in the coming months (subject to the parliamentary timetable).

1.13 The proposals in this CP have been prepared, and are dependent, upon the assumption that the Government lays legislation in line with the approach stated in its November 2022 statement. This includes ensuring that the PRA has the necessary powers to implement these proposals, and allowing for the PRA to use its existing powers where appropriate. Specifically, the PRA anticipates that the Government's legislation will contain provisions that have been carried over from the existing Solvency II legal framework with several amendments summarised as follows:

- restatement of the MA and FS calculation to maintain the existing methodology and calibration of the FS, as updated (among other things) to remove an effective restriction on the amount of MA taken for SIG assets, and allow additions to the FS in certain circumstances;
- restating certain MA eligibility conditions from the **Solvency 2 Regulations 2015**, as updated (among other things) to broaden the MA eligibility criteria to go beyond only allowing assets with fixed cash flows within the MA portfolio;
- reforming the powers of the PRA where firms breach the MA eligibility conditions, including to remove the automatic revocation of MA approval after two months; and
- creating space for the PRA to make rules (and clarifying the scope of the PRA's rulemaking powers) in relation to, among other things, specifying adjustments to the FS to take into account the additional risks from non-fixed cash flows, specifying portfolio limits, notched credit ratings for the FS calculation, and further eligibility conditions.

Interaction of the PRA's proposals with anticipated legislation on the matching adjustment

1.14 The PRA has developed proposals that will both implement and work alongside the Government's anticipated legislation. Where relevant, the PRA's policymaking and rules are constrained by the anticipated legislation, so as not to undermine the Government's

[2]The Government has stated that it will use the power at section 138BA FSMA to grant the PRA flexibility to disapply or modify the application of any of its rules. The power will be exercised by statutory instrument (s.84 FSMA 2023). For details, please refer **to Draft Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations**.

legislative intent for the MA. Therefore, the PRA's baseline for this consultation is the MA framework and calculation in the anticipated legislation as set out above in paragraph 1.13.

1.15 The reforms proposed in this CP interact with the Government's anticipated legislation in the following ways:

- reforms that reflect anticipated Government legislation, including where that legislation envisages further PRA Rules; and
- reforms that the PRA is proposing to introduce via broader SRF principles to deliver a coherent and complete regulatory regime.

Changes to the structure of the PRA Rulebook

1.16 The PRA is proposing to create a new Matching Adjustment Part within the PRA Rulebook. This part of the Rulebook would comprise existing requirements from the Technical Provisions Part of the PRA Rulebook (updated as necessary), requirements arising from the Government's anticipated legislation, and other requirements being consulted on in this CP.

1.17 In the case of the calculations of the MA and FS, the PRA considers that restating these requirements arising from the Government's anticipated legislation directly in the PRA Rulebook ensures all firm-facing calculation requirements would be accessible for firms in a single location, rather than being split across legislation and PRA rules. The PRA considers that this approach would deliver the following benefits:

- it would maintain the clarity and coherence of the PRA Rulebook and thus advance the PRA's primary objectives of firms' safety and soundness and policyholder protection; and
- consolidating these requirements in one place would allow firms to more easily see, understand and apply the requirements for investing in a broader MA asset pool than is currently permitted, thereby advancing the PRA's secondary competitiveness and growth objective.

1.18 The PRA considers that there are no significant costs arising from this proposal.

1.19 The introduction of a new Matching Adjustment Part would also enable the PRA to operationalise its new rules with minimum overall impact on the wider Rulebook. The Part is intended to be free-standing and so capable of implementation alongside the other changes to the MA regime, in advance of the wider changes the PRA proposes to make to its Rulebook as part of the Solvency II reforms.

Expected implementation timetable

1.20 Subject to the Government's legislative timetable and responses to this consultation, the PRA plans to publish final policy and rules on the MA during Q2 2024 with an effective date of 30 June 2024, with all other changes related to the Solvency II review taking effect on 31 December 2024. Implementation of the MA provisions in June will mean that firms that use the MA will be able to take advantage of these MA reforms in advance of 31 December 2024.

1.21 The PRA notes that the existing standard formula solvency capital requirement (SCR) framework may not cover additional risks that may arise from the widening of the range of investments that firms may hold in MA portfolios (for example, the risks inherent in assets with HP cash flows). The PRA will consider reforms to the standard formula SCR framework at a future point in time, and as part of this will consider whether related reforms are necessary to ensure it remains coherent with the final MA rules.

1.22 The proposals on the MA will be part of the new UK prudential regime for insurers which will eventually be known as 'Solvency UK'. However, since the proposals are being consulted on in stages, for clarity and internal consistency of the PRA policy materials, the PRA will continue to refer to the regime as Solvency II until such time as the references to Solvency II can be changed across all relevant materials.

The PRA's approach to matching adjustment permissions

1.23 The PRA is publishing a draft Statement of Policy (SoP) to explain the PRA's approach to granting, varying, and revoking regulatory permissions in relation to the MA, and what will be required of them as part of the application. In particular, the SoP provides:

- details on initial applications to apply the MA, and applications to change the scope of an MA permission, covering the need for firms to confirm and provide evidence of compliance with the MA eligibility conditions, and specifics in relation to applications that include assets with HP cash flows;
- details on the more flexible approach to MA permissions being introduced which will provide firms with clarity around how such a process will work in practice as well as the type of applications that are most likely to be suitable for this approach; and
- details on how the PRA would exercise its power to revoke MA permissions in a proportionate manner.

Accountability framework

1.24 The PRA has a statutory duty to consult when introducing new rules and changing existing rules under s138J FSMA, or new standards instruments (s138S FSMA). When not making rules, the PRA has a public law duty to consult widely where it would be fair to do so.

1.25 In carrying out its policymaking functions, the PRA is required to comply with several legal obligations. Further, FSMA 2023 has added specific obligations for the PRA to engage with Parliament via the relevant parliamentary committees. The PRA will comply with these obligations for this consultation and future policymaking activity.

1.26 The PRA considers that, within the constraints of the Government's anticipated legislation, the proposals in this CP will advance its primary objectives to promote the safety and soundness of the firms that it regulates and secure an appropriate degree of policyholder protection. The proposals, which will implement and work alongside the Government's anticipated legislation on the MA, focus on changes needed to support the Government's decision to widen the potential range of assets that firms can invest in within an MA portfolio. Alongside this, and again consistent with the anticipated legislation, the PRA proposes to introduce new requirements that may mitigate the potential additional risks that may arise from these new investments, which the PRA considers will advance its safety and soundness and policyholder protection objectives. At the same time, the PRA considers that the proposals around this increased investment flexibility will also advance its secondary competition objective, and its secondary competitiveness and growth objective. UK firms' competitiveness may also be improved through the widened eligibility criteria, which could increase expected returns; and UK growth may benefit from investment flexibility reforms contributing to insurers meeting their commitments to the Government to invest in UK productive assets. More detailed analysis of the proposals against the PRA's objectives is set out in each chapter of this CP.

1.27 The proposals in this CP are designed carefully to work together as a package of reforms to achieve the benefits set out, while continuing to advance the PRA's objectives. For example, in the investment flexibility proposals, the PRA's judgement on the appropriate level of overall exposure to the MA benefit from assets with HP cash flows has informed the PRA's proposed approach to assessing FS additions. The PRA has sought to design a package which allows greater flexibility for firms in determining these FS additions due to the existence of a 10% exposure limit on the aggregate contribution that assets with HP cash flows can make to a firm's MA. In considering feedback to the consultation, the PRA will take into account whether changes to any individual proposals would continue to ensure an appropriate balance within the overall package.

Cost benefit analysis

1.28 In developing the proposals set out in this CP, the PRA has had regard to its objectives and a range of factors that contribute to the cost benefit analysis (CBA). The baseline for the CBA is the current onshored legislative framework as supplemented by PRA Rulebook material in force, together with the anticipated legislation in line with the November 2022 statement. Chapter 10 of this CP contains analysis of the expected costs and benefits of the specific proposals. A summary of key benefits and costs is outlined below. The PRA has only considered the impact of changes that may arise from its proposals. The PRA considers that the benefits of its proposals outweigh the costs.

1.29 As the focus of this CP is the MA, the CBA baseline does not include the following areas of Solvency II reform:

- the PRA has not taken into account the projected capital release arising from the Government's reform of the risk margin; and
- the PRA has not assessed one of the measures included in the November 2022 statement, regarding stress testing, which the PRA is taking forward separately during 2024.

Benefits

1.30 Relative to the baseline, the proposals set out in this CP would lead to improved firm risk management and advance safety and soundness of firms and policyholder protection, through:

- enhanced senior management responsibility and improved management of MA portfolios and their inherent risks, resulting from the attestation process and requirement to demonstrate compliance with the PPP;
- greater assurance from the attestation process that the FS reflects all risks retained by firms and that the MA can be earned with high confidence;
- ensuring that the additional risks from assets with HP cash flows are allowed for appropriately within the MA;
- maintaining the quality of matching between asset and liability cash flows through the introduction of additional controls for assets with HP cash flows; and
- improved monitoring and supervision of firms by the PRA, in turn helping to realise the benefits of other policy proposals.

1.31 The proposals could facilitate effective competition, international competitiveness and growth, through:

- a contribution to a more level playing field resulting from improved consistency of approach between firms;
- reduced barriers to investment as a result of the proposed streamlined MA application approach for suitable assets;
- greater clarity about how the investment flexibilities will be applied in practice, which is a key part of facilitating productive investment and supporting medium-to-long-term growth; and
- improved incentives for private insurance and saving provision resulting from a broader range of liabilities being MA eligible.

1.32 The proposals will lead to improved clarity of expectations on the calculation of best estimate cash flows, the methodology for determining the FS addition for assets with HP cash flows, the proposed controls to the quality of matching for assets with HP cash flows and implementing a more granular FS to reflect differences in credit quality through notching which will be set out at a high level in the Government's anticipated legislation.

1.33 Once embedded, the proposals could improve consistency across firms' approaches, and reduce supervisory burden in the longer term, through:

- a proportionate and more efficient focusing of resources within firms and the PRA through the proposed design of the attestation approach, controls for assets with HP cash flows, and a pragmatic approach to notched credit ratings;
- making the proposal to implement a more granular FS (through notched credit ratings) mandatory, which will improve risk sensitivity; and
- a regular, structured approach to MALIR data collection, rather than relying on the current ad hoc MA data requests.

1.34 The proposals could reduce some capital costs associated with complying with regulatory requirements through, among other things, proportionate regulatory treatment of breaches of MA conditions.

1.35 In terms of asset allocation, the PRA considers that the proposals support greater diversification of asset portfolios for firms as the proposals target a broader range of assets classes. Firms may further benefit from better affordability of traditional assets to match annuity liabilities.

Costs

1.36 The proposals set out in this CP would lead to some implementation and ongoing compliance costs to firms, through:

- the development of the proposed MA controls framework for firms that invest in assets with HP cash flows;
- the development of methodologies to determine appropriate FS additions for assets with HP cash flows;
- the development of processes and additional resource required for the preparation of the attestation report and supporting evidence;
- the development and maintenance of systems and processes to support mandatory application of the requirement for firms to adjust the FS to allow for differences in credit quality;
- the obtainment of independent, external assurance to test for bias in internal ratings; and
- the additional resource, processes, and systems required to support more frequent MA data returns.

1.37 Depending on the distribution of assets within each credit rating band, the proposals to require firms to use notched credit ratings rather than ‘big letter' ratings could also increase TPs slightly, to the extent that firms may historically have chosen to invest proportionately more in assets towards the lower end of each current rating band.

1.38 For the PRA, there would be increased supervisory costs, through:

- the review of firm applications as they invest in a wider range of assets, such as those with HP cash flows;
- the review of firms’ attestations; and
- the assessment of MA applications in respect of new liabilities.

1.39 In summary, the PRA’s assessment is that the package of proposals in this CP would continue to advance an appropriate level of protection for policyholders, and the safety and soundness of insurers within the constraints of the Government’s anticipated legislation, while facilitating effective competition, and international competitiveness and growth.

'Have regards' analysis

1.40 In developing the proposals in this CP to implement and work alongside the Government's draft MA regulations, the PRA has had regard to the FSMA regulatory principles, and the aspects of the Government's economic policy set out in the **HM Treasury (HMT) recommendation letter** from December 2022. FSMA 2023 includes a measure amending the FSMA regulatory principles. This measure adds a regulatory principle relating to the UK's net zero emissions target. The PRA has had regard to this matter.

1.41 The FSMA regulatory principles that are considered most material to the proposals in this CP are those relating to proportionality, efficient use of the PRA's resources, sustainable finance, the supply of long-term investment and transparency.

1.42 Recognising that the size and composition of MA portfolios can vary materially from firm to firm, the proposals have been designed to be proportionate in their impact. Examples of this include: the proposed attestation approach where the expectation is that most focus will be on assets where the risk profile materially differs from those used to calibrate the published FS tables, the implementation of notching, standard modelling approaches for assets with HP cash flows where there is limited relevant data and the exposure is controlled through agreed safeguards, and the consequences for breaching the MA eligibility conditions.

1.43 The PRA also expects its proposals to result in firms taking greater ownership and accountability for the calculation of the FS and MA and to demonstrate this in their attestation. The work firms do in this area should allow the PRA to target its supervisory resources more efficiently.

1.44 On sustainable finance and the supply of long-term investment, the widening of the asset eligibility criteria should give firms greater scope to invest in a broader range of assets.

1.45 The PRA considers that the proposals are in line with the principle of transparency since the policy materials the PRA proposes to amend or introduce are intended to give increased clarity to firms over the PRA's intended approach to the MA and its expectations of firms.

1.46 The HMT recommendation letter (December 2022) focuses on competitiveness and growth in the interests of consumers and businesses. The PRA considers that its proposals will support both the competitiveness of the UK and (particularly by increasing competition and reducing costs) will also support growth and benefit consumers. By working alongside the Government's intention to revoke retained EU law and replace it with a structure set out in the MA regulation and rules designed for the UK, the proposals in this CP are aligned with the Government's plan to swiftly implement the outcomes of the SRF (supporting competitiveness), and its aim to deliver smart regulatory reform (supporting growth).

1.47 The 'have regards' that gave rise to particularly significant issues for consideration in relation to the proposals in this CP are set out in Chapter 11. Where analysis has not been provided against a 'have regard' for a proposal, it is because the PRA considers that 'have regard' to not be a significant factor for that proposal.

Impact on mutuals

1.48 The PRA has a statutory obligation to consider the impact of its proposals on mutual societies (s138K FSMA), referred to as 'mutuals'. The PRA considers that the impact of the proposals in this CP on mutuals is expected to be no different from the impact on other firms.

Equality and diversity

1.49 In making its rules and carrying out its policies, services, and functions, the PRA is required by the Equality Act 2010 to have due regard to the need to eliminate discrimination, to promote equality of opportunity, and to foster good relations between persons who share a protected characteristic and those who do not. In line with its responsibility under the Equality Act, the PRA has performed an assessment and considered the equality implications in formulating its proposals.

1.50 The design and calibration of the MA (including the eligibility requirements for assets held in firms' MA portfolios) have the potential to influence, commercially, the volume of business firms are prepared to write as well as the premiums charged to consumers. This includes products that are relevant to those with the protected characteristics of age (eg annuities and equity release mortgages (ERMs)) and disability (eg income protection policies).

1.51 The PRA will continue to consider the equality and diversity implications of the proposals during the consultation period, and in relation to further consultation concerning future operative proposals.

Changes to PRA rules and policy materials

1.52 The proposals set out in this CP would result in changes to the following parts of the PRA Rulebook and existing policy materials:

Table 1: Changes to PRA rules and policy materials

Policy material	Proposals
PRA Rulebook:	**The instrument would introduce new parts of the PRA Rulebook, as follows:** Matching Adjustment
PRA Rulebook:	**The instrument would amend the following Parts of the PRA Rulebook:** Technical Provisions Conditions Governing Business Reporting Glossary
Supervisory statements (SS)	**This CP would amend:** Solvency II: Matching adjustment (SS7/18) Solvency II: Internal models – modelling of the matching adjustment (SS8/18) Solvency II: Illiquid unrated assets (SS3/17) Solvency II: Prudent Person Principle (SS1/20)
Statements of policy	**This CP would introduce:** Draft SoP Solvency II: Matching Adjustment Permissions

1.53 Appendix 2 of this CP sets out the proposed draft rules in full for the proposals being consulted on.

1.54 For SS3/17 and SS7/18, given the number of textual changes necessary to the documents, the main documents accompanying CP19/23 are a clean version of the proposed updated statements. However, the PRA is also providing a version with changes marked up (relative to the current published version), to support an understanding of the changes. The

PRA's proposed amendments to SS8/18 and SS1/20 are in the PRA's standard format, providing details of the paragraphs the PRA is proposing to add, change or delete.

1.55 References related to the UK's membership of the EU in the policy materials covered by this CP have been updated as part of these proposals to reflect the UK's withdrawal from the EU. Unless otherwise stated, any remaining references to EU or EU-derived legislation refer to the version of that legislation which forms part of retained EU law.

1.56 Where the draft rules and policy material included in this CP include references to retained EU law that is not addressed in this CP or the Government's anticipated legislation on the MA, the drafts continue to cross refer to the retained EU law (as onshored). When making any rules and issuing final policy material in relation to drafts included in this CP, those cross references will be updated to refer to any requirements as they have been absorbed into the PRA's rules or other parts of the overall framework at that point in time.

Responses and next steps

1.57 This consultation closes on Friday 5 January 2024. The PRA invites feedback on the proposals set out in this consultation, including:

- the specific reform proposals per chapter;
- the CBA set out within Chapter 10; and
- the implementation timeline set out above.

1.58 Appendix 1 sets out a list of questions to guide responses to this consultation. In respect of the investment flexibility chapter in particular, the PRA welcomes feedback, both quantitative or qualitative, on its proposed approaches to allow for the additional risks in assets with HP cash flows, and would encourage respondents to provide relevant data and evidence wherever possible to inform the PRA's final policy decisions.

1.59 Please address any comments or enquiries to **CP19_23@bankofengland.co.uk**. Please indicate in your response if you believe any of the proposals in this CP are likely to impact persons who share protected characteristics under the Equality Act 2010, and if so, please explain which groups and what the impact on such groups might be. Your responses may be shared with HMT and/or the FCA. This means HMT and/or the FCA may review the responses and may also contact you to clarify aspects of your response.

2: Investment Flexibility

2.1 This chapter sets out the PRA's proposed changes to the MA framework to widen the range of assets that can be included in firms' MA portfolios. It is anticipated that the Government's MA regulations will widen the conditions for MA permission to allow for a limited proportion of assets with non-fixed cash flows to be included in the MA portfolio, subject to the risks to the quality of matching not being material and where the PRA determines the limited proportion. Accordingly, this chapter sets out the proposed changes to the MA framework to enable this expansion while also advancing the PRA's objectives.

2.2 The policy proposals in this chapter would:

- introduce new rules and expectations in relation to criteria for the inclusion of a wider range of assets in firms' MA portfolios beyond those currently eligible;
- introduce new expectations and rules in relation to controls on the quality of matching to account for the additional sources of cash flow uncertainty introduced by the extension to asset eligibility;
- introduce new expectations and rules in relation to approaches for the determination of FS additions for the additional retained risks arising from non-fixed cash flows on these additional assets; and
- introduce new expectations and rules in relation to approaches for the determination of best estimate cash flows for these additional assets.

2.3 The proposals in this chapter would:

- amend the PRA Rulebook Glossary (Appendix 2);
- introduce particular elements of the new Matching Adjustment Part of the PRA Rulebook (Appendix 2);
- introduce particular elements of the new statement of policy (SoP) – Solvency II: Matching Adjustment Permissions (Appendix 7). This SoP sets out the approach for how the PRA will grant new, and variations to, MA permissions for individual firms.
- make changes to SS3/17 – Solvency II: Illiquid unrated assets (Appendix 5);
- make changes to SS7/18 – Solvency II: Matching adjustment (Appendix 3);
- make changes to SS8/18 – Solvency II: Internal models – modelling of the matching adjustment (Appendix 4); and

- make changes to SS1/20 – Solvency II: Prudent Person Principle (Appendix 6).

2.4 The PRA considers that these proposals will facilitate increased investment flexibility over the assets that may be held in MA portfolios, increasing the incentive for insurers to invest in a wider range of assets including long-term productive assets. These proposals would provide firms with a clear framework to include additional types of assets in their MA portfolios, and to make appropriate allowance for the additional risks involved. The PRA considers that the proposals in this chapter represent a package, and that changes should be assessed in that context (see Chapter 1 of this CP for more details).

2.5 The proposed rules and expectations in relation to the updated eligibility conditions, quality of matching and determining any FS additions have been developed to mitigate the additional risks which may arise from the increased investment flexibility and hence advance the PRA's primary objectives. The proposals may also advance the PRA's secondary objectives, facilitating effective competition, and international competitiveness and economic growth by promoting investment in UK productive assets, and also leading to more competitive pricing for annuity business.

Widening matching adjustment asset eligibility beyond the fixed cash flows requirement

2.6 **Article 42(4)(k) of The Solvency II Regulations (2015)** currently requires that to be eligible for inclusion in an MA portfolio, asset cash flows must be 'fixed and cannot be changed by the issuers of the assets or any third parties'. The current regulations include a limited exception for inflation-linked assets and for assets that provide 'sufficient compensation' on early repayment. The PRA has also set out detailed expectations in Chapter 2 of SS7/18 about the circumstances in which it will consider asset cash flows to be fixed, and the PRA proposes that these expectations will continue to apply.

2.7 The anticipated MA regulations will widen the MA asset eligibility conditions to go beyond the current requirement for fixed cash flows, to allow a limited proportion of asset cash flows that are capable of being changed by the issuers of the assets or any third parties. In its November 2022 statement, the Government set out that those additional assets should have 'highly predictable cash flows', and furthermore that it expected that the vast majority of assets in MA portfolios would continue to have fixed cash flows (the current eligibility requirement). Further, the Government also set out that, for those additional assets, the PRA would be able to, for example: 'specify increases to the fundamental spread allowances to take into account the additional risks from non-fixed cash flows', as well as to apply portfolio limits.

2.8 The draft MA regulations specify that for such assets the risks to the quality of matching must not be material and that only a limited proportion of the portfolio (as determined by the PRA) may be affected.

2.9 Consistent with the anticipated legislation the PRA's proposals set out:

- criteria for the inclusion of additional asset cash flows that are not fixed or are capable of being changed by the issuers or any third parties;
- a controls framework to manage the non-fixity risks from individual assets, groups of assets and at a portfolio level;
- the application of FS additions to take into account the additional risks from non-fixed cash flows; and
- an approach to the setting of best estimate cash flows.

Criteria for the inclusion of assets with highly predictable cash flows

2.10 The PRA proposes that in order for additional assets to not give rise to material risks to the quality of matching, it is necessary for them to meet certain criteria. In particular, the PRA proposes that the additional assets, with cash flows that are capable of being changed by the issuers of the assets or third parties, that can be included in MA portfolios must satisfy the following criteria:

- the cash flows are contractually bound, and failure to meet the contractual terms is a default event;
- the contractual bounding applies to the timing of cash flows; and
- the contractual bounding applies to the amount of the cash flows.

2.11 The PRA considers that assets that meet the additional criteria may be considered as producing HP cash flows.

2.12 The additional assets with cash flows that are capable of being changed by the issuers of the assets or third parties must also meet the other relevant MA conditions as set out in the draft MA regulations, including:

- 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 the undertaking's internal credit assessment of a comparable standard.

2.13 The PRA also proposes an additional MA eligibility condition, relevant to all assets, that firms must demonstrate that the assets can be managed in line with the PPP (see Chapter 5 of this CP).

2.14 For assets with HP cash flows, the PRA considers contractual bounding in both timing and amount to be necessary to be able to ensure that an MA benefit can still be earned with a high degree of confidence. Further, contractual bounding supports both the credit assessment process and determining when an asset defaults.

2.15 Some assets may have contracts that do not specify upper bounds on the cash flow amounts, such as leases with 'upward only rent increases'. The PRA considers that the upper bounding of cash flow amounts for such assets may be demonstrated through the use of appropriate assumptions for the rate of any future escalation. The extent to which firms assume increases that are above the contractual minimum would be assessed in the context of risks to the quality of matching and with regards to the economics of the asset.

2.16 The PRA has previously set out in SS7/18 examples of possible contractual clauses which it considers enable the relevant assets to be assessed as producing 'fixed' cash flows. The PRA proposes to clarify the circumstances in which particular types of assets are likely to satisfy the PRA's expectations for assets with fixed cash flows, rather than as assets with HP cash flows.

2.17 Where assets have cash flows in one of the forms below, the PRA expects the MA regulations will allow these to be held in MA portfolios and thus the PRA proposes that these should be considered as assets with fixed rather than HP cash flows:

- fixed and cannot be changed by the issuers of the assets or any third parties;
- fixed except for a dependence on an inflation index, and the assets replicate the cash flows of the portfolio of insurance or reinsurance obligations that depend on inflation; and
- where issuers or third parties have the right to change the cash flows of an asset, provided the investor receives sufficient compensation to allow it to obtain the same cash flow by re-investing the compensation in assets of an equivalent or better quality.

The PRA proposes that, where the expectations set out in Chapter 2 of SS7/18 are met, certain assets should be considered as assets with fixed rather than HP cash flows. The PRA

considers that this will result in assets in existing MA portfolios being in the ‘fixed’ component following implementation of these proposals.

2.18 The PRA considers that where assets or pools of assets have previously been restructured to create an asset that met the ‘fixity’ requirement, firms may seek to include these in MA portfolios in an unrestructured form where they meet the proposed MA eligibility condition in the draft MA regulations and the PRA’s Rulebook. The PRA proposes that this would require a new MA application and that firms considering this should engage early in any such process with their PRA supervision team.

2.19 The PRA considers that these proposals will reduce the cost to firms of restructuring assets, either by permitting further assets in MA portfolios without restructuring or, in other cases, by including further cash flows from internally restructured assets. In the latter case this could be by the creation of mezzanine notes, where those notes have HP cash flows. The removal of the limit on the amount of MA benefit that may be recognised on SIG assets would further benefit such assets. These would count towards the overall limit on total exposures of additional risks (as set out in the next section). The PRA expects that the additional risks for such assets would normally be assessed by comparing the asset to a fixed cash flow alternative.

2.20 The PRA’s proposals in respect of the criteria for inclusion of assets with HP cash flows in MA portfolios are reflected in the new Matching Adjustment Part of the PRA Rulebook (Appendix 2) and changes to SS7/18 (Appendix 3).

Controls on the quality of matching

2.21 The PRA considers that without adequate controls, assets with HP cash flows have the potential to reduce the quality of matching in MA portfolios. It also has the potential to introduce material new risks to an MA portfolio. To manage this, the PRA proposes that the controls framework (including rules, guidance and the matching tests set out in SS7/18) for MA portfolios be extended and amended as follows:

- That a maximum of 10% of the total MA benefit of an MA portfolio may be generated by assets with HP cash flows;
- That assets with HP cash flows may be subject to additional safeguards considered appropriate by firms to ensure that the risks to the quality of matching are not material;
- The introduction of two further asset-liability matching tests, applicable only to firms investing in assets with HP cash flows;

- A minor amendment to Matching Test 1 to expect firms to model cash flows with a cash flow pattern that is consistent with their approach to asset–liability matching; and,
- A minor amendment to Matching Test 2 to expect firms to model HP cash flows with a cash flow pattern that is consistent with the market stress scenario being applied.

2.22 The PRA is proposing that, consistent with existing guidance on the use of restructuring as set out in SS7/18, where assets meet the eligibility conditions for HP cash flows, they should be included directly into MA portfolios. Where a firm has sufficient data to model the cash flow variability risks, it may be possible to increase investment through making use of a restructure that results in MA eligible notes. The value from the securitisation including the MA benefit and the value of any residual interest should not be expected to be greater than that including the assets in the MA portfolio in un-securitised form.

2.23 An MA permission condition as set out in the draft MA regulations is that 'any mismatch between the expected cash flows [of the assets and liabilities] must not give rise to risks which are material in relation to the risks inherent in the insurance or reinsurance business to which the matching adjustment is applied.' The PRA considers that changes to asset cash flows by the issuers of assets or third parties arise from two sources: (i) economic (pure) variability, and (ii) non-economic (event) variability.

2.24 Economic variability is most commonly seen in callable bonds, where the borrower has the option of when to redeem the asset within a bounded range of timings. There are often strong market price signals indicating the expected redemption date reflecting rational economic behaviour. Other examples of rational economic behaviour driven variability include future rent increases that are linked to an index, and Residential Mortgage-Backed Securities where prepayment behaviour may be linked to the economic cycle.

2.25 Non-economic variability is most commonly seen in assets where the borrower has options that are contingent on particular specified events that are specified in the contract, for example in the event of the destruction of the underlying asset there is an option to redeem at par on the receipt of an insurance payment.

2.26 Both types of variability can result in:

- Cash flows being received earlier than expected, for example where a callable bond is redeemed earlier than expected;
- Cash flows being received later than expected, for example where a callable bond is redeemed 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; and,

- 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.

2.27 The inclusion of such cash flows would introduce new risks to MA portfolios. The PRA considers that these risks can broadly be categorised as reinvestment risk or liquidity risk.

2.28 The PRA recognises that the additional reinvestment and liquidity risks posed by such assets may be idiosyncratic and hard to model. Models used to calculate the SCR are unlikely to be the most appropriate approach to capturing the cash flow matching risks that may arise in MA portfolios, hence the need for a controls framework The PRA therefore proposes safeguards be applied to manage these risks, to both (i) total exposures of additional risks and (ii) where considered appropriate, for individual assets, or groups of assets.

Total exposures of additional risks

2.29 The PRA considers it important that, to support safety and soundness and policyholder protection, the vast majority of MA cash flows remain fixed. The PRA proposes making a rule that a maximum of 10% of the total MA benefit of an MA portfolio may be generated by assets with HP cash flows. The PRA considers that a cap on the MA benefit at this level would be appropriate and consistent with the risks arising from the lower quality of matching arising from those assets being assessed as not material, and therefore not undermining the PRA’s primary objectives. The PRA also considers such a rule to be a practical and faithful implementation of the November 2022 Statement which set out in paragraph 4.5 that ‘the Government would still expect the vast majority of assets in matching adjustment portfolios to have fixed cash flows’. The PRA further considers that this limit, along with other proposed reforms to the Solvency II framework, would not constrain firms from meeting their stated commitments to Government to increase investment in productive long-term finance, unlocking tens of billions of pounds for potential investments at implementation and hence advancing the PRA's growth objective over the medium to long term.

2.30 The PRA has considered other potential formulations of this rule, including to limits based on market values or undiscounted cash flows. The PRA considers that the proposed rule is a more appropriate outcome based measure as it is more sensitive to the key drivers of risk to the MA benefit being earned: duration; credit spread; and FS. For example, a limit based on undiscounted cash flows would give equal weight to a cash flow payable in one year and an identical cash flow in fifty years, even though the latter would have a significantly lower present value; and a market value based limit would mean that two investments of the

same value but very different durations would inappropriately equally contribute towards the limit. The PRA considers that firms already have methodologies for the hypothecation of matching assets within MA portfolios which will both support compliance with this rule, and allow firms to use the full allowance in changing market conditions.

2.31 This rule supplements an MA permission condition that will be set out in the anticipated MA regulations, and accordingly any breach, as set out in Chapter 5 of this CP and in the SoP (Appendix 7), will need to be rectified within two months, after which a reduction in MA benefit may be required.

Individual assets or groups of assets

2.32 The PRA proposes that firms should consider whether further safeguards would be appropriate to ensure that the risks to the quality of matching are not material. The PRA considers that such safeguards, such as exposure limits proposed by firms which would become part of the MA permission conditions, may also support the PRA in reaching a decision on the MA application where it helps address limitations in FS addition modelling approaches and/or to support the use of a streamlined MA application process (see Chapter 5 of this CP and Chapter 3 of the draft SoP (Appendix 7)).

2.33 In order to comply with the PPP, firms should determine internal quantitative investment limits for the assets they are proposing to invest in. These limits should reflect the firm's investment and risk management expertise and the experience data available with respect to the additional risks being introduced into the firm's MA portfolio. The PRA considers that firms keeping these individual asset/asset type investment limits under review and amending such limits as appropriate as firms' risk management capabilities for these assets develops, is consistent with good risk management practices.

Additional Matching Tests

2.34 As the MA is predicated on asset cash flows matching liabilities cash flows, the PRA's implementation of Solvency II included three tests to assess the quality of matching set out in SS7/18. As set out above, assets with HP cash flows introduce two new risks to the quality of matching: reinvestment risk and liquidity risk. Accordingly, the PRA proposes two additional matching tests and including an assessment of the risks from assets with HP cash flows in firms' liquidity plans. For each matching test, the PRA sets out in SS7/18 the methodology and test threshold above which firms would be expected to report and explain breaches.

2.35 The additional Matching Test 4 would assess reinvestment risk by considering the MA benefit loss that may occur should HP cash flows not be received as expected. Firms would model the worst MA benefit scenario for each asset with HP cash flows. Where this results in

the asset being redeemed earlier than expected, firms may assume the proceeds are invested at a prudent rate for the residual term outstanding.

2.36 The additional Matching Test 5 would assess the additional liquidity risk that may occur should HP cash flows not be received as expected. Liquidity risk may result in firms being forced sellers of assets, which is contrary to the premise of the MA. Firms would model the lowest cash flows permitted under the contract, where necessary extending any redemption date. The test is broadly of the same format as Matching Test 1.

Change to Matching Test 1

2.37 A minor amendment is proposed to Matching Test 1 to expect firms to model cash flows with a cash flow pattern that is consistent with their approach to asset-liability matching. This will permit firms to use a more frequent modelling interval than the current requirement of annual, which may support improved monitoring of the quality of matching using this test.

Change to Matching Test 2

2.38 A consequential amendment is proposed to Matching Test 2 to expect firms to model HP cash flows with a cash flow pattern that is consistent with the market stress scenario being applied.

2.39 The PRA also proposes including in the MALIR (Chapter 8 of this CP) relevant information to monitor exposures to assets with HP cash flows.

2.40 The PRA's proposals in respect of controls on the quality of matching in MA portfolios are reflected in the new Matching Adjustment Part of the PRA Rulebook and changes to SS7/18.

Fundamental spread additions for assets with highly predictable cash flows

2.41 The FS should reflect all of the risks retained by firms.[3] As noted in the previous section, assets with HP cash flows have additional risks arising from the potential for cash flows to vary, including reinvestment and liquidity risks. The specification of the FS and the assets used in the calibration of the FS tables published by the PRA do not capture those risks. FS additions are therefore necessary for assets with HP cash flows.

[3] Technical Provisions 7.2(2) of the PRA Rulebook.

2.42 The November 2022 statement set out that 'the Government will ensure that the PRA has the powers necessary to adapt the MA regime to reflect these issues including through a higher fundamental spread allowance for assets without fixed cash flows'.

2.43 Where assets have HP rather than fixed cash flows, there is increased uncertainty for investors which may be compensated for within the asset pricing and hence credit spread. The materiality of this additional spread can be expected to vary, but in some cases, it could be material.[4] The PRA recognises that this potential cash flow variability is not a breach of the bond's contractual conditions and therefore is not typically allowed for in the credit rating. In some cases, early repayment (without adequate compensation to replace the redeemed cash flows) is permitted to avoid default, so such an option may in practice be used to enhance a credit rating.

2.44 The PRA considers that the reward for the additional risks due to a lack of fixity should not give rise to an MA benefit because they cannot be relied upon, even by a hold to maturity investor, to earn returns with high confidence. Therefore, that part of the spread that arises from lack of fixity of cash flows should be part of the FS, and not be used to increase Tier 1 (T1) capital before it has been earned. Accordingly, the PRA's overarching policy objective for the FS addition is for there to be an appropriate provision for the additional risks to matching from potential variations to cash flows and that any increase in credit spread which is compensation for cash flow variability does not result in an increased MA benefit for firms.

2.45. The PRA proposes a new rule that firms must be able to identify all sources of uncertainty in cash flow timing and/or amount, and to be able to make adequate allowance for these additional risks. To assist firms, the PRA also proposes to add guidance in Chapter 5 of SS7/18 on how firms can demonstrate making adequate allowance for these risks through a combination of projecting appropriate cash flows and additions to the FS. The PRA recognises that in many cases data will be scarce, leading to modelling challenges. In order to expedite investment decisions, the PRA proposes to allow standard methodologies to be used.

2.46 The PRA notes that the PPP requires that firms should be able properly to identify, measure, and manage the risks on the assets in which they are invested. The PRA proposes that firms should include details of the sources of cash flow uncertainty and how they have made allowance for this as part of their application to apply the MA.

[4] See for example the analysis of callable corporate bonds in R. Jarrow et al Reduced-form valuation of callable corporate bonds: Theory and evidence. Journal of Financial Economics 95 (2010) 227-248.

2.47 The proposed expectations set out principles for determining the FS addition including that:

- the FS addition should be sized such that, for a diversified portfolio of exposures that have HP cash flows, it covers a target percentile of the distribution of potential losses; and
- there should be a de minimis level of FS addition to reflect the reinvestment and portfolio rebalancing costs incurred from changes to cash flow patterns.

2.48 The PRA proposes a minimum FS addition of 10 basis points as an estimate for reinvestment and/or rebalancing costs. This reflects normal market conditions and is based on PRA analysis and market intelligence. Where firms have their own experience data to justify an alternative allowance for the total costs of trading assets in their MA portfolios, they may include this in their application.

2.49 The PRA considers that when determining the addition to the FS for assets with HP cash flows, firms ideally should be able to model a distribution of losses which would arise from uncertainty in the timing and/or amount of assets. The PRA recognises however, that for many assets with HP cash flows firms are unlikely to have sufficient data to model a loss distribution robustly. The PRA is therefore proposing that firms could adopt a standard, approximate approach, to making adequate allowance for the additional risks so that challenges identifying relevant and credible data should not be a barrier to timely investment.

2.50 More sophisticated modelling of the cash flow variability may be possible over time where relevant, credible data becomes available. The PRA is proposing guidance on the factors firms should consider when proposing to move to a more sophisticated approach for determining the FS addition in Chapter 5 of SS7/18.

2.51 For assets with economic variability, the PRA proposes that under a standard approach firms could project cash flows on a yield-to-worst basis together with a minimum FS addition for reinvestment and/or rebalancing costs. The PRA considers that more sophisticated modelling of such variability may be possible and that a market consistent approach would be an appropriate way to determine the relevant addition to the FS. Accordingly, firms may consider using a risk-neutral probability best estimate cash flow projection and then provision for the risks from changes to the cash flow pattern by considering the cost of the optionality under that projection. Given the lower reliance of this type of modelling on asset-specific data, the PRA expects sophisticated modelling the FS addition for these assets to be more common, albeit complemented by a standard approach that is expected to be a useful backstop to prevent delays in making initial investments while models are developed.

2.52 For assets with non-economic variability, the PRA considers that the modelling of a distribution of losses is likely to be more complex and, as noted above, in most cases firms are unlikely to have sufficient credible data to allow them to do this robustly. For the standard approach, the PRA proposes that firms provision a proportion of the difference in MA benefit arising from the worst case (from cash flow variation) outcome and the MA benefit arising from the best estimate (median) cash flow projection. Where assets can be repaid early then the PRA expects that the typical worst-case outcome will be a minimum MA benefit of zero, but this assumption should be considered in light of the prevailing operating conditions, for example where assets are trading above par and could be repaid immediately.

2.53 The PRA recognises that for such assets there is likely to be a wide range of sources of cash flow variation and therefore it is difficult to set a uniform expectation for the FS addition which would be suitable for all risks. The PRA considers, however, that an adequate allowance for a diversified range of cash flow uncertainty, taking into account the anticipated data limitations, is unlikely to be less than one quarter of the difference in MA benefit arising from worst case and best estimate cash flows at the point of investment. In practice, this would allow firms to retain up to three quarters of the additional MA benefit above the lower bound of the worst-case outcome, even in the absence of data to support more accurate estimates. The PRA recognises that there may be some variation in the proportion of the additional MA benefit retained by firms given the range of sources of cash flow variability, and that where firms have credible data, they may be able to justify retaining a higher proportion for particularly remote risks. The PRA will expect firms to assess the ongoing adequacy of the provision for the risks arising from cash flow variability and update the allowance within the agreed methodology as necessary.

2.54 The PRA considers that non-economic variability risks are more likely to be best represented by heavier-tailed distributions. The PRA considers that a provision of one quarter of the difference in MA benefit from median to worst cash flows is broadly equivalent to the 85th percentile of a fatter tailed distribution[5]. Where more complete and credible data does become available to support more sophisticated modelling, the PRA considers that targeting the 85th percentile of the modelled loss distribution would likely demonstrate adequate provision for the additional retained risks given the requirement for the MA to be able to be earned with a high degree of confidence. Given the higher reliance of this type of modelling on asset-specific data, which is expected to be scarce, the PRA expects modelling the FS addition for these assets to be less common and anticipates greater use of the standard approach.

[55] The ¼ of difference between median and worst MA outcomes would approximate to target c.80th percentile for Normal distribution, and for a T distribution with low degrees of freedom c.90th percentile.

2.55 The PRA considers it important that the FS addition be reviewed regularly to ensure it remains appropriate as operating conditions may change and also given any updated experience data for the variability. Chapter 6 of this of this CP outlines the PRA's proposals on attestation, the purpose of which is to ensure firms are accountable for the MA benefit being claimed, and the PRA proposes that the ongoing appropriateness of the FS addition should be within the scope of firms' attestations.

2.56 The PRA proposes that the additional FS allowance for cash flow variability be captured in the 'component B' assets that also provision for the cost of downgrades and any long-term average spread component of the FS. In practice, this would mean firms applying the 'basic' FS (as set out in Chapter 5 of SS7/18), and then the additional FS for assets with HP cash flows. The PRA has considered an alternative approach of applying the FS addition before the de-risking of all asset cash flows as this would adjust the shape of the expected cash flows to be consistent with those for fixed cash flow assets. The PRA considers that while this alternative approach has some technical merit, the proposed approach results in a nearly identical BEL (and hence MA benefit) but with significantly less complexity, operational risk and hence cost for firms.

2.57 The PRA's proposals in respect of FS additions are reflected in the new Matching Adjustment Part of the PRA Rulebook and changes to Chapter 5 of SS7/18. The PRA welcomes feedback, both qualitative and quantitative, from respondents on its proposed approach to FS additions and calibration of the parameters for standard approaches, and would encourage respondents to provide relevant evidence to help inform the PRA's final policy decisions.

Determining the best estimate cash flows

2.58 The PRA proposes that firms be given discretion over the methodology used to project HP cash flows. The methodology could be deterministic or statistical but should make full use of available market data and be proportionate to the scale of the risks posed by the asset.

2.59 Assets with HP cash flows do not have a uniquely defined set of contractual payments. For these assets, firms will therefore need to define a view of the best estimate set of cash flows for the following regulatory purposes:

- calculating the size of the MA;
- assessing the quality of matching; and
- inputs into the model used to calculate the SCR.

2.60 The best estimate liabilities (BEL) should 'correspond to the probability weighted average of future cash-flows…'.[6] 'The PRA considers that such an approach should be the default methodology for determining a best estimate payment profile for asset cash flows. However, the PRA considers that challenges to this approach include:

- Asset portfolios may include relatively small numbers of large investments with HP cash flows, and so diversification of cash flow risks could be limited.
- There could be limited data on which to base expected probabilities and hence the estimation error could be large. This could be particularly acute for assets falling into the 'event' variability category.

2.61 Given these challenges, the PRA does not propose the use of a single methodology for all asset types. Instead, the PRA proposes that firms tailor their approach to the risks presented by the assets. This means using a probability weighted approach where they have the data, and a deterministic or median approach where more reliance on expert judgement is required. This should give firms more flexibility and allow a proportionate approach to modelling.

2.62 In determining which of the two approaches to follow, the PRA considers that the distinction between types of variability introduced in paragraph 2.23 ('economic' and 'event' or non-economic) could be useful.

2.63 The PRA views this framework as helpful to firms as it considers that assets in the first category, those with economic variability, are more likely to have established models or data that can be used to determine a probability weighted best estimate cash flow profile. Conversely, the PRA considers that assets in the second category are more likely to require a significant degree of expert judgement when determining a best estimate cash flow profile.

2.64 The decision on which approach to take may not always be clear cut and the PRA expects firms to set out and justify the chosen methodology in their MA application. Scenarios where the PRA considers it could be appropriate to take a deterministic approach include:

- An infrastructure project where the project sponsor can prepay in the event of construction failure; and
- 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.

[6] Technical Provisions 3.1 of the PRA Rulebook.

2.65 The PRA considers that there are some principles that should apply regardless of the approach taken. This will help ensure consistency with the Technical Provisions Part of the PRA Rulebook. The PRA proposes making the following rules:

- the starting point for any modelling should be the contractual asset payments;
- where the asset cash flows are linked to market conditions, eg interest rates, inflation etc, firms should use assumptions consistent with the market implied rates; and
- where asset modelling relies on expert judgement, this should be subject to the same level of internal control as elsewhere within the firm's modelling of the SCR. (**Article 2 of the onshored Commission Delegated Regulation (EU) 2015/35 (SII CDR**).

2.66 The purpose of these rules is to ensure that the cash flows have a solid grounding, with adequate justification of any assumptions, and they prioritise the use of up-to-date market data.

2.67 The PRA's proposals in respect of best estimate cash flows for assets with HP cash flows are reflected in the new Matching Adjustment Part of the PRA Rulebook (Appendix 2), and changes to Chapter 5 of SS7/18 (Appendix 3).

Modelling assets with highly predictable cash flows under stress

2.68 The PRA considers that the issues noted above around data scarcity and reliance on expert judgement may be even more challenging when it comes to projecting assets with HP cash flows within internal models.

2.69 The PRA therefore proposes that firms be consistent in their approach to determining best estimate cash flows in the best estimate and under stress. For assets that have been modelled statistically, this would mean updating the projected cash flows based on the modelled economic conditions and assuming that counterparties act rationally from an economic perspective.

2.70 The PRA expects that where firms have used the same deterministic projection for best estimate and stress, they should carefully consider how the FS addition may change under stress. The FS addition may need to be updated for both changes in the stressed cash flow profile and the change in uncertainty about the cash flow profile. This could result in a material increase in order to reflect the increased likelihood of early repayment and hence loss of future MA benefit. The proposals will require firms to carefully consider and justify the assumptions they make, including how changes to the FS addition correlate with assumptions in the modelled scenario.

2.71 The standard formula (**Article 181 of the SII CDR**) sets out a series of reduction factors to be used in calculating the increase in the FS under stress. The PRA considers that alternative reduction factors may be required for assets with HP cash flows, but this is more appropriately considered in the next review of the standard formula.

2.72 The PRA therefore proposes making consequential changes to SS8/18 to set out its expectations in this area.

2.73 If firms invest in increasing volumes of assets with HP cash flows, the PRA will keep under review whether it may be appropriate to set out further expectations based on firms' observed practices.

PRA objectives analysis

2.74 The PRA has developed its policy proposals for assets with HP cash flows to give effect to the Government's widening of the eligibility conditions in a manner consistent with the PRA's objectives.

2.75 The PRA is proposing that firms must be able to demonstrate that assets can be managed in line with the PPP, in particular in being able to appropriately manage the additional risks from cash flow variability, and also to require bounding of the non-fixed cash flows. The PRA considers that these proposals should give confidence that the assets in firms' MA portfolios remain appropriate while practically giving effect to updated eligibility conditions in the draft MA regulations. These proposals also support the requirement in the MA regulations to demonstrate that risks to the quality of matching should not be material, and are key to advancing the PRA's primary objectives.

2.76 The inclusion of assets with HP cash flows in the MA portfolio is expected to increase the risks retained by firms, and appropriate consideration of these risks needs to be reflected in the MA requirements and supervisory guidance. The proposed additional controls and matching tests, and requirement for firms to identify the sources of cash flow uncertainty and to make adequate allowance for these risks through an addition to the FS should mitigate the risks to the matching of policyholder liabilities and hence advance the PRA's primary objectives.

2.77 The proposed standard/sophisticated approach for the FS additions has been developed to allow firms to invest in the wider range of assets permitted more quickly. In particular, allowing simpler approaches where firms do not have complete data to model the expected distribution of losses from HP cash flows should help facilitate effective competition, consistent with the PRA's secondary objective, by removing barriers to investment. The PRA considers that the proposals for safeguards (eg exposure limits and additional matching tests), and the proposal to include the FS additions within the scope of the attestation should

mitigate the potential risks which might otherwise arise to its primary objectives from these simpler approaches and modelling approximations.

2.78 The PRA will also consider potential risks to its primary objectives through post permission monitoring of these measures as part of the proposed MA framework. This will also allow the PRA the opportunity to take timely supervisory action if necessary to ensure safeguards remain effective and appropriate in changing circumstances.

2.79 The PRA has assessed whether the proposals in this chapter advance its secondary objective to facilitate, subject to relevant international standards, the international competitiveness of the UK economy and its growth in the medium to long term. The PRA considers that the proposed rules and updates to supervisory guidance should make the range of assets which firms can include in MA portfolios more flexible; this should consequently enhance the competitiveness and growth of the UK economy by promoting investment in UK productive assets, reducing the cost of retaining investment risks from UK annuity portfolios and also facilitating more competitive pricing for annuity business.

2.80 The PRA considers that having an FS that appropriately reflects the risks firms remain exposed to is important to support the medium to long-term growth of the UK economy because it reduces the risk of insurers contributing to financial instability if they hold financial resources insufficient to reflect the risks they run. Further, ensuring that risks from assets with HP cash flows are mitigated adequately is important to help support effective competition, by ensuring that firms do not benefit inappropriately from excessive MA to the detriment of competitors who may not be allowing appropriately for the additional risks posed by such assets. Increased investment flexibility will allow relevant insurers to hold a broader range of investments. This may increase the attractiveness of UK insurers, attracting further risk capital to the UK and increasing international competitiveness.

2.81 The proposed MA framework would increase the PRA’s assurance that firms’ MA assets remain appropriate and thereby advances the PRA’s primary objectives.

3: Liability eligibility

3.1 This chapter sets out the PRA's proposals to make changes to the PRA Rulebook and other policy material relating to aspects of liability eligibility within the MA portfolio. The proposed changes are consequential to the Government's anticipated reforms to the MA, as set out in the draft MA regulations.

3.2 The policy proposals in this chapter would:

- restate the existing MA liability eligibility conditions from **The Solvency 2 Regulations 2015** into the PRA Rulebook (with certain changes as described in this chapter);
- expand the underwriting risks that are permitted in MA portfolios to include recovery time risk; and
- permit the inclusion of the guaranteed benefits component of with-profits annuities in MA portfolios, where that component is legally established and identifiable as guaranteed within an insurance contract and would otherwise meet the MA eligibility requirements. Under this proposal, the non-guaranteed element would be retained outside the MA portfolio.

3.3 The proposals in this chapter would:

- amend existing MA liability conditions from The Solvency 2 Regulations 2015 and restate them into the new Matching Adjustment Part of the PRA Rulebook (Appendix 2); and
- make changes to SS7/18 – Solvency II: Matching adjustment (Appendix 3).

3.4 The PRA considers that the proposals outlined in this chapter would advance its primary objectives of safety and soundness and policyholder protection, as well as its secondary objectives of competition, and international competitiveness and growth. The proposals to extend MA eligibility to allow in-payment income protection liabilities and the guaranteed element of with-profits annuities would encourage firms to cover these liability cash flows with appropriately matched assets, improving the security of policyholder claims. They would also allow firms to deploy capital more efficiently without giving rise to prudential risks, thereby improving their competitiveness.

3.5 The proposal to restate existing MA liability eligibility conditions into PRA rules would ensure that the rules governing the application of the MA continue to reflect its underlying

rationale, with appropriately managed risks. This would also continue to support the robust regulatory regime under which the UK insurance industry currently operates, and which underlies customer confidence in UK insurers.

Restatement of existing MA liability conditions

3.6 The PRA anticipates that the MA regulations will specify some of the MA eligibility requirements, but otherwise provide for the PRA to make additional rules regarding MA eligibility, consistent with the principles underlying the SRF. In particular, the PRA expects that the following requirements, currently in Regulation 42 of the Solvency 2 Regulations 2015 will not be directly covered in the draft MA regulations:

- the contracts underlying the portfolio of insurance or reinsurance obligations must not give rise to future premium payments (Regulation 42(4)(g) of the Solvency 2 Regulations 2015);
- the degree of mortality risk permitted in the MA portfolio must be such that the best estimate of the portfolio of insurance or reinsurance obligations does not increase by more than 5% under a mortality risk stress that is calibrated in accordance with rules implementing paragraphs (2) to (5) of Article 101 of the Solvency II Directive (Regulation 42(4)(i) of the Solvency 2 Regulations 2015); and
- contracts underlying the insurance or reinsurance obligations must include no options for the policyholder, or only a surrender option with a surrender value not exceeding the value of the assets, valued in accordance with rules 2.1 and 2.2 of the Valuation Part of the PRA Rulebook, covering the insurance or reinsurance obligations at the time the surrender option is exercised (Regulation 42(4)(j) of the Solvency 2 Regulations 2015).

3.7 The PRA proposes that these regulations be restated into the PRA Rulebook. The rule restating Regulation 42(4)(i) of the Solvency 2 Regulations 2015 would be amended to refer to the relevant part of the PRA Rulebook instead of the Solvency II Directive; however, the PRA does not otherwise propose to amend the restated regulations.

3.8 The PRA considers that these conditions remain appropriate for liabilities proposed to be held in firms’ MA portfolios, for the following reasons:

- the PRA considers that liabilities that assume future premium payments are unsuitable for inclusion in an MA portfolio – the MA should only be available where the portfolio already holds sufficient assets to meet the liability cash flows;

- the PRA recognises that annuity liabilities may be exposed to mortality risk through guaranteed death benefits – the PRA considers that the mortality risk limit remains appropriate in allowing such annuity liabilities into the MAP, while restricting other insurance liability types where mortality is the dominant risk;
- the PRA considers that permitting the inclusion of liabilities with surrender values in excess of the value of the assets covering the liabilities would expose the firm to the risk of being a forced seller of other assets to meet the surrender option, undermining the rationale for applying the MA.

3.9 The proposed amendments to the PRA Rulebook are set out in Appendix 2.

Expanded liability eligibility conditions

3.10 The PRA considers that the existing MA liability conditions concerning the permitted underwriting risks and the splitting of insurance or reinsurance obligations under the Solvency 2 Regulations 2015 (regulations 42(4)(h) and 42(5) respectively) are also suitable to be restated in PRA rules. Nevertheless, the PRA considers that these conditions may reasonably be amended to widen the scope of eligible liabilities.

3.11 The PRA considers that liabilities included in an MA portfolio should be capable of being sufficiently well-matched to support the assumptions underlying the MA. To ensure this is the case, it considers it appropriate to continue to specify the underwriting risks permitted within MA portfolios of insurance or reinsurance obligations to be longevity risk, expense risk, revision risk, and mortality risk.

3.12 The PRA proposes to extend the list of permitted underwriting risks to include recovery time risk. The PRA defines this as the risk that income protection policyholders take longer to recover from sickness than is assumed in a firm's best estimate projection. The PRA considers that the cash flow profile of in-payment income protection claims is similar to that of in-payment annuities, where longevity risk is replaced with recovery time risk, and that they are suitable for inclusion in MA portfolios.

3.13 The PRA is not proposing to include a limit on exposure to recovery time risk within MA portfolios, because it considers this risk to play the same role for in-payment income protection liabilities as longevity risk does for in-payment annuities.

3.14 Regulation 42(5) of the Solvency 2 Regulations 2015 requires that the obligations of an insurance or reinsurance contract must not be split into different parts when composing the portfolio of obligations. The PRA considers that, given the operational complexities of such activities, notional splitting of liabilities remains inappropriate. Such splitting would also breach the MA condition on separate management of insurance and reinsurance obligations.

3.15 Notwithstanding this restriction, the PRA considers the guaranteed element of a with-profits annuity to be sufficiently contractually well-defined and fixed to allow this liability type to be an exception. The PRA proposes that the guaranteed benefits of with-profits annuities, where the fixed elements may be clearly identified and for which no future premiums are payable, would be permitted in MA portfolios where they meet the other requirements for MA eligibility. The PRA considers that the nature and risk profile of these liabilities are equivalent to those of ordinary annuities and so are suitable for inclusion in MA portfolios.

3.16 Under this proposal, the residual provision for future additional benefits would remain outside the MA portfolio. The PRA proposes that where firms include the guaranteed element of with-profits annuities in the MA portfolio, they should establish a clear policy regarding the possible addition of future attaching bonuses in the MA portfolio or elsewhere.

3.17 Where firms propose to include the guaranteed elements of with-profits annuities in an MA portfolio, they would be expected to submit a confirmation that the firm has satisfied itself that any implications for its with-profits business (including points around fairness, investment strategy and wider management) have been considered and, if necessary, discussed with the FCA. In such cases, the PRA would co-ordinate with the FCA in line with the agreed processes under the **PRA**/**FCA** Memoranda of Understanding.

3.18 This expansion of eligibility would apply to with-profits annuities, but not to the guaranteed elements of other policies such as periodic payment orders, where the risks associated with the variable portion of the benefits are materially different, and would raise challenges for appropriate asset-liability matching.

3.19 The proposed amendments to the PRA Rulebook are set out in Appendix 2, and the proposed changes to SS7/18 are set out in Appendix 3.

PRA objectives analysis

3.20 The PRA considers that the proposals in this chapter would advance its primary objectives of promoting the safety and soundness of regulated firms and securing policyholder protection, as well as the secondary objectives of competition, international competitiveness and growth, for the following reasons:

- The PRA considers that allowing in-payment income protection liabilities into MA portfolios would encourage firms to back these liabilities with appropriate matching assets, improving the security of policyholder claims in the same manner as applies to in-payment annuities in MA portfolios.
- The PRA considers that the nature and risk profile of the guaranteed elements of with-profits annuities are equivalent to the nature and risk profile of ordinary annuities,

which are already included in MA portfolios. For this reason, the PRA considers that permitting these liabilities into MA portfolios would also advance firms' safety and soundness, by incentivising firms to back the liabilities with appropriately matched assets.

- The PRA considers that the proposal to restate relevant parts of retained EU law represents a proportionate approach to maintaining safety and soundness and policyholder protection, while facilitating effective competition. The PRA considers that the regulations being restated would advance the PRA's objectives as part of the overall package of changes to Solvency II.
- Allowing in-payment income protection liabilities and the guaranteed element of with-profits annuities would allow firms to deploy capital more effectively and efficiently and provide better value for customers. The PRA expects this to contribute to UK competitiveness and growth.

4: Credit ratings under the MA

4.1 This chapter sets out the PRA's proposals regarding changes to the approach to credit ratings, with the exception of notching which is covered in Chapter 9 of this CP. Credit ratings are a key determinant of the MA benefit generated by a given asset. It is therefore important that credit ratings appropriately reflect the risk profile of a firm's asset holdings and if the rating suggests higher risk, that this is managed appropriately. For firms with internally rated assets, the PRA is particularly focused on the robustness of their internal credit assessments and related processes, given the anticipated MA regulations will have a requirement for these to be of a comparable standard to credit ratings. Specifically, this chapter sets out the PRA's proposals to make changes to the PRA Rulebook and other policy material in the following two areas:

- The treatment of assets of SIG credit quality within the MA portfolio. The proposed changes arise from the Government's proposed reforms to the MA, as set out in the November 2022 Statement. The proposed changes will make the PRA Rulebook and other policy material consistent with the relevant legislation and will reduce potential regulatory disincentives to hold SIG assets, or those rated close to SIG.
- The treatment of assets with internal credit assessments within the MA portfolio. The proposed changes to the PRA's expectations set out in SS3/17, with some of those existing expectations becoming PRA rules, with slight modifications, arise from the anticipated legislation regarding credit ratings. These requirements would complement and clarify the details in the anticipated MA regulation, and together with the proposed updates to SS3/17 are consistent with the PRA's supervision of firms to date.

The proposals are not intended or expected to lead to a change in the PRA's supervisory approach, or to impose an additional burden on firms.

4.2 The policy proposals in this chapter would:

- remove the requirement in Technical Provisions 7.2(3) of the PRA Rulebook for firms to apply a SIG MA cap;
- remove expectations in respect of how the SIG MA cap is reflected in the calculation of the MA and in firms' internal model methodologies;
- introduce new expectations in relation to the prudent management of assets backing policyholder liabilities, specifically investment in SIG assets in the MA portfolio;

- introduce new expectations around the assessment of the appropriateness of firms' internal models for modelling the MA in respect of SIG assets;
- with slight modification, substitute existing PRA expectations with requirements that internal credit assessments of assets in the assigned portfolio, as referred to in the MA regulations, would have to satisfy; and
- update expectations on the use of internal credit assessments to reflect the substituted requirements above and the PRA's current supervisory approach.

4.3 The proposals in this chapter would:

- amend the Technical Provisions Part of the PRA Rulebook (Appendix 2);
- make changes to SS7/18 – Solvency II: Matching adjustment (Appendix 3);
- make changes to SS8/18 – Solvency II: Internal models – modelling of the matching adjustment (Appendix 4);
- add a chapter (Internal Credit Assessments and Credit Ratings) to the new Matching Adjustment Part of the PRA Rulebook (Appendix 2); and
- make changes to SS3/17 – Solvency II: Illiquid unrated assets (Appendix 5).

4.4 The PRA considers that the combination of proposals in this chapter would advance its primary objectives of safety and soundness and policyholder protection. In particular, the proposals for SIG assets would ensure that firms give due consideration to the fixity of cash flows on SIG exposures, their compliance with the PPP, and the appropriateness of their internal model calibrations to reflect the associated risk profile. The PRA further expects the proposals to reduce regulatory disincentives to invest in SIG assets, or those close to SIG, thereby advancing the PRA's secondary competition objective and its secondary competitiveness and growth objective.

4.5 The proposals for internal credit assessments should increase the confidence, for the firm and the PRA, that can be placed on firms' internal credit assessments both for risk management purposes and as an important input into the calculation of the MA.

Removal of rules relating to a cap on the matching adjustment benefit for sub-investment grade assets

4.6 The current regime (**Technical Provisions 7.2(3) in the PRA Rulebook**) includes a requirement for firms to apply a SIG MA cap when calculating their TPs. This cap is applied

by increasing the FS 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 and is referred to in existing PRA rules and expectations.

4.7 The November 2022 statement set out that the Government would work with the PRA to remove the SIG MA cap. The draft MA regulations set out how the Government intends to legislate regarding the MA. It also sets out how the MA is to be calculated, and this does not include a SIG MA cap. For consistency, the PRA is proposing that Technical Provisions 7.2(3) would be deleted in order to enable the removal of the SIG MA cap.

4.8 In the current SS7/18, the PRA set expectations as to how the cap on the MA for SIG assets should be reflected in the calculation of TPs. As a consequence of the proposed deletion of Technical Provisions 7.2(3), the PRA proposes that these expectations are also deleted as they are no longer relevant.

4.9 The proposed amendments to the PRA Rulebook to support these proposals are contained in Appendix 2; the proposed changes to SS7/18 are set out in Appendix 3.

Investment in sub-investment grade assets

4.10 The proposed changes to the PRA Rulebook will remove a disincentive for firms to invest in SIG assets, and as a result firms may choose to invest more in these assets, or assets close to SIG within their MA portfolios. Removal of the SIG MA cap could also remove potential regulatory disincentives to invest in a wider range of assets, in particular the PRA understands that certain assets may be rated SIG while in construction phase, and respondents to the Government's Solvency II review consultation (paragraph 4.1) noted that the removal of the SIG cap should lead to increased investment in green and digital assets.

4.11 The PRA expects SIG assets to play a limited role within the assets backing policyholder liabilities, particularly as annuity policyholders do not necessarily benefit from the higher yields on those assets. To date SIG assets have formed a small part of MA portfolios (around 1% of total MA portfolio assets by market value at YE20), due to a combination of firms' management decisions for their investment portfolios and the current cap on MA benefit.

4.12 The PRA proposes to introduce an expectation that any investment in SIG assets should be at prudent levels. When assessing this the PRA additionally proposes that firms take account of the extent to which their investment grade asset holdings could downgrade to SIG in deteriorating market conditions, leading to a greater concentration of SIG assets in their portfolios. In line with the PPP, the PRA also considers that firms should invest in SIG assets only to the extent that 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.

4.13 The PRA further proposes to introduce an expectation that firms specifically take into account the lower credit quality, heterogeneous nature of SIG assets, and possible concentrations of exposure when setting their investment strategy and limits, when conducting ongoing monitoring of their MA portfolio(s) and when assessing their compliance with the PPP. The PRA also proposes to expect firms to have adequate work-out capabilities, aligned to their level of investment in SIG assets.

4.14 The PRA notes that SIG assets have significantly higher default and downgrade rates compared with investment grade assets, and this could lead to greater variability in future cash flows. Accordingly, the PRA proposes to introduce an expectation that firms consider carefully whether the expected cash flows on their SIG exposures can be sufficiently relied upon for the purpose of cash flow matching given the higher and more uncertain default rates and potential additional risks associated with such assets. The PRA further proposes an expectation that firms take these considerations into account when determining whether inclusion of such assets in the MA portfolio is in line with the PPP. The proposed changes to SS7/18 to reflect these proposals are set out in Appendix 3.

Modelling the fundamental spread for sub-investment grade assets in internal models

4.15 The PRA is aware that most firms currently include a SIG MA cap in their internal models used to calculate the SCR. The proposal to remove the current SIG MA cap for the purposes of calculating TPs may mean that some firms no longer consider that they should include a SIG MA cap within their internal models.

4.16 Internal models are required to capture all material quantifiable risks to which firms are exposed. Modelling approaches can capture these risks either directly or indirectly. The PRA notes that historically some firms may have placed less focus on the calibration of stresses for SIG assets due to the existence of the cap. Should the PRA remove the SIG MA cap, such firms may still choose to retain the cap within their internal models, at least in the short term, to ensure the continued adequacy of the internal model calibration for SIG assets. Other firms may also consider a SIG MA cap should be included in their internal models.

4.17 The PRA proposes to introduce an expectation that regardless of whether a firm includes a SIG MA cap in its model, the firm be able to demonstrate that the internal model adequately reflects the risk profile for SIG assets, paying particular attention to:

- the availability and credibility of data to calibrate stresses for SIG assets;

- the extent to which SIG assets are assumed to default in stress, the assumptions and judgements about recoveries, and how the firm's work-out processes have been reflected in the model;
- the heterogeneity of the portfolio given the greater breath of risks associated with SIG assets;
- potential concentration of risks in the SIG portfolio both in base and stressed conditions, recognising that overexposure to speculative investments is unlikely to be compatible with the prudent management of the portfolio as required by the PPP; and
- related to the above point, the risk of forced sales of SIG assets in stress scenarios in order to ensure continued compliance with risk management requirements, including the firm's own risk limits and investment mandates.

4.18 The proposed changes to SS8/18 to reflect these proposals are set out in Appendix 4.

Internal credit assessments

4.19 The PRA expects that the MA regulations will introduce a requirement for internal credit assessments, in the relevant portfolio of assets, to be comparable to those arising from an external credit rating. The PRA considers that this requires some changes to its expectations set out in SS3/17, with some of those expectations becoming PRA rules with slight modifications. Accordingly, the PRA proposes to introduce new requirements that internal credit assessments would have to satisfy. These cover the risks that should be considered in making such assessments, comparisons against issue ratings that could have resulted from a credit rating agency (CRA), and the need for appropriate validation and external assurance.

4.20 The PRA considers that these requirements would complement the draft MA regulations. These are accompanied by proposed changes to SS3/17 (Appendix 5) which includes updated guidance for firms, to reflect the PRA's current supervisory approach.

Proposed internal credit assessment requirements in the PRA Rulebook

4.21 The anticipated MA regulations require that the credit quality of MA assets must be capable of being assessed through a credit rating or the firm's internal credit assessment of a comparable standard. The PRA considers this requirement to be important because ratings are and will continue to be one of the key drivers of the FS. The PRA notes that for assets with HP cash flows this requirement will also provide some assurance on the appropriateness of the features and structure of the assets for backing liabilities in firms' MA portfolios. Given this requirement, the PRA proposes that, as per the detail in the draft MA regulations, a firm's

internal credit assessment must be of a comparable standard to a credit rating as defined in MA regulations,[7] and that the internal credit assessment process and outcomes must be appropriate.

4.22 Building on the proposed requirement for ‘comparable standard’, the PRA also proposes that internal credit assessments must:

- consider all possible sources of credit risk, both qualitative and quantitative, and how these types of credit risk may interact;
- produce outcomes that lie within the plausible range of issue ratings that could have resulted from a CRA as defined in [x] of MA regulations;[8]
- produce outcomes that are broadly consistent with CRA issue ratings, at an asset type[9] and portfolio level, with no bias;
- be derived via an internal credit assessment process that is subject to appropriate validation and assessment of its on-going appropriateness;
- be subject to proportionate independent external assurance to ensure that the internal credit assessment outcomes lie within a plausible range of issue ratings that could have resulted from a CRA; and
- be produced by a function that is independent, with effective controls in place to manage any potential conflicts of interest.

4.23 The PRA further proposes to introduce a requirement that, upon request, firms must demonstrate compliance with the above requirements to the PRA. The PRA considers that this approach is consistent with that used for the ‘Appropriateness of the Level of Technical Provisions’ Chapter in the Technical Provisions Part of the PRA Rulebook.

[7] [x] of MA regulations: ‘credit rating’ means a credit rating (defined in Article 3(1) of Regulation (EC) No 1060/2009 of the European Parliament and the Council of 16 September 2009 on credit rating agencies) issued by a credit rating agency.

[8] [x] of MA regulations: ‘Credit rating agency’ means a credit rating agency registered [or certified] by the FCA in accordance with Regulation (EC) No 1060/2009 of the European Parliament and the Council of 16 September 2009 on credit rating agencies.

[9] Asset type is used here to mean categories of assets that have similar features and/or similar methodologies for the purposes of determining the credit rating or internal credit assessment for that type of asset.

4.24 The PRA considers that these requirements would increase the confidence that the PRA and the wider market can place on firms' internal credit assessments both generally and as an input into the calculation of the MA.

4.25 By introducing a requirement for internal credit assessments to consider all risks to which the asset is exposed, the PRA expects that there will be improvements in consistency between the risk identification exercise and the internal credit assessment, therefore supporting good risk management.

4.26 By requiring firms to consider how internal credit assessments would compare against issue ratings that could have resulted from a CRA, including appropriate independent external assurance, the PRA expects that this will act as a useful check and balance alongside the validation and assessment of the ongoing appropriateness of the internal credit assessment process.

4.27 The PRA notes that firms are already required not to solely or mechanistically rely on credit ratings or CRA for assessing the creditworthiness of an entity or financial instrument under **Article 5a(1) of Regulation (EC) No 1060/2009 of the European Parliament and of the Council**.

4.28 In addition, in relation to larger or more complex exposures, where a firm's internal credit assessment generates a lower capital requirement than the one generated by credit ratings issued or endorsed by UK-registered CRAs, the PRA notes that internal credit assessment shall not be taken into account when determining the SCR. The PRA considers that this is consistent with the existing Technical Provisions 7.2(4) of the PRA Rulebook (which is now proposed to be replaced by elements of the Matching Adjustment Part of the PRA Rulebook) and Article 4(5) of the SII CDR.

4.29 The proposed changes to the PRA Rulebook to support these proposals are contained in Appendix 2.

Proposed internal credit assessment amendments to SS3/17

4.30 To reflect the proposed legislative and PRA Rulebook changes, and to support consistency in firms' interpretation of the requirements and promote transparency in the PRA's existing supervisory approach, the PRA also proposes to update a number of the expectations in SS3/17 as set out below.

4.31 The PRA proposes that references to External Credit Assessment Institutions (ECAIs) in SS3/17 will be changed to Credit Rating Agencies (CRAs) to reflect **Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019**.

4.32 The proposed requirements would apply directly to firms' internal credit assessments, as opposed to the resulting credit quality step (CQS) mapping. In line with this, the PRA proposes to introduce an expectation that a firm should consider how it has met the credit rating comparability requirements for each asset type when selecting the appropriate CQS mapping scale to use i.e. the mapping scale it considers most appropriate from the scales applicable to different CRAs that are set out in **Commission Implementing Regulation (EU) 2016/1800**.

4.33 The changes anticipated in the MA regulations, together with the PRA's proposed rule changes and updated expectations, are expected to result in a more systematic approach to the CQS mapping process once the requirements in relation to internal credit assessments have been met. Accordingly, the focus of the stated expectations would shift to comparisons between internal credit assessments and the issue ratings that could have resulted from a CRA, as opposed to the current drafting where the comparisons are based on the resulting CQS from firms and CRAs. As firms are already assessing the consistency of their internal credit assessments and issue ratings that could have resulted from a CRA, the PRA considers that there is no material change in the overall supervisory approach arising from its proposals.

4.34 The PRA proposes that when assessing the broad consistency and no bias requirement, and whether their internal credit assessment would exceed any rating caps from CRAs in meeting the plausible range requirement set out above, firms should consider internal credit assessments by rating notch. This expectation is consistent with the proposal to increase the granularity of the FS by rating notch. The PRA considers that any bias within a CQS, where firms' internal credit assessments (on a notched basis) are either generally stronger or weaker than comparable issue ratings that could have resulted from a CRA, would have greater consequence where the FS itself varies by rating notch. The PRA recognises that some firms may have to develop their current internal credit assessment processes to allow them to produce internal ratings on a notched basis.

4.35 The PRA further proposes to introduce an expectation that broad consistency and no bias may be assessed in a range of different ways including the proportion of the sampled assets which have higher versus lower notched internal credit assessments relative to comparable CRA issue ratings.

4.36 The PRA considers that robust validation of firms' internal credit assessment processes and independent external assurance of firms' internal credit assessment outcomes are important components that would enable firms to demonstrate compliance with the proposed requirements. The PRA proposes to amend existing expectations to set out details of the type of validation framework that would be expected for firms' internal credit assessment outcomes, including remediation actions that would be expected to be taken upon breaches

of certain validation thresholds. Firms would be expected to resolve any validation failures which result in the FS being lower than is merited based on the validation criteria, by amending its internal credit assessment methodology, assumptions, and/or processes. The PRA proposes that firms should assess the materiality of any validation failures which have not been remediated when considering whether an FS addition is needed in line with [x] of MA regulations, to compensate for the extent of any bias at an asset type or portfolio level.

4.37 Finally, given the critical role of the internal credit assessment function in meeting the proposed requirements, the PRA proposes certain expected criteria for the role and the individual who is responsible for the function, in addition to the existing expectations in relation to expertise and managing conflicts of interest. These include the approval of its appointment by the management body, access to the management body, distinct responsibility for the function where justified by the nature, scale and complexity of the assets held, and having appropriate experience for the role.

PRA objectives analysis

4.38 Within the constraints placed on the PRA by the draft MA regulations, the PRA considers that the proposals in this chapter would continue to advance its primary objectives of safety and soundness and policyholder protection for the following reasons:

- the removal of the current SIG MA cap for the purposes of calculating TPs would result in a one-off increase in own funds for any firm matching MA liabilities with SIG exposures for which the cap is biting. However, the PRA does not expect this increase to be material as firms currently do not have significant holdings of SIG assets in their MA portfolios;

- the PRA's proposed expectations would ensure that, when investing in SIG assets, firms give due consideration to the extent to which the expected cash flows can be relied upon for the purposes of cash flow matching and continuing compliance with the PPP. This would in turn help ensure that firms' investment strategies and risk management in respect of SIG assets are aligned with the risks associated with such assets;

- the proposed expectations on how firms reflect risks relating to their SIG exposures in their internal models would support the internal model calibration remaining appropriate for firms' risk profiles; and

- The credit quality of assets in the assigned portfolio as referred to in the draft MA regulations must be capable of being assessed through a credit rating or the undertaking's internal credit assessment of a comparable standard as set out in the

draft MA regulations. Given the growth in the amount of assets held by insurers where only an internal credit assessment is available and noting that this assessment is undertaken by the firm owning the asset or its asset manager, the PRA considers that the proposals should provide increased confidence to the PRA, firms and the wider market that internal credit assessments are robust.

4.39 The PRA considers that the proposals in this chapter would also advance the PRA's secondary competition objective and its secondary competitiveness and growth objective for the following reasons:

- firms would have fewer potential regulatory disincentives to invest in a wider range of assets, with the proposed expectations around fixity of cash flows and PPP simultaneously encouraging good risk management;
- the proposed flexibility of approach in relation to application of a SIG MA cap in firms' internal models would help facilitate effective competition between firms using internal models by not expecting a specific modelling methodology and widening the pool of assets that firms can invest in; and
- ensuring that internal credit assessment are of a comparable standard to credit ratings should help level the playing field between firms, including with smaller firms that may rely more on credit ratings.

5: MA Permissions, Breaches, and Consequential Rule Changes

5.1 This chapter sets out the PRA's proposed approach to MA permissions. Following FSMA 2023, the PRA expects that the remaining retained EU law will be revoked, including on-shored **Commission Implementing Regulation (EU) 2015/500** (the 'MA ITS') and the **SII CDR**. Therefore, this chapter sets out the proposed PRA framework for granting MA permissions in the UK, including the consequences for breaching MA eligibility conditions that would come into effect, alongside the Government's proposed reforms to the MA, as set out in its draft MA regulations.[10]

5.2 The policy proposals in this chapter would:

- restate various existing regulations relating to MA eligibility conditions and applications into PRA rules and a new SoP;
- create an additional MA eligibility condition that firms must demonstrate that the portfolio of assets and each individual asset can be managed in line with the PPP;
- create a streamlined approach for granting permission to apply the MA in certain situations;
- amend the consequences of breaching MA eligibility conditions; and
- clarify PRA expectations around the use of delegated authority to submit MA applications.

5.3 The proposals in this chapter would:

- replace rules 6 and 7 of the Technical Provisions Part of the PRA Rulebook with a new part relating to the MA (Appendix 2);
- make changes to SS7/18 – Solvency II: Matching adjustment (Appendix 3); and

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[10] The Government has stated that it will use the power at s138BA FSMA to grant the PRA flexibility to disapply or modify the application of any of its rules. The power will be exercised by statutory instrument (s.84 FSMA 2023). For details, please refer to **Draft Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations**.

- introduce a new SoP – Solvency II Matching Adjustment Permissions (Appendix 7). This SoP sets out the PRA's approach to granting new, and variations to, MA permissions.

5.4 The PRA considers that the proposals in this chapter would advance its primary objectives of safety and soundness and policyholder protection, as well as its secondary objectives of competition, international competitiveness, and growth. The streamlined approach for certain MA applications would allow the PRA to focus its resources on the most material risks to the safety and soundness of the firms the PRA regulates, and to continue to secure appropriate protection for policyholders, while enabling firms to make investments in an efficient and timely manner. The proposed changes to the consequences for breaches of MA conditions would reduce the risk of any cliff-edge effects for UK insurance firms, which could threaten their safety and soundness. The proposed changes would enable them to restore compliance in a more proportionate manner while still bearing adverse consequences for serious or sustained breaches. The proposal to restate existing regulations into PRA rules would provide consistency with existing provisions that support a robust insurance regulatory regime.

Restatement of existing regulations into PRA Rules and Statement of Policy

5.5 The draft MA regulations specify some conditions that would apply to the use of the MA, and provide for the PRA to set out further eligibility conditions in rules. The PRA also proposes to make additional rules regarding the MA. This is consistent with the principles underlying the SRF, with the permissions being granted under s138BA of FSMA 2023. In particular, the following requirements, currently in the Solvency 2 Regulations 2015, are not expected to be directly covered in the MA regulation:

- the restriction that the assigned portfolio of MA assets may not be used to cover losses arising from other activities of the undertaking (Regulation 42(4)(d) of the Solvency 2 Regulations 2015); and

- the restriction on the simultaneous use of the MA with the volatility adjustment (VA) or the transitional measure to the risk-free interest rate (TMIR) (Regulation 42(4)(l) to (m) of the Solvency 2 Regulations 2015).

5.6 The PRA proposes to ensure that these provisions are appropriately established, without change, through PRA rules, as it considers that the provisions remain appropriate with respect to firms applying the MA.

5.7 In relation to the first of the above, the PRA considers that the rationale for applying the MA requires that firms hold sufficient assets to match the relevant liabilities and maintain that assignment throughout their lifetime, so that firms are not exposed to the risk of changing spreads. As a result, the PRA considers that it is not appropriate for firms to use assets backing MA liabilities to cover losses arising from other activities of the undertaking.

5.8 In relation to the second of the above, the PRA considers that the VA and the TMIR are not suitable to be applied at the same time as the MA as otherwise their application may lead to an improperly low value for the BEL by double-counting the benefits of adjustments to the basic risk-free rate.

5.9 Technical Provisions 6.2 currently provides that firms applying the MA shall not revert to an approach that does not include an MA. The PRA intends to retain this approach under the new Matching Adjustment Part of the PRA Rulebook, and so firms seeking to revert to an approach that does not include applying the MA to the whole or a portion of the MA portfolio will accordingly need to submit an MA application (as set out in Chapter 2 of the SoP in Appendix 7).

5.10 The onshored MA ITS currently sets out requirements around MA applications, including the documentation required from firms and the process the PRA will follow in assessing an application and reaching a decision. The PRA proposes to restate, explicitly or implicitly, most of the existing provisions in a new SoP, which would also set out the PRA's approach to reviewing applications for assets with HP cash flows, and a new streamlined approach to reviewing certain applications. Some areas of the MA ITS are also already covered, or proposed to be covered, in SS7/18.

5.11 In a small number of areas the PRA is proposing not to restate existing provisions of the MA ITS. This is where it considers that the provisions will cease to be relevant or appropriate in the new regime. This is explained further below.

5.12 Some existing provisions relate to matters concerning the European Union and the coming into force of Solvency II. The PRA does not consider that these remain relevant for future UK insurance regulation and is therefore proposing that they be deleted. This covers recitals 10 to 12 and articles 7(2) and 9 of the MA ITS.

5.13 The PRA expects to reach a decision on an MA application within six months of the date of receipt. In order to make the MA application process more flexible, the PRA is proposing to remove the current requirement for it to formally undertake a completeness assessment of an MA application as well as any provisions that refer to an application clock. Firms would still be expected to submit the evidence they consider necessary for the PRA to reach a decision and would be asked to confirm that they have done so. The PRA would also be able to request further evidence if necessary; this would likely increase the review time required for

the application but there would not be a formal 'stopping of the clock'. In line with this the PRA proposes to update recital 2 of the MA ITS in Chapter 2 of the proposed SoP to reflect the proposed process and it proposes not to retain articles 6(2), 6(3), 6(4), and 6(8).

5.14 To allow firms greater flexibility in how they evidence compliance with the MA eligibility conditions, the PRA is proposing to remove the more prescriptive requirements around the evidence that needs to be provided in respect of assets and liabilities (proposed for inclusion) in the MA portfolio. The PRA therefore proposes to delete articles 2(c) and 3(b) of the MA ITS and not restate these in other policy documents. The PRA also proposes not to restate article 2(b), as this information will be included in the proposed MALIR (see Chapter 8 of this CP).

5.15 In order to avoid placing an undue burden on firms, the PRA proposes that the items required under articles 5(b) and 5(e) of the MA ITS will no longer form part of the minimum content of an MA application but firms should have them available on request. The PRA also proposes to remove the assessments covered by articles 5(c) and 5(d) of the MA ITS from the minimum contents of the application. It will instead rely on the elements most relevant to the MA application being available on request, with other items most likely to be covered as part of ongoing supervision. The PRA considers that the items covered by 5(c) and 5(d) would be assessed as part of a firm's attestation process (if appropriate) which will give greater focus to the firm's assessment of its risk profile against the assumptions underlying the MA.

5.16 The PRA is not proposing to retain the points in articles 4(c) and 4(d) of the MA ITS in the SoP. Respectively, these cover adjustments to own funds to reflect any reduced transferability between the MA portfolio and non-MA portfolio, and the reflection of any reduced scope for diversification in the SCR. The PRA considers that these points are sufficiently well-captured in Chapter 7 of SS7/18. The PRA is also not proposing to restate article 8 of the MA ITS in the SoP. The PRA instead proposes to cover its approach to revoking MA permissions more fully in Chapter 2 of the SoP (compared to the MA ITS) and also cover breaches of MA eligibility conditions in Chapter 8 of SS7/18, where some additional new content is being proposed.

5.17 The PRA does not propose to retain article 7(4) of the MA ITS, which requires the PRA to clearly state reasons for it rejecting an MA application. This is because permission to use the MA will be granted under the new s138BA permission power, as opposed to a standalone MA approval power (as is currently the case), and therefore the procedural requirements applicable generally to s138BA will apply. A formal process covering a rejection of an application will be put in place as part of wider work operationalising s138BA of FSMA 2000. In light of this, the PRA does not consider it helpful to retain this relatively narrow point given the wider process the PRA would follow in the event of an application being rejected.

5.18 The PRA expects to receive an increased volume of MA applications and considers that a well-organised consolidated MA application is necessary to be able to efficiently assess change of scope MA applications. The PRA proposes that firms with MA permissions should consolidate all information provided in support of this permission into one **suite of** document**s**. This would ensure that applications for a variation of permission include complete and comprehensive documentation for the existing permission, with clearly signposted updates covering the subsequent change of scope.

5.19 The proposed amendments to the PRA Rulebook are set out in Appendix 2, the proposed changes to SS7/18 are set out in Appendix 3 and the proposed new SoP is set out in Appendix 7.

Prudent Person Principle

5.20 The PRA considers that it is appropriate to require firms to include in their MA applications evidence that the assets they wish to invest in are capable of being managed in line with the PPP, both at the level of the portfolio and individual assets. The PRA considers that this is a necessary condition for an asset to be held in an MA portfolio, as assets held in MA portfolios are intended to be held over the lifetime of the obligations, and therefore firms should be able to bear the associated risks and be able to manage them over a potentially significant timeframe. As firms are already subject to the PPP, the PRA expects firms to provide readily available information that they would have prepared as part of their existing processes to assess whether any new assets they wish to invest in are capable of being managed in line with the PPP. Where this increases a firm's analysis, then this would be addressing shortcomings in its current processes.

5.21 While all firms are required to comply with the PPP, the links between the PPP requirement in Chapters 2 and 3 of the Investments Part of the PRA Rulebook (to which SS1/20 relates) and the MA eligibility conditions are not explicit. The PRA considers that introducing this requirement into MA applications is important given the different treatment of assets within MA portfolios for both regulatory balance sheet and regulatory capital purposes, namely material reductions in both BEL and SCR. As a result, risk concentrations in the MA portfolio can have a much bigger impact than concentrations in assets outside of the MA portfolio.

5.22 The proposed amendments to the PRA Rulebook are set out in Appendix 2, the proposed changes to SS7/18 are set out in Appendix 3, the proposed changes to SS1/20 are set out in Appendix 6, and the proposed new SoP is set out in Appendix 7.

Streamlined matching adjustment application approach

5.23 In order to help facilitate insurers' ability to include new investments in MA portfolios, while allowing the PRA to maintain appropriate levels of safety and soundness and policyholder protection, the PRA proposes to introduce a streamlined MA application approach for certain types of applications. For all MA applications, the PRA proposes in the SoP to reach a decision as quickly as possible, and it expects to provide its decision no later than six months from its receipt of a firm's application. Where applications are assessed under a streamlined approach, the PRA would expect to reach a decision in a shorter timeframe.

5.24 Applications reviewed under this approach would be assessed against the MA eligibility conditions prior to granting permission. The assessment of other factors relating to the ongoing application of the MA (eg ratings or valuations) may be deferred until after MA permission has been granted, and conducted as part of the PRA's ongoing supervision of the firm.

5.25 When a firm engages with the PRA regarding a proposed MA application, the PRA will indicate whether such an application is likely to be suitable for a streamlined approach. It expects that this approach would be suitable where applications are clearly in line with the MA eligibility conditions, propose less complex changes, or where firms propose appropriate safeguards. Where a firm applies for a variation to an existing MA permission, the PRA proposes that a streamlined application approach may be suitable for:

- the addition of assets or liabilities for which the firm already has permission, but which present new features or risks; or
- for assets or liabilities with new combinations of features and/or risks for which the firm already has permission.

5.26 The November 2022 statement supported a streamlined eligibility application process for less complex assets. Nevertheless, it may be possible for the range of assets potentially suitable for a streamlined approach to cover certain more novel assets, including those which have HP, rather than fixed, cash flows. However, as a streamlined approach increases the risks to the PRA's statutory objectives, it may only be possible in such cases if a firm were also to propose safeguards or mitigants for these risks. In view of this, it will become even more important for the firm to consider safeguards to ensure that the risks to quality of matching are not material should the firm seek to use the streamlined approach.

5.27 For other cases, the risks and complexities associated with the assets (eg internal securitisations) may mean that it is not possible to apply a streamlined approach, even if safeguards are proposed by the firm.

5.28 Further details can be found in Chapter 3 of the SoP in Appendix 7

Breaches of matching adjustment conditions

5.29 Under the current regime, firms must cease to apply the MA if eligibility conditions are breached and compliance is not restored within two months, and they may not apply to have MA permission restored for at least a further 24 months (Regulation 42(4)(n) of the Solvency 2 Regulations 2015 and Technical Provisions 6.4 of the PRA Rulebook). The PRA considers that total loss of the MA may be unduly penal in certain circumstances, and may introduce inappropriate instability to a firm's balance sheet.

5.30 The PRA proposes to retain the two-month period provided for firms to restore compliance with MA conditions. The PRA does not consider that minor breaches of MA eligibility conditions should necessarily result in a restriction on the application of the MA, including breaches that can be rectified within two months. Nevertheless, the PRA does not consider regular or frequent breaching and restoration of MA compliance, within the two-month window, to be acceptable for normal management of the MA portfolio. The PRA considers that this would likely indicate inadequate management and controls of the MA portfolio and would raise questions relating to the appropriateness of the MA permission. As such, the PRA proposes setting an expectation that firms should not breach MA eligibility conditions on a regular or frequent basis.

5.31 The PRA proposes that where compliance is not restored within the two-month window, firms would automatically be required to reduce the amount of MA in a staggered fashion, rather than be subject to immediate termination of the MA permission (which would be the outcome under the current framework). The PRA proposes that this reduction would be at least 10% of the unadjusted MA, increasing by an additional 10% for each further month after the two-month window that a firm is not in compliance with MA eligibility conditions.

5.32 The PRA further proposes that if the MA has been reduced to zero, the PRA would expect to revoke the permission to apply the MA. If the firm were to restore compliance during the period in which the reduction to the MA is in effect but the MA has not yet been reduced to zero, the restriction would be rescinded. Firms would be expected to seek confirmation from the PRA that they have satisfactorily restored compliance with MA conditions before they return to applying the full MA.

5.33 The PRA considers that where a firm commits a significant breach of MA conditions, or repeatedly breaches MA conditions, there may be some circumstances where it is still appropriate to consider revoking the firm's permission to apply the MA, even where the MA has not yet been reduced to zero. An example of a significant breach is where a firm fails to address in a timely manner a PRA notification that it considers a firm to be in breach of MA eligibility conditions.

5.34 Any firm that has had its permission to apply the MA revoked will be required to submit an application for a permission to apply the MA again. The PRA does not propose to set any expectations regarding a minimum time limit between revocation and reapplication; however, it will expect that firms reapplying should demonstrate that they have addressed the issues which previously led to the permission being revoked.

5.35 The proposed amendments to the PRA Rulebook are set out in Appendix 2, and the proposed changes to SS7/18 are set out in Appendix 3

Delegated authority to submit matching adjustment applications

5.36 The MA ITS recognises that an application for permission to apply the MA is a strategic decision for risk management and capital planning purposes, and accordingly set an expectation that the involvement of the board in MA applications should be carefully considered. The PRA's experience is that this has been interpreted differently by different firms, with some requiring board sign-off, whereas others have relied on delegated authority. Notwithstanding the strategic nature of applying for use of MA, the PRA recognises that the frequency with which firm boards meet may result in the time taken to submit an application to the PRA taking longer than would otherwise be the case if full board sign-off were not required.

5.37 The PRA considers that the board of a firm may delegate authority for approval and submission of new MA applications and applications to modify the scope of existing MA permissions to a suitable sub-committee of the board or to approved senior managers.

5.38 The proposed changes to SS7/18 are set out in Appendix 3.

PRA objectives analysis

5.39 The PRA considers that the proposals in this chapter would advance its primary objectives of promoting the safety and soundness of regulated firms and securing policyholder protection for the following reasons:

- the PRA considers the provision of evidence that the MA application meets the PPP will promote its primary objectives of safety and soundness and policyholder protection. The PRA considers its proposal will improve firms' management of their MA portfolios and awareness of risk concentrations;
- the streamlined application approach would only be available where a firm proposes straightforward changes to its MA permission. More complex changes would only be likely to be considered under the streamlined approach where additional safeguards are proposed, such as exposure limits or additional risk management controls. These measures would allow the PRA to focus its resources on the most material risks, while continuing to limit the risks to policyholder protection;
- the proposed amendments to the consequences for firms breaching MA conditions will reduce the risk of instability on a firm's balance sheet. A complete loss of MA after only two months could, in some circumstances, lead to a very significant impact on a firm's financial resources, and potential instability in the UK financial system;
- the reduction in MA of at least 10% for each month after the two-month window that a firm is not in compliance with MA conditions would result in the firm holding higher TPs. This would be a proportionate allowance for the additional risks during this period of non-compliance and limit the firm's ability to distribute excess own funds, during the period of a breach; and
- putting in place a reduction in MA for breaching MA conditions for more than two months, alongside a revocation of MA permission after the MA reaches zero, would provide an appropriate incentive for firms to maintain compliance with MA conditions, and to address the causes of the breach in a timely manner.

5.40 The PRA considers that the proposals in this chapter would also advance the PRA's secondary objectives of competition, and international competitiveness and growth for the following reasons:

- a streamlined application approach for certain assets should allow firms to receive a faster decision on MA eligibility for new assets. This would potentially allow firms to move more rapidly when investment opportunities arise, and thereby promoting growth, while not weakening the PRA's primary objective;
- the ability to delegate authority to a suitable committee or any group of individuals may allow a less onerous and time-consuming process for firms to submit an MA application. This more flexible approach is designed to allow firms to submit applications and respond to follow up queries on MA applications more quickly; and

- the PRA considers the proposed amendments to the consequences for firms breaching MA conditions to be a more proportionate measure than under the existing regime. The proposal would allow firms to rectify breaches with responses better aligned with the long-term stability and growth of the firm and the industry.

As the PPP requirement builds on an existing regulatory requirement, and is a requirement to provide evidence rather than to develop new processes, the PRA considers that it does not constrain competition or international competitiveness and growth.

6: Matching adjustment attestation

6.1 This chapter sets out the PRA's proposals on the attestation to be provided by firms in respect of the MA. These proposals would require a senior manager at each affected firm to attest to the PRA on the sufficiency of the FS and the quality of the resulting MA generated by the assets in their MA portfolio(s). The proposals would also permit firms to increase the FS, where necessary, to ensure it covers all risks retained by the firm and hence ensure the TPs remain adequate.

6.2 The policy proposals in this chapter would introduce the following requirements:

- an attestation must be made to the PRA using standardised wording that is set out in the PRA Rulebook;
- an attestation must be given, for each MA portfolio within the firm, annually and additionally upon any material change in the firm's risk profile;
- the PRA senior management function holder (SMF) who holds the prescribed responsibility for the production and integrity of the firm's financial information, and its regulatory reporting (PR Q),[11] must be responsible for the attestation;[12]
- a policy on providing the attestation must be put in place and maintained by firms, as well as appropriate internal processes, systems, and controls to allow a firm to analyse and justify its use of the FS in accordance with the attestation; and
- an attestation document must be provided to the PRA, setting out the attestation itself alongside a supporting attestation report.

6.3 The proposals in this chapter would:

[11] As provided for in Insurance – Allocation of Responsibilities 3.1(4) of the PRA Rulebook.

[12] Where a firm has multiple MA portfolios, for example with respect to with profits funds, depending on the firm's internal governance arrangements, it may be possible for a firm to apply for a modification of the rules, to nominate a different SMF for each MA portfolio. Each modification application would be considered on a case-by-case basis.

- add Chapters 9 Attestation Requirements, 10 Internal Governance for the Attestation, 11 Disclosure of the Attestation, and 12 Form of the Attestation to the new Matching Adjustment Part of the PRA Rulebook (Annex B of Appendix 2);
- make changes to SS7/18 – Solvency II: Matching adjustment, Chapter 5 (Appendix 3); and

- make changes to SS8/18 – Solvency II: Internal models – modelling of the matching adjustment, Chapters 2 and 4 (Appendix 4).

6.4 The PRA considers that the proposals would ensure that firms own and are accountable for the level of MA benefit being taken, resulting in greater assurance over the sufficiency of the FS and quality of the MA. This is particularly relevant for, but not limited to, firms' investments in assets that have different risk profiles from those used in the existing FS calibration, or from the relevant assumptions underlying the MA as set out in Chapter 7 of this CP. As well as private, unrated and illiquid assets, these may include assets with HP cash flows which would become MA eligible under a separate proposal as set out in Chapter 2 of this CP. The proposed attestation scope would cover the sufficiency of additions to the FS in respect of those assets with HP cash flows. The proposed attestation scope also covers any adjustments needed to the FS to reflect differences in credit quality by rating notch, including assets that do not yet have a notched rating as set out in Chapter 9 of this CP.

6.5 The PRA considers that the attestation proposals are necessary to advance its primary objectives of safety and soundness and policyholder protection. The MA represents a material contribution to firms' capital resources, and individual firms' investment strategies differ from each other and from the simple portfolios of corporate bonds on which the FS model specified by legislation is based, and which may diverge even further in future given the expansion of the range of MA eligible assets. The proposals advance the PRA's secondary objective of facilitating effective competition by reducing the risk of firms applying an inappropriate FS or MA, and facilitating a level playing field between firms.

6.6 As well as enabling the investment freedoms that directly advance the PRA's secondary objective of international competitiveness and growth, the proposals also advance this objective because:

- firms' ownership of the MA is consistent with high risk-management standards, which supports international competitiveness; and

- holding an insufficient FS or claiming excessive MA is likely to increase the risk of insurers having insufficient financial resources, which could adversely affect their ability to support investment and contribute to the medium to long term growth of the UK economy.

Attestation requirement

6.7 In its November 2022 statement, the Government announced that the design and calibration of the FS would be broadly unchanged[13] and that it would legislate to expand the range of MA eligible assets. The Government also announced its support for the PRA taking forward a number of supervisory measures and its support for the PRA's use of these measures to hold insurers to account in maintaining safety and soundness and policyholder protection (paragraph 1.13 of the November 2022 statement). These measures included the attestation requirement for 'nominated senior managers with formal regulatory responsibilities and sanctions under the SMR to attest formally to the PRA whether or not the level of the FS on their firm's assets is sufficient to reflect all retained risks, and that the resulting MA reflects only liquidity premium and apply a higher FS through an add-on where they conclude that the standard allowance is insufficient.'

6.8 In line with the November 2022 statement, the PRA proposes that firms would be required to attest to the PRA on the sufficiency of the FS and the quality of the resulting MA.

6.9 The PRA considers that the proposals would:

- reduce the risks arising from the FS being determined solely by a single, simple, sector-wide model, in the face of the increasingly broad range of assets that firms are holding within their MA portfolios; and
- manage the additional risks from the widening of MA asset eligibility and the removal of the MA cap on SIG assets.

6.10 The proposals would also help ensure firms own and are accountable for the amount of MA applied. The PRA would expect firms to review the size of the FS and MA separately from each other, ie not simply attest to the MA as the residual spread having first determined the FS. The PRA considers this to be appropriate because there is significant judgement and uncertainty in decomposing the spread into compensation for retained risks (which needs to be covered by the FS) and other factors that are not related to retained risks (which result in the MA). The PRA has also observed wide variation in the amount of MA across asset classes as a result of the current, largely mechanical approach to calculating the FS. Separate verification and provision of a credible rationale for the size of the MA would improve assurance that the MA generated by the wide range of assets in which firms invest is a fair reflection of the returns that a firm applying the MA can be confident of earning.

[13]Two exceptions to this are: adding more granularity to the existing FS by allowing it to vary by rating notch, and the removal of the MA cap on SIG assets.

6.11 Where firms judge the FS to be insufficient, or the derived MA inconsistent with the attestation, the proposals would permit firms to apply a voluntary addition to the FS and to reflect this in the attestation. This FS addition would be applied via the new Matching Adjustment Part 17 of the PRA Rulebook and could be reassessed by firms at the next attestation.

6.12 The PRA recognises that the attestation requirement may in some cases result in voluntary additions being made by firms to the FS as firms take ownership of the MA applied in the valuation of their liabilities. Many of the assets in firms' MA portfolios have a similar risk profile to those used to calibrate the FS and, in such cases a voluntary FS addition is unlikely to be needed; as such the PRA does not expect its proposals to result in a general increase in the level of FS applied to all assets. However, as set out above, under the existing FS / MA construct, there is a wide range of spreads and hence of MA even for assets of the same currency, sector, CQS, and term. The PRA would expect a firm's attestation to provide greater insight into the drivers of variation in MA and lead to improved management of the risks identified. Where a firm concludes that, after allowing for risk management and mitigation, the variation in MA cannot be justified by the risk and return characteristics of assets, a voluntary FS addition could result in a narrowing of the range.

6.13 The PRA would not expect any voluntary FS addition to automatically result in a reduction in the SCR. The PRA expects firms to consider the extent to which the risks that are allowed for in a voluntary FS addition are also allowed for within the calibrations underlying the SCR and consequently how they may change in stress conditions.

6.14 The proposed amendments to the PRA Rulebook to support these proposals are contained in Appendix 2; the proposed changes to SS7/18 are set out in Appendix 3; the proposed changes to SS8/18 are set out in Appendix 4.

Attestation statement

6.15 The PRA proposes the attestation wording to be defined in the PRA Rulebook would be as follows:

'As at the effective date of the firm's Solvency and Financial Condition Report (SFCR): 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.'

The aim of using a standardised wording is to promote a level playing field with all MA firms attesting to the same standard.

Attesting to the sufficiency of the FS

6.16 The PRA considers the proposed attestation wording for the FS to be aligned with the FS requirements in legislation, namely that the FS reflects all the risks retained by firms.[14] Examples of factors the PRA would expect firms to consider include whether:

- the asset has risks that are not reflected in the data used for calibrating the published standard FS;
- all the risks are fully captured in the asset's rating;
- the asset's rating is sufficiently accurate, reliable, up-to-date, and granular, or whether there has been a material event affecting credit risk that is not yet reflected in the rating;
- the rating transition behaviour or loss on downgrade are expected to be different from that assumed in the standard published FS;
- additional risks arising from various sources of cash flow non-fixity have been sufficiently captured by the required FS additions; and
- when compared to the data underlying the published FS, the portfolio could experience a reduced level of diversification due to common risk factors.

Attesting to the quality of the MA

6.17 The proposed attestation wording in respect of the MA is aligned in its intent, but more general than the one used in the November 2022 statement, which referred to the 'MA reflecting liquidity premium only'. The PRA agrees that the liquidity premium may be the most obvious example of compensation that can be earned with a high degree of confidence by a buy-and-hold investor.[15] However, the PRA also acknowledges that there may be other sources of such compensation, particularly for private assets. Examples of these include opportunities with barriers to entry which allow lenders to earn additional spread, or assets where a firm has invested in specialised skills to source, develop and manage the investment, and part of the spread represents compensation for that investment and ongoing expense.

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[14] [x] of MA regulations

[15] See Chapter 7 for a fuller list of the Assumptions underlying the MA.

6.18 The PRA proposals would place an expectation on firms to demonstrate that they understand how the market is pricing the asset's risks and hence are able to identify the sources of anticipated returns. The PRA would expect firms to satisfy themselves whether it is reasonable, with sufficient justification, to recognise a proportion of these anticipated returns in the MA. Conversely, firms would be expected to consider whether any 'excess spread' on an asset could be indicative of additional, but unidentified risks or greater variability and uncertainty around an expected outcome, reducing the level of confidence that the MA could be earned.

6.19 The PRA notes that the MA forms part of the relevant risk-free rate that is used to discount the liabilities of MA eligible business, and accordingly the degree of certainty should be commensurate with that purpose. Nevertheless, the PRA considers that requiring the MA to be earned free of any risk would not be practical. It is not possible to predict the future with certainty or guarantee that the MA will be earned under all circumstances.

6.20 The PRA considers the proposed attestation requirement for the 'MA to be earned with a high degree of confidence' is an appropriate standard to provide a safeguard to the amount of MA being claimed. This would require the MA to be materially more certain than a 50th percentile or best estimate basis. This is for the following reasons:

- the MA contributes directly to T1 capital, which is required to be of the highest quality based on its loss absorbency and permanent availability;

- as opposed to other assumptions used in the calculation of the BEL, no additional amount (risk margin) is held for this assumption to ensure that TPs achieve the standard set out in Technical Provisions 2.2; and

- the MA additionally offsets falling asset values in a credit stress. This means that by design it becomes more material at those times when asset values are most depressed, ie greater reliance is placed on the MA for the protection of policyholders in times of stress.

6.21 In the proposed amendments to SS7/18, the PRA has set out a non-exhaustive list of justifications that firms may have for their ability to earn the MA with a high degree of confidence. The proposed expectation on the degree of confidence is consistent across all MA assets, and firms should target the same level of certainty as they would for a portfolio of liquid corporate bonds with fixed cash flows and up to date, accurate credit ratings.

6.22 The PRA recognises that there is significant judgement and uncertainty in spread decomposition, which involves quantifying the likelihood and the impact of certain risks materialising, and the compensation that is commensurate with these risks. Academic

research on spread decomposition likewise encompasses a wide range of estimates.[16] The proposed MA attestation wording would allow for the role of judgement and give room for reasonable differences in views.

6.23 Under the proposals, the PRA would expect firms to take a proportionate approach to satisfying themselves on their ability to earn the MA. In practice this means that more focus would be required for those assets with a comparatively high level of MA.

6.24 The proposed amendments to SS7/18 set out a possible approach that firms could use to systematically review the evidence for the attestation. This is summarised below:

- identify assets in the MA portfolio with a similar risk profile as those used in the PRA's calibration of the existing FS. Then consider whether the FS reflects all retained risks;
- identify assets in the MA portfolio that are different to, or have additional risk factors from, those used in the PRA's calibration of the existing FS, such as internally rated, internally valued, private, restructured assets, or assets with HP cash flows. Then consider whether the FS reflects all retained risks; and
- review all assets in the portfolio and explain (or modify) the MA on assets that are material contributors to the MA. There should be clearly articulated metrics for identifying material contributors.

The proposed amendments to the PRA Rulebook to support these proposals are contained in Appendix 2 and the proposed changes to SS7/18 are set out in Appendix 3.

Attestation responsibility

6.25 The PRA proposes that a nominated SMF would submit the attestation to the PRA. One of the objectives for the proposals is to improve the governance and oversight of the MA and the PRA considers that having a named senior manager, rather than a committee, should encourage individual accountability and hence support the effectiveness of the measure.

6.26 The SMF responsible for the attestation should have responsibility for the calculation of the FS and hence the ability to increase it if necessary. The PRA considers that this individual is most likely to be the person with prescribed responsibility for the production and integrity of the firm's financial information and its regulatory reporting, PR Q, from Insurance – Allocation of Responsibilities 3.1(4) in the PRA Rulebook. The PRA therefore proposes this

[16] See Chart 1 in the annex to discussion paper (DP) 2/22 – **Solvency II Review: Matching Adjustment and reforms to the Fundamental Spread**.

individual, who would usually be the Chief Financial Officer (but may differ depending on how responsibility is allocated within the firm), must provide the attestation. A firm should approach its usual supervisory contact, in the first instance, if it considers that its governance arrangements mean that an alternative SMF would be more appropriate to undertake the attestation.

6.27 The PRA recognises that the nominated SMF may have delegated their responsibility for elements of the balance sheet valuation to a relevant committee or individual. Nevertheless, the proposals would require ultimate accountability for the attestation to rest with an individual SMF, or SMFs if the responsibility is shared.

6.28 The proposed amendments to the PRA Rulebook to support these proposals are contained in Appendix 2 and the proposed changes to SS7/18 are set out in Appendix 3.

Attestation document, report, and disclosure

6.29 The PRA proposes for firms to put in place a formal attestation policy, and for each attestation, to submit an attestation document and accompanying report to the PRA. The expected content of each of these are set out in the proposed updates to the PRA Rulebook and changes to SS7/18. The proposals would not require firms to provide the PRA with all the evidence underlying the attestation, however the PRA would expect suitable signposting of any evidence that the attestor has relied on. The PRA proposes that this evidence could subsequently be requested by supervisors on an ad hoc basis.

6.30 The PRA proposes that neither the attestation report nor the underlying evidence would be within the scope of external audit. This is because the purpose of the attestation is already one of assurance on the FS and MA.

6.31 The PRA considered whether to require public disclosure of the evidence underlying the attestation. This could facilitate a greater degree of market discipline and transparency on the quality of each firm's MA. However, the PRA currently considers that these benefits do not justify requiring firms to disclose what would likely be commercially sensitive information, given the detailed asset-level risk analysis that may need to be undertaken to assess the MA for certain assets. In light of this, the PRA does not propose to introduce public disclosure of the attestation material. Instead the proposals expect firms to engage bilaterally with the PRA, with additional guidance provided if necessary, over time. Nevertheless, firms would have to disclose within their SFCR whether or not an attestation has been made.

6.32 The proposed amendments to the PRA Rulebook to support these proposals are contained in Appendix 2 and the proposed changes to SS7/18 are set out in Appendix 3.

Attestation frequency and level

6.33 The PRA proposes that the attestation must be given annually, with an effective date aligned to the firm's SFCR, and provided no later than 14 weeks after the firm's financial year end to which it relates. The PRA considers that aligning the effective date of the attestation with the SFCR would increase confidence over the reported results, and benefit from other assurance work conducted on the asset valuation.

6.34 The PRA also proposes that an out of cycle attestation must be performed upon a material change in the firm's risk profile. Examples of a material change in risk profile that would trigger an out of cycle attestation are given in the proposed amendments to SS7/18. The period for submitting the out of cycle attestation would be agreed bilaterally with the PRA.

6.35 The PRA proposes that the attestation must be given at the MA portfolio level as opposed to legal entity or group. This is because each MA portfolio should be organised and managed separately from the other activities of the undertaking ([x] of MA regulations).

6.36 The proposed amendments to the PRA rulebook to support these proposals are contained in Appendix 2 and the proposed changes to SS7/18 are set out in Appendix 3.

PRA objectives analysis

6.37 The PRA considers the proposals set out in this chapter advance the PRA's primary objectives of safety and soundness and policyholder protection. As of YE22, the MA benefit was worth around £66 billion to UK annuity insurers. Of this around £32 billion adds to own funds and the rest reduces regulatory capital requirements. Given the materiality, it is important for policyholder protection that the FS reflects all the retained risks and firms have high confidence that the MA will be earned. The attestation requirement would further support this by holding firms accountable to ensuring the sufficiency of the FS and the quality of the MA.

6.38 The PRA considers the attestation proposals set out in this chapter would also advance the PRA's secondary objective of effective competition. It would reduce the risk of an inappropriate FS being applied to firms' assets and therefore contribute to a level playing field.

6.39 The PRA considers the attestation proposals set out in this chapter would additionally advance the PRA's secondary objective of international competitiveness and growth both directly and through enabling other reform elements such as increased investment flexibility. This is because:

- improved firm ownership of the resulting MA, consistent with high risk-management standards supports international competitiveness; and

- holding an insufficient FS or claiming excessive MA is likely to increase the risk of insurers having insufficient financial resources, which could affect adversely their ability to support investment and contribute to the medium to long term growth of the UK economy.

7: Assumptions underlying the MA

7.1 This chapter sets out the key conceptual and technical assumptions underlying the MA (and FS). These assumptions are based on the existing Solvency II framework. The PRA expects firms to take these into consideration when complying with the relevant Solvency II requirements, including the proposed attestation process.

7.2 The PRA expects firms to take these into consideration when complying with the relevant Solvency II requirements in respect of TPs and governance, including the proposed attestation process.

7.3 The proposals in this chapter would make changes to SS7/18 – Solvency II: Matching adjustment (Appendix 3) by introducing a new chapter setting out the key conceptual and technical assumptions underlying the MA, and how firms would be expected to use/consider them.

7.4 The PRA considers that its primary objectives of safety and soundness and policyholder protection would be advanced by the proposals in this chapter. Setting out the assumptions underlying the MA in the PRA's policy material would give greater transparency to firms regarding the PRA's interpretation of these, help to improve consistency in firms' compliance with the relevant risk management requirements, and support the proposed attestation process. The promotion of consistency of approach and the transparency provided would also help to advance the PRA's secondary competition objective and its new secondary competitiveness and growth objective.

The assumptions underlying the matching adjustment

7.5 The phrase 'assumptions underlying the MA' (or equivalently 'assumptions underlying the calculation of the MA') is used in certain contexts in the current Solvency II framework, for example, the requirement that firms regularly assess the sensitivity of their TPs and eligible own funds to the assumptions underlying the calculation of the MA (Conditions Governing Business 3.2(2)(a) of the PRA Rulebook). The PRA considers that setting out the assumptions underlying the MA in one place would provide clarity to firms on what they are expected to consider in these contexts. These assumptions are based on the existing Solvency II framework and the PRA is not proposing any changes to them beyond restating them in SS7/18.

7.6 The PRA considers it is useful to distinguish between two categories of assumptions:

- **Conceptual assumptions**: setting out the logical underpinning of the MA as a concept.
- **Technical assumptions**: setting out the policy requirements in relation to the technical information published by the PRA for the calculation of the MA (i.e. inputs to the calculation of **technical information** for the FS).

The PRA expects firms to assess both categories of assumptions when determining whether the MA being applied is consistent with the assumptions underlying the MA.

Conceptual assumptions

7.7 The PRA considers the key conceptual assumptions underlying the MA to be as follows:

- Firms that are suitably cash flow matched in respect of their assets and liabilities and adopt a hold-to-maturity investment strategy are not exposed to certain risks. Therefore, those firms may expect to earn, with high confidence, the portion of the credit spread on their assets that represents compensation for risks to which they are accordingly not exposed;[17]
- The total credit spread can be decomposed into two components: the FS which reflects compensation for the risks retained by the firm and the MA which is the residual spread reflecting compensation for risks that are not retained by the firm.[18] The FS covers (at least) compensation for expected default and downgrade losses, as set out in the Matching Adjustment Part of the PRA Rulebook;
- The FS for the risks retained by the firm is calculated using a transparent, prudent, reliable, and objective method, which is consistent over time and between assets of different currencies and countries as set out in the Matching Adjustment Part of the PRA Rulebook;
- The FS applied to each asset is derived from historical, long-term data that is relevant for that asset's duration, credit quality, and asset class as set out in the Matching Adjustment Part of the PRA Rulebook; and
- The firm follows effective risk management practices and, when implementing the hold-to-maturity investment strategy, replaces assets for the purpose of maintaining matching only where the expected asset and liability cash flows have materially changed as set out in [x] of the MA regulations.

[17] [x] of the MA regulations, Chapter 4 of the Matching Adjustment Part of the PRA Rulebook, Recital 31 of Directive 2014/51/EU of the European Parliament and of the Council

[18] The MA may include the additional spread relating to costs incurred in origination or mitigation of risks that would otherwise be retained as discussed in paragraphs 5.37 and 5.38 of SS7/18 – 'Solvency II: Matching adjustment' (Appendix 3).

Technical assumptions

7.8 The PRA considers that the following are the key policy requirements in relation to the technical information published by the PRA for the calculation of the MA:

- Credit ratings, or equivalent credit assessments, on individual assets are an objective and reliable measure of risk – these credit ratings are mapped to an FS that appropriately reflects the asset's credit quality;[19]
- 30% of an asset's market value can be considered recoverable on default, as set out in the Matching Adjustment Part of the PRA Rulebook;
- Expected downgrade losses are determined based on immediately replacing a downgraded asset with an asset of the same asset class, same cash flow profile, and the same or higher credit quality, as set out in the Matching Adjustment Part of the PRA Rulebook; and
- The FS is at least 35%, or in the case of UK Government bonds 30%, of the 30-year average of the observable credit spreads on assets of the same duration, credit quality, and asset class, as set out in the Matching Adjustment Part of the PRA Rulebook.

7.9 In addition to the above, the PRA's published technical information for non-government exposures is based on data for well-diversified portfolios of corporate bonds. Therefore, the technical information assumes that the risk profile of firms' exposures is well represented by a well-diversified portfolio of externally rated and traded corporate bonds.

7.10 The proposed changes to SS7/18 to reflect these conceptual and technical assumptions are set out in Appendix 3.

Use of the assumptions underlying the MA in practice

7.11 The PRA proposes clarifying, by introducing a specific expectation in SS7/18, that it expects firms to consider the conceptual and technical assumptions set out in the section above when considering how they comply with TPs requirements (as set out in the Technical Provisions and Matching Adjustment Parts of the PRA Rulebook), the Investments Part of the PRA Rulebook and governance requirements (as set out in the Conditions Governing Business Part of the PRA Rulebook).

7.12 The PRA further considers that the assumptions underlying the MA would be particularly relevant for firms in the following circumstances:

[19] Chapter 4 of the Matching Adjustment Part of the PRA Rulebook and Articles 4(1) and 4(5) of the SII CDR

- in respect of PRA rules that refer to the assumptions underlying the MA;
- when determining whether their MA portfolio is invested and managed in line with the PPP (Investments Part of the PRA Rulebook);
- when determining any appropriate FS additions and safeguards in respect of assets with HP cash flows (Matching Adjustment Part of the PRA Rulebook); and
- when determining if any additions in accordance with Matching Adjustment 4.16 are appropriate to ensure that the FS reflects risks retained by the firm including any FS additions the firm considers necessary as part of the attestation process (Matching Adjustment Part of the PRA Rulebook).

7.13 The technical information published by the PRA is based on data for government and corporate bonds and is calculated using the assumptions set out in paragraph 7.8. Having clarity on these technical assumptions and the conceptual assumptions underpinning the MA should help firms determine if their MA portfolio is invested and managed in line with the PPP.

7.14 Under Matching Adjustment 5; assets with HP cash flows may be included in the MA portfolio, subject to the FS additions and use of other possible safeguards described elsewhere in this CP. These are intended to address the fact that some of the assumptions set out above do not hold given the variability of cash flows for such assets. Setting out the assumptions underlying the MA should assist firms in considering what risks are already captured in the technical information published by the PRA for the calculation of the MA and where additions and other potential safeguards are needed to account for new risks not captured.

7.15 The proposed attestation process is intended to result in greater ownership by firms of the MA, raising the importance of consistency in the interpretation of the assumptions underlying the MA. Identifying the assumptions underlying the MA should also enable firms to establish whether these are consistent with the risk profile of their portfolio. This should assist in determining whether any additions in accordance with (Matching Adjustment 4.16 and Matching Adjustment 8) are appropriate including any FS additions the firm considers necessary as part of the attestation process (Matching Adjustment 9).

7.16 If a firm concludes that its risk profile deviates from the conceptual and technical assumptions underlying the MA, the PRA proposes introducing an expectation that such a firm should take remedial action including potentially applying an FS addition, changing its management and governance of the MA portfolio (eg investment policies) or removing assets from the MA portfolio.

7.17 The PRA considers that the proposals set out in this chapter will enable firms to make a robust assessment of whether they may expect to earn, with high confidence, the portion of the credit spread on their assets that represents compensation for risks to which they are not exposed. The proposed changes to SS7/18 to reflect these proposals are set out in Appendix 3.

Capital add-ons in respect of the matching adjustment

7.18 The Solvency II framework already includes a provision to apply a capital add-on in circumstances where there is 'significant deviation from the assumptions underlying the MA' (Article 37(1)(d) of Directive 2009/138/EC and SII CDR Article 278(1)). The PRA has recently consulted in **CP12/23** on bringing those provisions across to its policy framework, essentially unchanged from the framework inherited from the EU (see PRA's draft SoP on Capital add-ons in CP12/23).[20]

7.19 The PRA is not proposing to change its policy or practice about the potential use of capital add-ons for the MA. For clarity, the PRA expects to consider the same assumptions as set out above when determining if the risk profile of a firm deviates significantly from the assumptions underlying the MA.

7.20 The PRA will consult in due course on reflecting this proposal in its proposed SoP – Solvency II: Capital add-ons.

PRA objectives analysis

7.21 The PRA considers that the proposals in this chapter would advance its primary objectives of safety and soundness and policyholder protection for the following reasons:

- restating the conceptual and technical assumptions underlying the MA in the PRA's policy material would provide clarity and promote increased consistency and transparency in respect of relevant Solvency II requirements, including the requirements on firms' risk management systems that refer to the assumptions underlying the MA; and
- clarity around the conceptual and technical assumptions underlying the MA should improve the objectivity and robustness of firms' approaches to applying any additions to the FS including any FS additions the firm considers necessary as part of the attestation process.

[20] Solvency II: Capital add-ons in Appendix 13 of CP12/23 – Review of Solvency II: Adapting to the UK insurance market.

7.22 The PRA considers that the proposals in this chapter would advance the PRA's secondary competition objective as defining the conceptual and technical assumptions underlying the MA would improve consistency across firms' interpretations of these and hence support a level playing field. The PRA considers that the proposals in this chapter would also advance the PRA's secondary competitiveness and growth objective through their support of other reform measures on attestation and assets with HP cash flows.

8: Matching Adjustment Asset and Liability Information Return data collection

8.1 This chapter sets out the PRA's proposal to introduce a new reporting requirement, whereby firms with permission to apply the MA would be required to complete a Matching Adjustment Asset and Liability Information Return (MALIR). The MALIR would formalise the collection of data that has previously been collected by the PRA on an ad hoc basis.

8.2 The policy proposals in this chapter would:

- introduce a new annual reporting requirement in PRA rules for firms to provide portfolio metrics and detailed information on the assets and liabilities held in their MA portfolios;
- introduce a new reporting template setting out the information that would be required and the format in which it would be provided (the MALIR template); and
- introduce a process that would allow firms to apply for a waiver from the requirement to submit a MALIR, or part thereof, in certain circumstances.

8.3 The proposals in this chapter would:

- introduce new rules in the Reporting Part of the PRA Rulebook (Appendix 2); and
- make changes to SS7/18 – Solvency II: Matching adjustment (Appendix 3).

8.4 The PRA considers that the proposals in this chapter would advance its primary objectives of safety and soundness and policyholder protection. In particular, the proposals would help ensure that firms give due consideration to the monitoring of assets and liabilities held in their MA portfolios and would allow the PRA to focus its supervisory activity towards areas of greatest potential risk.

8.5. The PRA further considers that the proposals would enable the PRA to better identify potential systemic risks, supporting the safety and soundness of firms in the annuity sector (in particular). It would also enable the PRA to understand better the extent to which firms are investing in capacity enhancing assets that directly contribute to UK economic growth, and the nature of such investments, therefore supporting the PRA's new secondary competitiveness and growth objective. In addition, the option for a waiver to be granted on the grounds of materiality would reduce the risk of a disproportionate burden being placed on

certain firms, and would also reduce barriers to entry, helping advance the PRA's secondary competition objective.

The MALIR

8.6 Since the introduction of Solvency II, the PRA has requested firms with MA approval to participate in a voluntary MA data collection exercise on four separate occasions. The focus of this data collection has been on the assets and liabilities held in firms' MA portfolios, including information on asset types, the FS, and MA generated by each asset and the asset cash flows. The data collected has been used extensively by the PRA, including in day-to-day supervision of firms' use of the MA and peer analysis. Such data has therefore provided a significant supervisory tool by, for example, allowing the PRA to identify assets that generate significant amounts of MA benefit and focus its supervisory efforts on these areas of higher potential risk. This is particularly important given the size and materiality of firms' MA portfolios.

8.7 The PRA is aware of the potential for there to be significant changes in MA portfolios in the next few years due to a combination of expected growth in the UK Bulk Purchase Annuity (BPA) market,[21] Solvency II reforms and firms' stated plans to substantially expand investment in assets they consider would contribute to **UK economic growth**. In view of these changes and the potential rapidity with which they could occur, the PRA considers that the more structured and frequent provision by firms of detailed data on their MA assets and liabilities would support effective ongoing supervision. This would include embedding of the new proposed attestation requirement which, unless there was a material change in risk profile, would also be completed on an annual basis. It would also give the PRA greater insight into the nature and size of firms' investment in different assets which would assist in future work to analyse stress testing results provided by firms as part of the increased focus on stress testing set out in the November 2022 statement.[22] The PRA also considers that there are disadvantages in continuing the collection of information on an ad hoc basis, not least higher costs and greater uncertainty for firms compared to a regular data collection.

8.8 Furthermore, the PRA considers that it would be beneficial for both the PRA and firms if the PRA were to collect this data on a regular basis.

8.9 The PRA therefore proposes to introduce new rules requiring:

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[21] **LCP report on future demand and supply in the buy-in and buy-out market** (October 2022).

[22] Paragraph 1.13 of the Government's November 2022 consultation response identifies requiring insurers to participate in regular stress testing exercises prescribed by the PRA as one of the additional measures to advance policyholder projection post implementation of the Solvency II reforms.

- all firms with approval to apply the MA to complete and submit the MALIR to the PRA on an annual basis from year end 2024;[23]
- a separate MALIR submission to be completed for each MA portfolio;
- the MALIR to be submitted 130 business days after a firm's financial year end[24] (for most firms this would be by 23 June each year); and
- the MALIR to be completed in line with instructions and definitions that would be set out in the PRA Rulebook.

8.10 These proposals aim to collect data in a way that minimises the resource burden for both firms and the PRA. In particular, moving to a formalised annual cycle of reporting would allow firms to build the MALIR into their reporting processes while the use of an alternative reporting timeframe to most other financial year-end regulatory reporting requirements would avoid putting additional pressure on firms' year-end reporting processes.

8.11 The PRA also recognises that the volume of data requested in the MALIR is substantial. As part of the PRA's wider commitment to ensuring that reporting requirements are fit for purpose, the PRA intends to review the content requested and the ongoing need for the data at an appropriate future time, which is expected to be prior to the Government review of the appropriateness of the FS calibration noted in the November 2022 statement.[25] The PRA considers that such a review point is suitable for this purpose. It would also allow the period of data collection to be sufficient to provide some certainty and stability on the reporting requirements, to allow trend analysis to be undertaken and to reflect the anticipated growth in the BPA market over this time.

8.12 The proposed amendments to the PRA Rulebook to reflect these proposals are set out in Appendix 2.

[23] It is intended that the rules implementing the MALIR will come into force on 31 December 2024, due to the need to sync the introduction of the MALIR with wider changes to the reporting framework. To clarify, the first MALIR submission will be due in 2025 in respect of year end 2024.

[24] This is equivalent of 12 weeks following the relevant year-end reporting deadlines.

[25] In paragraph 1.15 of its November 2022 Statement (**Review of Solvency II: Consultation – Response**) the Government noted it will review whether the calibration of the fundamental spread remains appropriate in 5 years' time and that prior to this the PRA will undertake an assessment of the impact of the Solvency II reforms on its statutory objectives, including whether further changes are needed.

The MALIR template

8.13 The PRA proposes that the MALIR template would build on the template used for its last ad hoc collection of **MA asset and liability information** as at YE22. As a result, firms with permission to use the MA should be familiar with the basic form and substance of the MALIR.

8.14 The PRA further proposes that an Excel based template would continue to be used for the MALIR for a minimum of two years, while a project is undertaken (with appropriate engagement with affected firms) to assess the need for and implement, if necessary, an alternative reporting interface. This would allow firms time to amend their systems and processes in an orderly manner without imposing an undue burden on reporting and development teams.

8.15 In terms of data fields, the PRA proposes that data is collected covering the following five broad areas:

- asset features, including sector of exposure, issuer country and currency, and individual asset characteristics;
- asset ratings, including whether each asset is internally or externally rated;
- asset-level metrics, including the yield, spread, FS and MA in respect of each asset;
- asset and liability cash flows; and
- portfolio metrics, including (where relevant) the results of the PRA matching tests.

8.16 As per previous voluntary MA data collection requests, the proposed MALIR would contain some cross-over with Quantitative Reporting Template submissions (QRTs). The PRA has carefully assessed data fields where such overlap would occur and has considered these necessary either to allow the MALIR to give a comprehensive picture of the assets and liabilities held in the relevant MA portfolio or to ensure complete data is collected where the overlap is only partial. For example, the QRTs collect data on assets held in MA portfolios but do not cover all assets held, notable exclusions being derivatives and reinsurance. The MALIR would collect data for all assets which means in this case there would only be a partial overlap with MA asset data collected in the QRTs. The PRA expects that the degree to which the data overlaps with the QRTs would assist with data validation for both the PRA and firms.

8.17 The PRA proposes to minimise changes relative to the last ad hoc request at YE22 focussing on:

- tightening areas where there were previously inconsistencies, by, for example, relating to the collection of data for both term and duration and to provide clear definitions for each; and

- adding new data fields to support other proposed Solvency UK reforms, by, for example, proposing to collect specific data in respect of assets with HP cash flows and assets which are considered to be capacity enhancing i.e. which directly contribute to UK economic growth via the financing of increased capacity in both capital and labour stock and tangible and intangible assets in the economy.

8.18 The PRA recognises the benefits of stability and certainty in the information requests that it makes of firms. As such, the PRA intends that the format and content of the MALIR would remain, for the most part, unchanged (unless an important, unanticipated data set were to be needed) from YE24.

8.19 The table below sets out the full list of data fields that the PRA proposes would be requested as part of the MALIR. Data fields that are new additions since the MALIR year end 2022 are followed by a '*': For further detail and explanation of terms please see the MALIR template and associated instructions (Appendices 8 and 9).

Table 1: List of data fields the PRA proposes to include in the MALIR

MALIR template title	Reference	Detailed data fields
Firm Information: The following data fields should be completed on a portfolio basis	MALIR 1 - 1.1	Undertaking name
	MALIR 1 - 1.2	Legal Entity Identifier (LEI)
	MALIR 1 - 1.3	FRN
	MALIR 1 - 1.4	MAP reference
	MALIR 1 - 1.5	Reporting reference date*
	MALIR 1 - 1.6	Reporting submission date*
	MALIR 1 - 1.7	Initial submission or re-submission*
Asset Cash flows: The following data fields would need to be	MALIR 2 - 2.1	Component A/B/C of the MAP
	MALIR 2 - 2.2	Asset Type

MALIR template title	Reference	Detailed data fields
completed on an individual asset level	MALIR 2 - 2.3	Internal high level asset classification
	MALIR 2 - 2.4	Internal detailed asset classification
	MALIR 2 - 2.5	Description of assets or where further detail may be helpful
	MALIR 2 - 2.6	Item Title
	MALIR 2 - 2.7	CIC Code
	MALIR 2 - 2.8	Asset ID Code
	MALIR 2 - 2.9	Asset ID Code Type
	MALIR 2 - 2.10	Issuer Sector
	MALIR 2 - 2.11	FS Sector
	MALIR 2 - 2.12	Issuer Country
	MALIR 2 - 2.13	Currency
	MALIR 2 - 2.14	FS table used
	MALIR 2 - 2.15	Valuation method Solvency II
	MALIR 2 - 2.16	Credit Quality Step (CQS)
	MALIR 2 - 2.17	Rating method
	MALIR 2 - 2.18	Name of Internal Methodology
	MALIR 2 - 2.19	Internal Rating

MALIR template title	Reference	Detailed data fields
	MALIR 2 - 2.20	Fitch Rating
	MALIR 2 - 2.21	Moody's Rating
	MALIR 2 - 2.22	S&P Rating
	MALIR 2 - 2.23	Other CRA Rating
	MALIR 2 - 2.24	Notched rating used
	MALIR 2 - 2.25	Underlying property exposure
	MALIR 2 - 2.26	Internally restructured
	MALIR 2 - 2.27	Small Medium Enterprise
	MALIR 2 - 2.28	Partial recognition of cash flows
	MALIR 2 - 2.29	Asset in construction phase
	MALIR 2 - 2.30	Climate target / Green
	MALIR 2 - 2.31	Hedging Asset
	MALIR 2 - 2.32	Capacity Enhancing Assets*
	MALIR 2 - 2.33	Primary / Secondary Investment*
	MALIR 2 - 2.34	Highly Predictable Asset*
	MALIR 2 - 2.35	Uncertainty Provision*
	MALIR 2 - 2.36	Duration

MALIR template title	Reference	Detailed data fields
	MALIR 2 - 2.37	Term*
	MALIR 2 - 2.38	Yield
	MALIR 2 - 2.39	Risk Free Rate
	MALIR 2 - 2.40	Credit Spread
	MALIR 2 - 2.41	Base recovery rate
	MALIR 2 - 2.42	Probability of Default*
	MALIR 2 - 2.43	Residual FS Allowance*
	MALIR 2 - 2.44	FS Addition - Highly Predictable*
	MALIR 2 - 2.45	FS Addition - Other*
	MALIR 2 - 2.46	Fundamental Spread
	MALIR 2 - 2.47	MA Benefit (%)
	MALIR 2 - 2.48	MA Benefit (£m)
	MALIR 2 - 2.49	Market Value as at effective date
	MALIR 2 - 2.50	Notional value
	MALIR 2 - 2.51	Cash flow type
	MALIR 2 - 2.52	Gross monthly cash flows
Liability Cash flows: The following data	MALIR 3 - 3.1 C01	Present value at basic RFR £m for Level or fixed-escalation claim cash flows

MALIR template title	Reference	Detailed data fields
fields would need to be completed on an aggregate portfolio level	MALIR 3 - 3.1 C02	Present value at basic RFR £m for Inflation-linked claim cash flows
	MALIR 3 - 3.1 C03	Present value at basic RFR £m for Expense cash flows
	MALIR 3 - 3.1 C04	Present value at basic RFR £m for Other cash flows
	MALIR 3 - 3.2 C01	Present value at basic RFR + MA £m for Level or fixed-escalation claim cash flows
	MALIR 3 - 3.2 C02	Present value at basic RFR + MA £m for Inflation-linked claim cash flows
	MALIR 3 - 3.2 C03	Present value at basic RFR + MA £m for Expense cash flows
	MALIR 3 - 3.2 C04	Present value at basic RFR + MA £m for Other cash flows
	MALIR 3 - 3.3 C01	Gross liability cashflows by month for Level or fixed-escalation claim cash flows
	MALIR 3 - 3.3 C02	Gross liability cashflows by month for Inflation-linked claim cash flows
	MALIR 3 - 3.3 C03	Gross liability cashflows by month for Expense cash flows
	MALIR 3 - 3.3 C04	Gross liability cash flows by month for Other cash flows
	MALIR 3 - 3.4	Description of items included under 'Other' liability cash flows

MALIR template title	Reference	Detailed data fields
	MALIR 3 - 3.5	Description of items included under 'Expense cash flows'
Portfolio Output: The following data fields would need to be completed on an aggregate portfolio level	MALIR 4 - 4.1	Total spread on assets
	MALIR 4 - 4.2	PD allowance [A]
	MALIR 4 - 4.3	Residual Fundamental Spread Allowance [B]
	MALIR 4 - 4.4	FS Addition – Highly Predictable [C]*
	MALIR 4 - 4.5	FS Addition – Other [D]*
	MALIR 4 - 4.6	Fundamental Spread allowance [A] + [B] + [C] + [D]
	MALIR 4 - 4.7	Matching Adjustment benefit (bps)
	MALIR 4 - 4.8	Matching Adjustment benefit (£m)
	MALIR 4 - 4.9	Matching Adjustment benefit (bps) as per QRT SR22.03.01, R0060 in C0010
	MALIR 4 - 4.10	Matching Adjustment benefit (£m) as implied by QRT S22.01.01, R0010, C0090
	MALIR 4 - 4.11	Matching Adjustment benefit (£m) as implied by the sum of MALIR 2 - 2.48
	MALIR 4 - 4.12	Explanation of any differences between the MA Benefit in bps in MALIR 4 - 4.7 and MALIR 4 - 4.9

MALIR template title	Reference	Detailed data fields
	MALIR 4 - 4.13	Explanation of any differences between the MA Benefit in £m in MALIR 4 - 4.8, 4.10 and 4.11
	MALIR 4 - 4.14	Qualitative explanation of any difference between total Solvency II amount of assets in the MAP (£m) and total Solvency II amount of assets in QRTs S06.02
Matching Tests: Where possible the results of the PRA tests would be reported on a portfolio basis in the following fields. Where this is not possible, they should be reported at a firm level	MALIR 5 - 5.1 to 5.7	The results, where relevant, in % terms, of PRA Cashflow Tests 1 – 5 as set out in the Appendix of SS7/18, should be reported in the MALIR along with an explanation of any failures.
Assets - further info	MALIR 6	Free form entry
Form S06.02 Reconciliation	MALIR 7	Free form quantitative reconciliation between S06.02 and the MALIR if necessary

8.20 The proposed amendments to the PRA Rulebook to reflect these proposals are set out in Appendix 2.

A waiver process for the MALIR

8.21 The PRA recognises that for some firms with MA approval, the requirement to complete the MALIR on an annual basis may be disproportionate given the size of the firm or its MA portfolio(s).

8.22 To address this, the PRA proposes introducing a waiver process for the MALIR whereby a firm could approach their usual supervisory contact to discuss, on an MA portfolio basis,

applying for an exemption from the MALIR reporting requirements, or part thereof. This process would be consistent with the PRA's standard waiver and modifications process under s138A FSMA (and would be on a case by case basis).

8.23 In assessing such an application, the PRA expects that the materiality of the portfolio would be an important factor, although other considerations relevant to the proportionality of the requirement would also be taken into account, including the size of the firm and the nature of the asset holdings in the portfolio.

8.24 The proposed changes to SS7/18 that reflect these proposals are set out in Appendix 3.

PRA objectives analysis

8.25 The PRA considers that the proposals in this chapter would advance its primary objectives of safety and soundness and policyholder protection for the following reasons:

- formalising the MALIR process could contribute towards firms improving the monitoring of assets, liabilities, and risks within their MA portfolios;
- introducing a regular MALIR reporting framework would support the PRA's understanding of the assets and liabilities held in firms' MA portfolios and the ability to target its supervisory activity towards areas that pose greatest risk to its primary objectives; and
- receiving detailed data on firms' MA asset holdings, including closer monitoring of changes in the size and nature of MA portfolios, their investment mix, and the extent of their investment in new or more innovative asset types over time, would allow the PRA to have early sight of possible risks across the industry.

8.26 The PRA considers that the proposals in this chapter would also advance the PRA's secondary competition objective, and its secondary competitiveness and growth objective for the following reasons:

- the option for a waiver to be granted on the grounds of materiality would reduce the risk of a disproportionate burden being placed on certain firms and would also reduce barriers to entry; and
- closer monitoring of the changes in the size and nature of MA portfolios, including collecting data on assets which are considered to be capacity enhancing, would help identify potential systemic risks, supporting the stability of the annuity sector in particular, and ongoing growth and competitiveness more generally.

9: Notching

9.1 This chapter sets out the PRA's proposed changes to the MA calculation which would increase the granularity of the FS where appropriate, to reflect differences in the credit quality of assets by credit rating notch. These proposed changes are driven by the November 2022 statement which set out the Government's support for the MA calculation being updated to allow for notched ratings and that it would legislate to make this possible. This chapter also covers expected implications of the proposed changes for firms' internal models and internal credit assessment processes and outcomes.

9.2 The proposals in this chapter would:

- introduce a requirement that the FS applied by all firms with an MA permission must reflect, where appropriate, differences in the credit quality of their assets by rating notch for the purposes of calculating their TPs. If this is not possible for some assets, then firms would be required to take this into account in their MA attestation process;
- require firms to derive a more granular FS by rating notch by linearly interpolating the technical information published by the PRA for each relevant CQS;
- introduce an expectation that firms justify any differences in the granularity at which the credit quality of their assets is reflected in their TPs and internal models used to calculate SCR, and set out the factors the PRA would expect firms to consider when doing this;
- introduce an expectation that, where a firm considers that its risk profile requires it to increase the granularity at which credit quality is reflected in its internal model, but that developing its model is not straightforward and may take some time, then remedies should be considered in the interim; and
- introduce requirements and expectations for the purposes of assessing the appropriateness of firms' internal credit assessments by rating notch, which are explained in detail in Chapter 4 of this CP.

9.3 The proposals in this chapter would:

- introduce particular elements of the new Matching Adjustment Part of the PRA Rulebook (Appendix 2);
- make changes to SS7/18 – Solvency II: Matching adjustment (Appendix 3);
- make changes to SS8/18 – Solvency II: Internal models – modelling of the matching adjustment (Appendix 4); and

- make changes to SS3/17 – Solvency II: Illiquid unrated assets (Appendix 5), as explained in Chapter 4 of this CP.

9.4 The PRA considers the proposals in this chapter would advance its primary objectives of safety and soundness and policyholder protection. In particular, the proposals would increase the risk sensitivity of the FS, making it more reflective of the risks retained by firms in their MA portfolios. The proposals would also help ensure firms' internal ratings and internal models for calculating the SCR better reflect the risks retained. The PRA expects its proposal for all firms to adjust the FS to reflect differences in credit quality by rating notch to promote consistency of approach thereby helping to advance the PRA's secondary competition objective.

9.5 The proposals in this chapter would also advance the PRA's secondary competitiveness and growth objective as a more granular risk assessment will result in better risk management incentives that over the long run should contribute to greater competitiveness and growth of the UK economy by avoiding potential undue advantage from firms taking different approaches. The requirement to adjust the FS to reflect differences in credit quality by rating notch (where possible and appropriate) would also apply to all relevant assets in firms' MA portfolios so not introducing any potential new regulatory barriers to investment of MA portfolios in the UK economy and its growth in the medium to long term.

Mandatory application of a notched FS

9.6 In the current regime, the calculation of the FS reflects the CQS for each asset, and no further granularity is reflected regarding the credit quality of firms' exposures in their MA calculations, beyond that of the relevant CQS.

9.7 The November 2022 statement set out that the Government supported the MA calculation being updated to allow for notched ratings and indicated that it would legislate to make this possible. This is consistent with **FS1/22** where the PRA noted that a number of respondents to **DP2/22** identified the introduction of notching as a means of improving the FS design. The draft MA regulations refer to the general term 'credit quality' rather than CQS in the context of the MA and FS. This together with [x] of the MA regulations makes provision for the FS to reflect more granular differences in credit quality than is the case currently.

9.8 The **technical information** published by the PRA, provides FS data by CQS, ranging from CQS 0 to CQS 6, and firms map their assets to the relevant CQS. The granularity of the CQSs correspond to rating categories and do not differentiate the relative credit quality of exposures within each CQS. For example, for exposures rated by S&P Global Ratings, there are three ratings notches in the BBB rating category that are all mapped to CQS 3: BBB+; BBB; and BBB-.

9.9 Accordingly, there is a risk that assets with materially different credit risk characteristics may be receiving the same treatment in the calculation of TPs. Specifically, the FS is currently the same for all assets of a given CQS that map to the same FS table. This undermines the requirement for the FS to reflect all of the risks retained by firms as per the Matching Adjustment Part of the PRA Rulebook. In addition, internal models are not always reflective of credit quality beyond the level of rating category, potentially leading to a deficiency in the ability of models to capture all material quantifiable risks (Solvency Capital Requirement – General Provisions 3.3(1) and Solvency Capital Requirement – Internal Models 11.6 of the PRA Rulebook). These factors support additional rules and expectations to ensure that TPs and the SCR better reflect the risks inherent within firms' exposures.

9.10 The PRA proposes that when calculating the MA for the purpose of their TPs, firms would be required to adjust the FS to reflect, where appropriate and possible, differences in the credit quality of exposures by rating notch.

9.11 The PRA considers that this proposal would:

- improve the risk sensitivity of the FS by reflecting the relative credit quality of exposures within each rating category;
- help promote consistency of approach between firms;
- reduce cliff-edge effects arising from material changes in the FS between CQS; and
- avoid unduly incentivising firms to hold assets of the lowest credit quality within a given CQS.

9.12 The PRA understands that this proposal would require firms to source or derive notched ratings for all relevant exposures. As part of ongoing risk management, the PRA expects that firms' risk functions would seek the most up to date credit risk information possible, including in respect of differences in credit quality by rating notch. However, the PRA recognises that firms may not be able to rate or obtain ratings for a small number of their exposures on a notched basis or there may be delays in doing so. In the small number of cases where a notched rating is not available, the PRA proposes introducing a requirement that the firm must use the FS for the CQS to which the exposure is mapped. The appropriateness of the resulting FS would then be expected to be explicitly considered as part of the attestation process. This would include whether there is potential bias towards the lower notch within a given CQS ie whether the risk profile of the assets suggest they would be more likely to attract a rating at the lower end of the CQS band if a more granular rating method was available. This proposal allows for a pragmatic approach in such cases while mitigating the associated prudential risks.

9.13 The proposed changes to the FS calculation set out in this chapter would apply before any FS additions to reflect risks on assets with HP cash flows (Chapter 8 of the Matching Adjustment Part of the PRA Rulebook) or adjustments to the FS as part of the proposed attestation process (Chapter 9 of the Matching Adjustment Part of the PRA Rulebook).

9.14 The proposed amendments to the PRA Rulebook to support these proposals are contained in Appendix 2.

Implementation of a notched FS in the technical provisions calculation

9.15 The draft MA regulations do not specify the granularity at which differences in credit quality should be reflected in the PRA's published technical information. The PRA proposes that it continues to publish technical information in respect of the FS at the level of CQS. This would preserve the current FS calibration for assets where no adjustment for differences in credit quality by rating notch is required and would also allow firms some flexibility in terms of how a notched FS is implemented.

9.16 In considering when it would be appropriate to require the FS used for calculating firms' TPs to reflect differences in credit quality by rating notch, the PRA proposes allowing for such differences where it would enhance the risk sensitivity of the FS without introducing spurious accuracy to the calculation. The PRA proposes that the FS would only be adjusted and applied on a notched basis for assets that:

- do not use PRA-published FS tables for 'Central Government and Central Bank bonds' – this is because it would be impractical to do so as these tables are not published by CQS; and
- are mapped to CQS 1 – CQS 5 (inclusive) –this takes account of availability of data for different CQS and current practice in respect of credit ratings, whereby exposures mapped to CQS 0 are much less likely to be rated on a notched basis and data for CQS 6 exposures is particularly sparse at this time.

9.17 To apply a notched FS, the PRA proposes that:

- the existing CQS-level technical information published by the PRA is applied unadjusted to the middle rating notch within each CQS;
- for each remaining rating notch, linear interpolation is applied to the published technical information assuming that intermediate rating notches are evenly spread between consecutive CQS pairs; and
- interpolation is applied in respect of the PD component of the FS and at least the overall FS.

9.18 The PRA proposes that, where needed, linear interpolation would be applied to each consecutive CQS pair starting with CQS 0 and CQS 1 in order to derive the necessary FS adjustments. For avoidance of doubt, the CQS level calibrations would be applied to all assets mapped to CQS 0 and CQS 6 without adjustment.

9.19 The PRA considers that requiring firms to adjust the PD to reflect differences in credit quality by ratings notch would ensure that firms' cash flow matching reflects credit quality at this more granular level. If only the overall FS were to be applied on a notched basis, then this would diminish the extent to which the increased risk sensitivity of the FS is reflected in how firms manage their MA portfolios as assets would continue to be matched to MA liabilities using the existing risk-adjustment by CQS, making them less responsive to small changes in credit quality.

9.20 The PRA's preference is for all components of the FS to reflect differences in credit quality by rating notch as this would best reflect the different risk profile of firms' exposures by rating notch. However, the PRA also notes that adjusting each component of the FS could increase the complexity of the MA calculation without necessarily providing increased risk management insights or changing the overall FS.[26] The PRA's proposal allows firms flexibility to decide how the non-PD components of the FS reflect differences in credit quality by rating notch ie by interpolating those components directly, or by deriving them as a balancing item. However, to give such flexibility the PRA considers it would be more appropriate and proportionate for firms to derive notch-level calibrations themselves than for the PRA to publish a wide range of technical information covering both options.

9.21 The PRA's proposal that firms would use linear interpolation to adjust (at least) the published PD and overall FS aims to strike an appropriate balance between simplicity (and transparency) and technical robustness. The PRA considers that the use of linear interpolation to derive an FS by ratings notch is justifiable on a technical basis considering the underlying data and risks implied by different credit ratings.

9.22 The following two examples illustrate how linear interpolation could be used in practice to adjust the FS to allow for differences in credit quality by rating notch.

Interpolation examples

Table 2 contains an extract from the technical information published by the PRA as at 31 December 2022. This is used as the basis of the two examples that then follow. In both examples, answers are rounded to 3 significant figures at each step of the process.

[26] For example, cost of defaults, cost of downgrades, long-term average spread, as well as the total FS.

Table 2: FS technical information for a 10-year non-financial GBP cash flow as at 31 December 2022				
	CQS 0	**CQS 1**	**CQS 2**	**CQS 3**
PD (probability)	0.10%	0.40%	1.30%	3.90%
PD (percentage)	0.01%	0.03%	0.09%	0.27%
Cost of downgrade (percentage)	0.03%	0.06%	0.19%	0.09%
FS	0.11%	0.34%	0.42%	0.58%
Long term average spread	0.32%	0.96%	1.20%	1.64%

Example 1: Interpolation applied at PD and overall level for AA+ rated non-financial GBP cash flow

Assume that the AA+ cash flow is mapped to CQS 1. As AA+ is the highest notch within CQS 1, then an adjustment to the FS is required. To do this we need to interpolate to the mid-point of CQS 0 and CQS 1.

A	PD probability (used to de-risk cash flow for cash flow matching)	$\frac{1}{2} \times 0.1\% + \frac{1}{2} \times 0.40\% = 0.25\%$
B	PD percentage	$\frac{1}{2} \times 0.01\% + \frac{1}{2} \times 0.03\% = 0.02\%$
C	Overall FS	$\frac{1}{2} \times 0.11\% + \frac{1}{2} \times 0.34\% = 0.225\%$
D	Residual FS = C – B	$0.225\% - 0.02\% = 0.205\%$

Example 2: Interpolation applied at component level for A- rated non-financial GBP cash flow

Assume that the A- cash flow is mapped to CQS 2. As A- is the lowest notch within CQS 2 then an adjustment to the FS is required. To do this we need to interpolate to $1/3^{rd}$ of the difference between CQS 2 and CQS 3.

A	PD probability (used to de-risk cash flow for cash flow matching)	$\frac{2}{3} \times 1.30\% + \frac{1}{3} \times 3.90\% = 2.17\%$

B	PD percentage	$\frac{2}{3} \times 0.09\% + \frac{1}{3} \times 0.27\% = 0.15\%$
C	Cost of downgrade	$\frac{2}{3} \times 0.19\% + \frac{1}{3} \times 0.09\% = 0.157\%$
D	Long term average spread	$\frac{2}{3} \times 1.20\% + \frac{1}{3} \times 1.64\% = 1.35\%$
E	Overall FS = max (B + C, 35% x D)	0.473%
F	Residual FS = E – B	$0.473\% - 0.15\% = 0.323\%$

9.23 The proposed amendments to the PRA Rulebook and changes to SS7/18 to support these policy proposals are contained in Appendix 2 and Appendix 3 respectively.

Differences in the granularity at which credit quality is reflected in technical provisions and internal models

9.24 Chapter 4 of SS8/18 includes an expectation that when determining SCR via their internal models, as a starting point, firms should consider modelling the FS at the same level of granularity as is used in the calculation of TPs. However, the PRA recognises that due to data limitations and the way in which different modelling approaches work in practice, it may not always be possible or desirable for internal models to be adjusted to reflect differences in credit quality by rating notch. In recognition of this, the PRA therefore proposes introducing an expectation that firms should justify any differences in the granularity at which credit quality is reflected in the FS for the purposes of calculating the TPs and the SCR.

9.25 Further, the PRA proposes that at least the following points should be considered in firms' justifications for any differences in the granularity at which credit quality is reflected in their internal models compared to that used for the purposes of calculating TPs:

- the extent to which the credit quality of the firm's exposures (by ratings notch) differs from that underlying the indices used to calibrate their spread and transition stresses, including whether the firm has a bias or concentration towards the lowest notch in each CQS;
- the pattern of variation in spread and transition stresses by rating notch;
- the consistency between the granularity at which spreads and transitions are modelled;
- the availability and credibility of relevant data;

- the difference in the MA that results from applying the FS on a notched basis relative to the MA that would have been obtained assuming no adjustment for notching for the purposes of calculating TPs;
- the granularity of decisions that the model is used to support;
- consistency of rebalancing assumptions; and
- the type of modelling approach used.

9.26 These proposals are reflected in proposed changes to SS8/18 (Appendix 4).

Increasing the granularity at which credit quality is reflected in internal models – operational considerations

9.27 Where a firm considers that its risk profile requires it to increase the granularity at which credit quality is reflected in its internal model, for example, to model the FS by rating notch, then it would need to develop a methodology that meets the relevant internal model requirements. In doing this they would be expected to take account of existing expectations set out in Chapter 4 of SS8/18 as well as the PRA's proposed new expectations in Chapter 4 of SS8/18 that:

- firms should consider whether allowance should be made for basis risk arising from the distribution of their assets by notched rating compared to the distribution in the calibration data used (paragraph 4.11, bullet 1); and
- the implications of any differences in granularity in available historic transition data and the assumptions needed for modelling (paragraph 4.35A).

9.28 If developing its model is not straightforward for a firm and may take some time, the PRA proposes that the firm would be expected to consider other possible remedies until it has completed the necessary development, including potentially increasing the capital requirement calculated by the internal model, in order to ensure that the SCR complies with the core calibration standards at all times as required in Solvency Capital Requirement – General Provisions 3.3 and 3.4.

9.29 The primary motivation for this proposal is to allow firms time to develop their models while mitigating prudential risks arising from the SCR potentially being under-stated while these developments are ongoing.

9.30 This proposal is reflected in the proposed changes to SS8/18 (Appendix 4).

Internal ratings and their validation

9.31 The PRA recognises that some firms may have to develop their current internal credit assessment processes to allow them to produce internal ratings on a notched basis, while

other firms may already produce notched level internal ratings for all internally rated assets. Chapter 4 of this CP covers credit ratings under the MA. This includes proposed requirements and expectations for the purposes of assessing the appropriateness of internal credit assessments by rating notch. These proposals recognise that internal credit assessments are heavily reliant on expert judgement, and validating such assessments on a notched basis could be challenging. The PRA is therefore focusing its expectations in this regard on assessing potential bias in internal credit assessment outcomes (relative to CRA issue ratings) rather than asset by asset outcomes in isolation. This is explained in detail in Chapter 4 of this CP.

9.32 The PRA's proposals in respect of internal credit ratings are reflected in proposed amendments to the Matching Adjustment Part of the PRA Rulebook (Appendix 2) and changes to SS3/17 (Appendix 5).

PRA objectives analysis

9.33 The PRA considers that the proposals in this chapter would advance its primary objectives of safety and soundness and policyholder protection for the following reasons:

- The proposals for the FS to reflect differences in credit quality by rating notch (where appropriate) should improve the risk sensitivity of the FS, helping it to better reflect the risk profile of firms' exposures; and
- The proposed expectation that firms should consider applying other possible remedies, where necessary, while they develop their internal models to allow for greater granularity in respect of credit quality, should ensure that their SCRs are not understated in the interim.

9.34 The PRA considers that the proposals in this chapter would also advance the PRA's secondary competition objective and its secondary competitiveness and growth objective for the following reasons:

- The proposed implementation approach for notching (eg use of linear interpolation) is a much simpler approach compared to plausible alternatives and thereby minimising additional cost and complexity in the regime;
- The proposal to require all firms to adjust the FS to reflect differences in credit quality by rating notch (where possible and appropriate) should ensure that there is consistency of approach, avoiding potential undue advantage from firms taking different approaches and therefore facilitating effective competition between firms; and
- The proposal to require the FS to be adjusted (if appropriate) for all exposures mapped to CQS 1 to CQS 5 (inclusive), except for Central Government and Central

Bank bonds, should prevent undue advantage being gained by clustering at the lower notch within a given CQS.

10: Cost benefit analysis

10.1 In developing the proposals set out in this CP, the PRA has considered its objectives and a range of key factors that contribute to the cost benefit analysis (CBA). The baseline for the CBA is the current onshored legislative framework as supplemented by PRA Rulebook material in force, together with the anticipated legislation in line with the Government's November 2022 statement. The PRA has therefore only considered the impact of changes that may arise from its proposals including using data provided during the period of the Solvency II Review. The PRA welcomes feedback on this analysis to inform its final policy decisions.

10.2 The table below summarises the baseline for each area of reform.

Table 3: Baseline for CBA underlying each proposal

Area of reform	Baseline for the CBA
Investment flexibility	The baseline is expected legislation, which permits the inclusion of assets with HP cash flows into MA portfolios where there is no material risk to the quality of matching, among other requirements. The November 2022 statement notes that 'the Government would still expect the vast majority of assets in matching adjustment portfolios to have fixed cash flows'. The baseline includes any FS additions that firms may determine in the absence of PRA proposals. The costs and benefits set out only apply for firms that choose to take up the additional investment flexibility, although the benefits of investment are spread more widely.
Liability eligibility	The baseline is current PRA rules and guidance, the current MA application process, and current MA eligibility requirements. Therefore, retained EU law is considered part of the baseline.

Area of reform	Baseline for the CBA
Removal of rules relating to a cap on the MA benefit for SIG assets	The proposed changes are a consequence of the Government's proposed reforms to the MA, as set out in the November 2022 statement. The proposed changes are therefore part of the baseline.
MA permissions, breaches, and consequential rule changes	The baseline is existing regulation and MA ITS, together with the existing process that is followed in event of an MA breach (as set out in the PRA Rulebook and Regulation 42 of the Solvency 2 Regulations 2015). The consequential rule change proposals do not result in any material changes to current restrictions on firms with MA approval. The PRA is restating statutory requirements into the PRA Rulebook, which already exist under the current regulations. The PRA considers there are no costs or benefits arising from the proposal to restate relevant parts of retained EU law.
Attestation	The baseline is no attestation requirement as part of firms' current MA-specific risk management requirements and practices.
MALIR data collection	The baseline is current regulations, which do not request data specifically relating to MA portfolios. Instead, firms have submitted data to periodic ad hoc exercises by the PRA.
Notching	The baseline is no requirement for firms to adjust the FS to allow for more granular differences in credit quality.

10.3 As the focus of this CP is the MA, the CBA baseline does not include the following areas of Solvency II reform:

- the PRA has not taken into account the projected capital release arising from the Government's reform of the risk margin, which will increase insurers' financial resources; and

- the PRA has not assessed one of the measures included in the November 2022 statement, regarding stress testing. The PRA will comment further in due course about its future stress testing plans.

Summary data used in baseline

10.4 In carrying out the CBA, the PRA has considered the impact on the following outcomes: MA portfolio asset allocations, BPA sales, and individual annuity rates. Within scope of the CBA are UK Solvency II firms with MA approval (at the time of publication, 19 entities and 23 MA portfolios) or firms that might seek permission to apply the MA in future. [27] The proposals will be primarily of interest to all UK Solvency II firms, the Society of Lloyd's and its members and managing agents, and third-country branch undertakings where they are applying or have applied to use the MA.

10.5 The proposals mainly affect annuity products, although the PRA is proposing that liabilities eligible for the MA should include protection products that are in payment and the guaranteed component of with-profits annuities. While the proposals may spur sales of these products, their current volumes are much smaller than sales of annuities.[28]

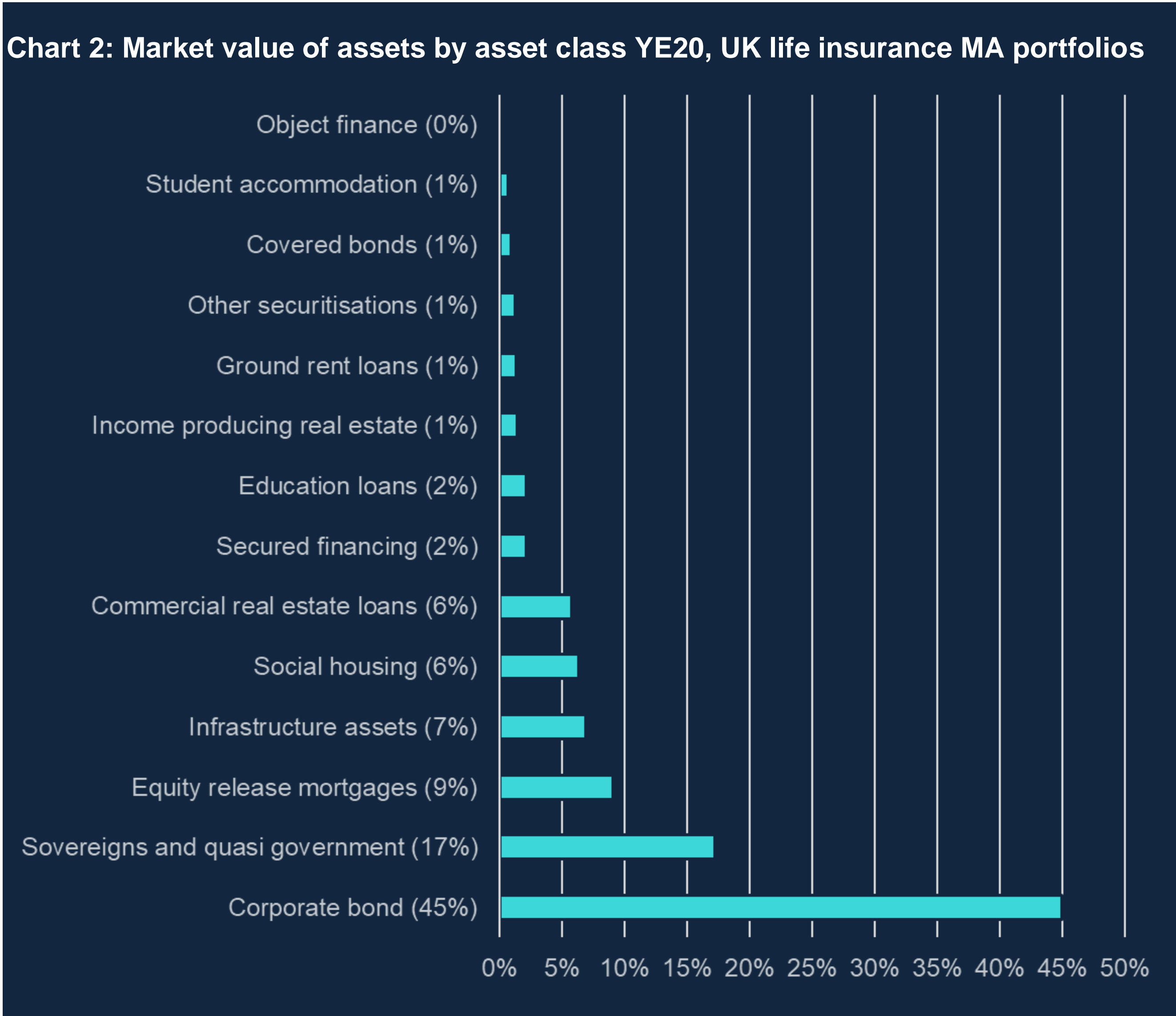
10.6 The total size of assets backing annuity liabilities within the MA by market value was approximately £350 billion[29] at YE20, which is the most recent comprehensive, and fully validated MA dataset.

10.7 Life insurers invest in a wide variety of assets within their MA portfolios, as shown in Chart 2.

[27] PRA analysis of Matching Adjustment (MA) Asset & Liability Data submissions by firms as at YE22.

[28] See Chart 3.1 **Insurance aggregate data annual report | Bank of England**.

[29] The PRA analysis of Matching Adjustment (MA) Asset & Liability Data submissions by firms as at YE20. At YE22, the figure is approximately £290 billion, based on the PRA analysis of assets reported by firms in reporting template S.06.02. The reduction in asset values within MA portfolios was largely due to higher yields at YE22, which markedly reduced the market value of long dated assets compared to YE20.



Source: The PRA[30]

10.8 Life insurers pass on some of the credit spread less a deduction for credit risk (FS), ie some of the MA, to pension schemes in their pricing of BPA.[31] Individual annuity rates have closely tracked long-term gilt rates,[32] [33] which fell after the 2008 financial crisis and have recently increased.

[30] **Who's concentrating? Trends in the life insurance sector and the need for strong reinsurance and investment risk management** – speech by Charlotte Gerken.

[31] **Bulk annuity pricing opportunities in 2020** - PwC UK.

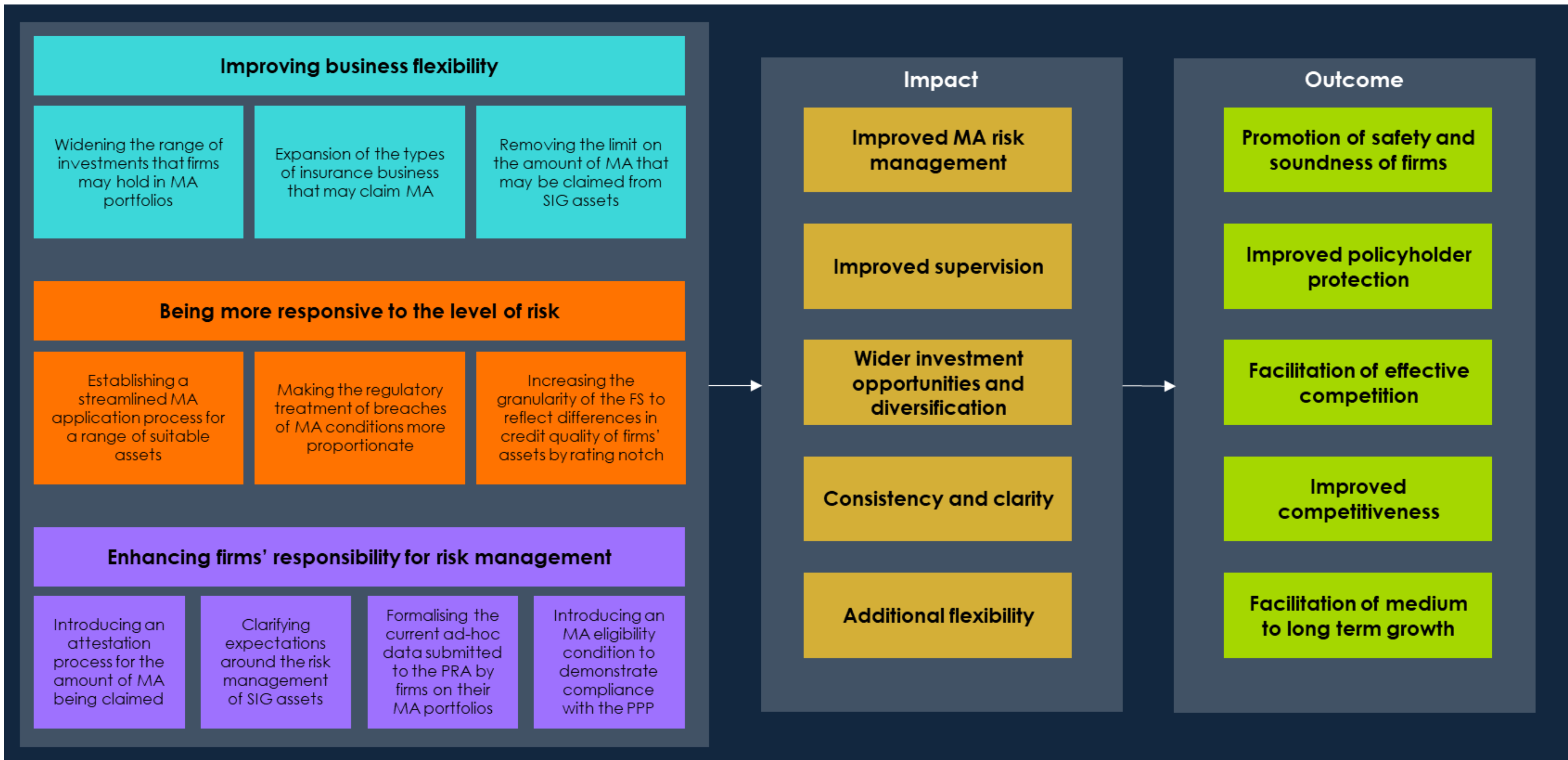
[32] **Annuity Rates Chart | latest changes to pension income**.

[33] **The Money's Worth of annuities in the UK between 2006 and 2014** – ScienceDirect.

Assessment of costs and benefits

10.9 The PRA has assessed the costs and benefits of the proposals set out in this CP against the baseline set out above, with the key benefits set out in Chart 3 below. The PRA has included quantitative estimates of the costs where possible, using information obtained from firms, setting out which costs apply at a firm level vs at an asset level as appropriate. The PRA has also sought to separate estimates for initial implementation costs vs the ongoing costs of complying with regulatory requirements. The PRA has provided estimates of cost savings as part of its assessment of benefits, where appropriate.

Chart 3: Key benefits of proposals in this CP relative to the CBA baseline



10.10 The PRA considers that the benefits of its proposals outweigh the costs. The PRA welcomes feedback on the CBA as part of this consultation.

Benefits

10.11 Relative to the baseline, the proposals are expected to advance the PRA's primary objectives of safety and soundness of firms, and policyholder protection, through:

- enhanced senior management responsibility and improved management of MA portfolios and their inherent risks, resulting from the attestation process and requirement to demonstrate compliance with the PPP;
- better matching between asset and liability cash flows relative to the baseline through the introduction of additional controls for assets with HP cash flows;
- where applicable, an FS that is more reflective of firms' exposures, where the attestation process concludes that a voluntary addition to the FS is appropriate in order to allow the required attestation to be made. This would help ensure that the FS is calibrated appropriately for those exposures, and makes an appropriate allowance for any additional risks arising from assets with HP cash flows;
- a closer link between the FS and the risks retained by firms in their MA portfolios, where firms holding a greater portion of assets at the lower rating notch within a given CQS would be required to use a higher FS to reflect the increased level of expected loss on these assets. As an illustration, see example 2 in Chapter 9 of this CP, which shows that the FS increases from 42 bps to 47.3 bps ie by 5bps for a non-financial GBP 10 year cash flow rated A-. Conversely, firms that hold a greater portion of assets at a higher rating notch within a given CQS would use a lower FS. The PRA considers that this is appropriate as it reflects a lower risk profile; and
- an improved understanding by the PRA of firms' investments and sources of MA, including areas of concentration of HP cash flows in the MA portfolio. The PRA expects that this will lead to improved monitoring and supervision of firms, providing clarity on firms' MA portfolios and in turn helping to realise the benefits of other policy proposals, notably the review of firms' attestation reports and MA benefit calculations.

10.12 The proposals are expected to facilitate effective competition, and international competitiveness and growth, through:

- greater clarity about how the investment flexibilities would be applied in practice, giving firms greater confidence in making investment decisions. The PRA

considers that these proposals are a key part of facilitating greater productive investment and supporting medium to long term growth while not impeding the PRA's primary objectives;

- improved consistency of approach between firms resulting from the PRA's proposals, which contributes to a level playing field, thereby helping to facilitate the PRA's secondary competition objective;
- reduced barriers to investment as a result of the streamlined MA application approach for suitable assets (set out in Chapter 5 of this CP) should allow firms to receive a faster decision on MA permission for new assets that meet the criteria. This will potentially allow firms to move more rapidly when investment opportunities arise, and to reduce the associated transaction costs due to time savings;
- creating the conditions for modest reductions in the cost of annuities for pension scheme and retail customers, by widening the universe of assets firms may derive MA from; and
- improved incentives for private insurance and saving provision resulting from a broader range of liabilities being MA eligible. The PRA considers that the inclusion of in-payment income protection and the guaranteed component of with-profits annuity products in MA portfolios could enable firms to use capital more efficiently. This could result in better pricing for customers and encourage innovation, contributing to the UK's long-term growth and competitiveness.

10.13 A benefit of the proposals is that they will provide clarity, through the publication of PRA expectations, to firms on how to implement the reforms announced in the November 2022 statement and set out in the draft MA regulations. These expectations address:

- (i) the calculation of best estimate cash flows, (ii) the methodology for determining the FS addition, and (iii) the application of the proposed additional controls to the quality of matching for assets with HP cash flows; and
- the proposal to implement a more granular FS by requiring firms to adjust the FS to allow for more granular differences in credit quality through notching.

10.14 Once embedded, the proposals could improve consistency between firms' approaches, reducing supervisory burden in the longer term, through:

- more efficient use of supervisory resources as supervisors will be able to better understand how the firm has satisfied itself that the assumptions are reasonable as part of its attestation;
- making mandatory the proposal to implement a more granular FS, which would improve visibility of the credit quality of asset portfolios. This will ensure that where firms hold assets with lower credit quality within a given CQS, they do not

take undue MA benefit, and conversely that where firms hold assets with higher credit quality within a given CQS, they are not subject to an undue restriction on the amount of MA benefit they are able to claim; and

- the ability for firms to plan for a regular MALIR data collection alongside other regulatory reporting processes. The incremental supervision cost savings of a regular MALIR data collection, rather than ad hoc requests, are not expected to be material, based on the historic pattern of collection. The MALIR data collection will however have the benefit of more up-to-date data for supervisory purposes.

10.15 The proposals could reduce some capital costs for firms associated with complying with regulatory requirements (increases to TPs and SCR), through:

- a more proportionate treatment of breaches of MA requirements, which currently result in the loss of the full MA benefit if they are unremedied after two months. The proposals result in a gradual reduction in MA benefit for firms that breach MA conditions, as such firms would continue to benefit from applying a reduced MA benefit, whereas under the current regime firms would lose the MA entirely. Further, current requirements prohibit firms that lose MA benefit for this reason from reapplying for the MA within two years, whereas the proposals eliminate this prohibition; and
- a small reduction (within the range of £30 million to £120 million) in best estimate income protection liabilities in payment resulting from widened liability eligibility criteria for inclusion within MA portfolios. The cost reduction is more uncertain for with-profits annuities but is expected to be of lower materiality. The proposals may have a positive impact on the size of the market for newly eligible liabilities, though this is difficult to quantify.

10.16 The PRA considers that allowing firms to delegate authority to a suitable board committee to approve an MA application may allow a less onerous and time-consuming process for firms to submit an MA application and respond to follow up queries, a benefit for firms. Having consistency and clarity on PRA expectations in this regard will also help to improve competition. The proposed safeguards that firms will implement as part of the streamlined pathway for MA applications seek to avoid any material adverse effect on the safety and soundness of firms or on policyholder protection.

10.17 The PRA considers that the proposal to require a senior manager to attest to the PRA on the sufficiency of the FS should increase transparency and accountability and is warranted given the significant level of MA benefit available to firms. One **FCA study** found positive effects of attestation requirements. The FCA's attestation measure, introduced on 1 January 2022, required senior managers to attest that their firm has complied with General Insurance (GI) Pricing Practices rules. The FCA found that most

firms complied with the request and were able to take necessary actions in line with the rule. The PRA considers that its proposals may produce a similar response, resulting in improved risk management for MA portfolios.

10.18 The PRA considers that the nature and risk profile of the guaranteed elements of with-profits annuities are equivalent to the nature and risk profile of conventional annuities, which are already included in MA portfolios. For this reason, the PRA considers that permitting these liabilities into MA portfolios would also continue to advance firms' safety and soundness.

10.19 The PRA considers that the proposed reduction in MA for breaching MA conditions for more than two months, alongside the proposed revocation of MA permission after the benefit reaches zero, provides an appropriate incentive for firms to maintain compliance with MA conditions, and to address the causes of the breach in a timely manner. The PRA considers that its proposals, to reduce MA more gradually for firms in breach, and to apply the MA fully once compliance is restored, are more proportionate than the current regime of complete revocation of MA approval for 24 months. The PRA considers its proposals reduce the likelihood of breaches of regulatory solvency requirements arising from MA breaches and inappropriate instability in insurer balance sheets.

Costs

10.20 The proposals would give rise to some increased implementation and ongoing compliance costs to firms. These costs are expected to vary according to the scale and complexity of MA portfolios, and the extent to which firms are already compliant with the proposals. In aggregate, across all 19 firms with MA approval, total ongoing costs from year 1 are estimated to range between £7 million and £9 million each year, with an additional £2 million to £3 million for implementation costs across all 19 firms excluding one-off cost estimates or those that apply at an asset level. These costs arise through:

- the proposed controls framework, for assets with HP cash flows, which includes new matching tests and additional management information. The PRA estimates these compliance costs to be less than £30,000 per firm per year, as the data required to calculate and monitor the new tests should already be available to firms, and the calculations are largely similar to those in the existing tests. The expense will be nil for firms that choose not to take advantage of the increased investment flexibility;
- the development, internal governance, implementation, and approval for new methodologies to determine the additions to the FS for assets with HP cash flows for firms that take advantage of the new investment flexibilities. The PRA

expects that firms will use the standard approach or relatively simple models. The PRA estimates the initial cost of developing standard models would fall within the region of £10,000 to £20,000 for each asset at the point of investment, with this cost falling over time as firms (i) develop experience in investments in assets with HP cash flows and (ii) identify similarities between assets that reduce the need to develop additional models. This range is particularly sensitive to the specific asset being considered;

- the derivation of notched ratings for firms that do not currently have these assigned for all of their assets. The PRA considers that this is likely to be most challenging for implementing more granular internal rating methodologies, with estimated one-off costs ranging from £60,000 to £150,000, depending on asset types, and their amount within MA portfolios. The PRA notes these costs are unlikely to vary much by size of the firm. Some firms already have notched ratings for all their assets and would not incur additional costs;
- the amendment of systems and processes to obtain the necessary data, update data feeds, and carry out the calculations to reflect more granular credit quality features in the FS. The PRA expects implementation costs to range from £5,000 to £50,000 per firm depending on complexity of systems, with the lower end applying for firms that already have the required data processes in place. The PRA does not consider that ongoing compliance costs are likely to increase, as once firms have codified the derivation of the FS to allow for differences in credit quality into their processes then this should become part of their calculation approach;
- the development of processes and additional resource required for the preparation of the attestation report and supporting **evidence**, including any FS additions for assets with HP cash flows. The cost of implementing an attestation policy, listing the evidence, and producing the attestation report for a firm with an ‘average risk profile’, with holdings in only a small number of illiquid asset types, is estimated to range between £30,000 and £50,000 per year. Compiling and reviewing the evidence could be significantly more expensive with the initial set up costs likely to be higher than the ongoing costs. These ongoing costs could range from £100,000 to £1 million per year depending on the amount of new business and the size and complexity of the firm's investment portfolio. These costs may reduce over time, depending on any changes in risk profile. The PRA expects that this will build on information already available as part of compliance with the PPP, the MA risk management requirements, and ensuring the appropriateness of the level of the firm’s TPs. For firms with existing processes to form an independent view on the risks underlying their MA portfolios, the incremental costs will be more limited and correspondingly incremental benefits would also be more limited. The PRA recognises that justifying the size of the MA is a new requirement and has tailored the proposals to ensure the work

undertaken by firms is proportionate to the risk, with greater focus on those assets with a comparatively high level of MA. Further details on the attestation report can be found in Chapter 6 of this CP;

- as signalled in January this year in the **Insurance 2023 Supervision Priorities Letter**, growing concentrations, in particular to assets that are internally rated and valued, may result in a greater exposure to credit and concentration risk. As set out in SS3/17 as part of their own risk management the PRA expects expect firms to gain appropriate assurance on the ratings of these assets. The cost of obtaining independent, external assurance to test for bias in internal ratings is estimated to lie in the range of £20,000 to £500,000 per firm. The actual cost would depend on the nature and complexity of the firm's assets and the current level of external assurance sought. The lower end of the range represents the incremental cost to validate the more granular notched ratings, which has been included in the CBA. Whereas firms that would need to carry out further independent reviews to meet the PRA's existing expectations would incur higher costs which we consider to be part of the baseline and these costs have not been included in the CBA. The PRA notes this cost would vary both by firm and over time;
- the additional resource, reporting processes, and systems required to support an annual MALIR data collection. The PRA estimates that the initial implementation costs to firms would be within the range of £70,000 to £110,000 per firm per year, although firms that have invested in systems and processes as part of the PRA's past ad hoc requests could incur much lower costs. The PRA notes there may be some synergies if the data is used for other purposes, eg to support the attestation process; and
- ongoing compliance costs to support the MALIR data collection, estimated to lie in the range of £30,000 to £50,000 per firm per year. The PRA considers that as the MALIR replaces information that would otherwise be requested on an ad hoc basis by supervision teams as part of normal business as usual activity, firms may realise cost savings from not going through additional governance for each individual request.

10.21 The PRA does not expect that the proposals on how the best estimate cash flows are derived for assets with HP cash flows would materially increase compliance costs to firms. The PRA considers that firms would need to be able to project cash flows for internal valuation processes, incurring the costs of amending systems for this capability regardless of the PRA's proposals. The PRA expects that modelling may be more complicated for assets with HP cash flows compared with assets with fixed cash flows, however this is a function of the asset. As a result, the PRA does not expect its proposals to be unnecessarily burdensome, relative to firms' own practices.

10.22 The proposed mandatory requirement for firms to adjust the FS to allow for notched credit ratings could increase TPs slightly across firms (by approximately £1 billion[34] out of an MA benefit of around £40 billion–£50 billion at YE20). At YE22, the PRA expects that the impact would not materially change from YE20. The PRA expects that the impact as a percentage of TPs would not vary materially by firm. The PRA notes that impacts in this area relate to a more accurate representation of firms' risk profiles, and that firms may be able to realise a benefit instead if they rebalance their portfolios over time towards the higher, rather than the lower notches of each CQS.

10.23 The PRA considers that the proposals for a more granular FS should not generally represent increased costs associated with internal models for firms as existing expectations already state firms should justify the granularity of the underlying modelling performed to determine the stressed FS.[35] Similarly, standard formula firms are required to assess the ongoing appropriateness of the standard formula. Should the adjustment to the FS to allow for differences in credit quality act as a catalyst for firms to seek to change their models (or indeed develop a new model) then this would be to remedy an existing modelling deficiency. The PRA recognises the exception to this is where firms' models quantify the SCR by determining the total FS in stress rather than the change in the FS from base to stress. These models would be more likely to require some change post introduction of notching to avoid any increase in the base FS effectively being 'reversed' in the SCR. The PRA estimated the cost of a model change in CP12/23 – **Review of Solvency II: Adapting to the UK insurance market**. However, this cost arguably stems from the limitations of such models rather than due to the introduction of notching. The PRA does not expect this to lead to a change in capital costs for firms. The implementation cost for firms that conclude they need to amend their internal models will vary by firm depending on the overall complexity of their internal models as a whole.

10.24 For the PRA, there would be an increased supervisory cost (estimated at £450,000 initially and £350,000 per year subsequently), through:

- the review of firm applications, models used for FS additions, monitoring an increased number of matching tests, and monitoring the proportion of assets with HP cash flows in MA portfolios. This cost is estimated at £300,000 per year;
- the review of firms' attestations and ensuring consistent interpretation of our expectations. The cost will be highly dependent on the quality of the

[34] The figure of £1 billion was estimated using the average split of assets by notched ratings for MA portfolios reported by firms in the YE22 quantitative reporting templates. This information was used in conjunction with the MALIR data collected at YE20 to approximate the change in MA benefit from the introduction of notching.

[35] See Chapter 4 of SS8/18 – **Solvency II: Internal models – modelling of the matching adjustment**.

documented evidence provided, and the subsequent engagement with firms. Costs would likely be materially higher upon the review of the first round of attestation reports, and for an initial period where thematic review across the industry may be completed, with costs broadly reducing over time. Initial review costs are estimated to be around £120,000, and 'steady state' review costs are estimated to be £20,000 per year, but could be materially higher where there are new types of asset investments; and
- the assessment of MA applications in respect of new liabilities, is estimated to be an ongoing cost of £30,000, although this does depend on the amount of new applications.

Impact on asset allocation

10.25 Insurers' asset allocation decisions for annuity business are complex and likely to reflect a range of factors including:

- the cash flow profile and duration of annuity liabilities;
- the credit risk of individual assets and of the portfolio as a whole;
- the price, or yield, of assets;
- the availability and market size, or supply, of assets;
- the need to offer attractive prices to customers;
- the need to compensate providers of risk capital;
- the risk appetite of the insurer;
- the investment expertise of the insurer; and
- regulatory requirements, including meeting MA requirements and the SCR.

10.26 This is evident from insurers' current asset allocations, which shows a balance is being struck between return and risk, and other factors.

10.27 The PRA considers that given this complexity and the range of relevant factors insurers will take into account, it is difficult to estimate reliably the impact of the reforms on specific changes in insurers' asset allocation decisions. Any such changes will only happen gradually as new business is written, or existing portfolios are rebalanced.

10.28 Overall, the PRA considers that the proposals support greater diversification of asset portfolios for firms. The PRA also notes various initiatives being taken forward by the insurance sector to increase insurers' investments in productive finance following the Government's November 2022 statement.

10.29 The PRA asked firms that participated in the Solvency UK Investment Flexibility Subject Expert Group (SEG) earlier in 2023 for specific examples of investments that firms could have invested in were the investment flexibility proposals implemented. Firms provided examples ranging from: renewable energy projects, to infrastructure

projects, student accommodation, and shared ownership/social housing. The PRA considers that many of these examples given by firms would be facilitated under its proposals. Further, the proposed controls on the quality of matching and proposed FS additions (set out in Chapter 2 of this CP) should increase firms' confidence that they would be able to invest in assets with HP cash flows in MA portfolios. The PRA considers that the increase in supply in debt financing from insurers may reduce the cost of capital for these projects, proving an economic benefit to the project sponsors.

10.30 The PRA notes that the proposed MA controls framework (and in particular the proposal to cap the level of MA benefit firms can obtain from assets with HP cash flows to 10% of the overall MA benefit) may at some point constrain firms in the level of MA benefit they can obtain from their investments in assets with non-fixed cash flows. The PRA considers that the proposed controls framework is consistent with the Government's November 2022 statement, and it does not expect FS additions to have a material impact relative to the baseline. The PRA considers that the proposed 10% aggregate cap on MA benefit from assets with HP cash flows implements the Government's decision that the vast majority of assets in MA portfolios should have fixed cash flows and the anticipated statutory requirement that the presence of assets with HP cash flows does not result in a material risk to the quality of matching. The PRA also considers that the accompanying controls together strike an appropriate balance between enabling firms to include a wider range of assets in their MA portfolios, enhancing competitiveness and growth, while maintaining safety and soundness and policyholder protection by avoiding material risk to the close matching of assets and liabilities on which the MA relies. The PRA does not consider that the cap would be a short-term constraint on firms' ability to obtain an MA benefit from investments in assets with HP cash flows. Furthermore, in the longer-term, even if the cap on MA benefit were to apply, firms would still be able to invest in these assets subject to their overall requirement to invest in line with the PPP.

10.31 On credit quality, the PRA expects a modest rebalancing towards assets with higher notched ratings within a given CQS, reflecting the lower risks associated with holding these assets. The PRA considers that this is an appropriate risk management incentive, recognising the lower risk of higher-notched assets.

Impact on annuity pricing

10.32 The PRA has also considered the impact of the proposals on the bulk purchase and individual annuities markets. The proposals on investment flexibility and notching of credit ratings are most likely to impact these markets.

10.33 The BPA market is forecast to be an area of **significant growth for UK insurers**. The rise in interest rates over the last two years has increased the numbers of pension schemes now able to afford to transfer their liabilities to UK insurers.

10.34 There are likely to be a number of potentially constraining factors in the growth of the BPA market. One such consideration is likely to be the availability of MA eligible assets to back pension liabilities. The availability and expected return on these assets drive both market pricing and capacity.

10.35 The PRA's proposals for investment flexibility will expand the universe of assets eligible to be held in MA portfolios. The PRA expects that this will have a positive impact on the ability of insurers to source MA eligible assets. This widening of MA eligibility will allow insurers to invest in assets that may earn higher expected yields than the existing universe of MA eligible assets (for a given level of risk). It also allows firms to diversify their MA portfolios into new asset types.

10.36 In a competitive market, the PRA expects these benefits to be at least partially passed on to pension schemes through modest reductions in the prices of BPA transactions. The PRA has based its assessment on a discounted cash flow model of a BPA transaction for various liability profiles and with different asset allocation strategies.

10.37 The impact of applying a FS using notched credit ratings will depend on whether insurers skew their asset allocation for new business towards 'positively' or 'negatively' notched assets. The PRA does not expect this to have a material impact on BPA pricing.

10.38 Relative to the baseline of expected legislation, the PRA considers that the proposals create the conditions for modest reductions in the cost of annuities for pension scheme and retail customers. However the extent to which this occurs will vary by firm.

Summary

10.39 Overall, relative to the baseline, the PRA considers that, within the constraints placed on it by legislation, the proposals would continue to advance the PRA's safety and soundness and policyholder protection objectives through the effective introduction and operation of the controls set out in this CP. The PRA considers that its proposals also support the continued safety and soundness of insurers by ensuring the FS better reflects firms' retained risks thereby applying a more appropriate MA benefit, while facilitating effective competition, and international competitiveness and economic growth through a more proportionate approach to permissions and breaches. In aggregate, the PRA considers that the package of proposals taken together will enable insurers - if they choose - to invest more in a way that advances the PRA's growth objective over the medium to long term.

11: Have regards analysis

11.1 This chapter sets out the PRA's analysis of the proposals in respect of the FSMA regulatory principles, the aspects of the Government's economic policy set out in the HMT recommendation letter from December 2022, and the Legislative and Regulatory Reform Act (LRRA) principles of good regulation.

11.2 The PRA considers that the proposals set out in this CP form part of an overall package. The implementation of the safeguards around the MA attestations, enhanced data collection, notching etc are all considered necessary to implement, in a manner consistent with the PRA's objectives, the package of reforms that in the November 2022 statement and that will be legislated for in the Government's anticipated legislation. These reforms include, amongst others, the widening of asset and liability eligibility.

11.3 Consequently the have regards analysis has been completed as a standalone chapter rather than a consideration in each individual chapter.

11.4 Factors to which the PRA is required to have regard and which were significant in the PRA's analysis of the proposals outlined in this chapter are considered below. The PRA has had regard to other factors as required. Where analysis has not been provided against a 'have regard' for the proposals, it is because the PRA considers that 'have regard' to not have a significant bearing on these proposals.

Competition (FSMA regulatory principles)

11.5 FSMA sets out a number of regulatory principles with respect to competition including:

- the proportionality of regulation; and
- recognition of the differences between businesses

11.6 The proposals in this CP will apply to all firms that have MA permissions or that apply for MA permission in the future. The size and composition of MA portfolios can vary materially from firm to firm. The proposals recognise this and hence have been designed to be proportionate in their impact.

Chapter 2 – Investment flexibility: The proposals recognise and seek to accommodate the wide range of assets that would become eligible under the new regulations. As such, firms will have flexibility to develop their own methodologies on projecting the best estimate cash flows and adjusting the FS. The proposed approval process is such that the PRA will allow firms to have less complex day-one FS additions, proportionate to the materiality of the risks being run.

Chapter 6 – Matching adjustment attestation: The proposals expect firms to take a proportionate approach with most focus being placed on those assets with comparatively high levels of MA or where there is significant basis risk between the assets in question and those used for the calibration of the published FS. Firms that adopt a less complex investment strategy where the investments are publicly traded and rated by a CRA will therefore be able to take a more proportionate approach.

Chapter 8 – MALIR: firms will be able to request a waiver where the costs would be disproportionate compared to the size of the portfolio. There will also be a review point, set to coincide with the wider five-year review announced in the November 2022 statement, to ensure that the data collected is still necessary and relevant.

Chapter 9 – Notching: The proposed methodology has been designed to be simple and transparent with flexibility for firms on how to best implement it considering their existing modelling approach.

Where a notched rating is not available, firms will be able to use the unadjusted FS but must separately consider the limitations of this approach as part of the attestation process.

When calculating the SCR, the proposals allow scope for firms to consider other possible remedies eg in the case that the firm’s exposures are tilted towards lower rated notches, until it has completed the necessary development to fully reflect its more granular risk profile in the model. This could include increasing the capital requirement calculated by the internal model, in order to ensure that the SCR complies with the core calibration standards at all times.

The proposals summarised above also recognise that firms may have taken different approaches to modelling the SCR and hence imposing a ‘one size fits all’ methodology could disproportionately affect some firms.

Growth and competitiveness (HMT recommendation letter)

11.7 In its December 2022 letter, HMT included a series of recommendations to the Prudential Regulation Committee about aspects of the Government’s economic policy to which it should have regard. There are two specific have regards; supporting the

Government's ambition to encourage economic growth in the interests of consumers and businesses, and the Government's strategy to promote competitiveness.

11.8 There are four specific considerations in respect of the first have regard:

- facilitating investment in productive assets;
- sustainable finance and the supply of long-term investment;
- better outcomes for consumers; and
- smart regulatory reform.

11.9 The PRA considers that the proposals in this CP could have significant benefits for facilitating investment in productive assets and sustainable growth. MA portfolios contain significant quantities of long duration assets and the proposed widening of the asset eligibility criteria means that asset features which were previously ineligible, or uneconomic to restructure, could now become viable investments to be included in insurers' MA portfolios.

11.10 Some respondents to the Government's Solvency II Review consultation suggested that widening eligibility could increase long-term productive investment and reduce product pricing, while also future-proofing the regime against new developments. At the same time, the lack of fixed cash flows in MA portfolios introduces new risks to the quality of matching which require additional controls, including on the overall quantity of HP assets. The proposed controls have been set at a level that the PRA considers consistent with its objectives for the safety and soundness of firms while not unduly constraining the ability of firms to obtain an MA benefit for these wider investments.

11.11 The widening in asset and liability eligibility could both increase firms' expected returns and reduce both the level and volatility of the capital they hold against their liabilities. This may enable firms to compete more intensively against each other and reduce premium rates on some lines of business thereby providing better outcomes for customers.

11.12 The increased granularity of the FS (because of the allowance for notched ratings) should also help provide better outcomes for customers as the TPs should be more risk sensitive thereby increasing policyholder protection.

11.13 The proposed reforms are also designed with the Government's SRF in mind, in which regulators set the detailed requirements which apply to firms directly through their rulebooks, operating within a framework established by the Government and Parliament. For example, the consequential rule changes will restate various existing regulations relating to MA eligibility conditions and applications into PRA rules and a new SoP.

11.14 The second set of considerations within the HMT recommendations letter are focused on the Government's strategy to promote the international competitiveness of the UK and include;

- the Future Regulatory Framework (FRF) Review;
- trade and inward investment into the UK;
- UK attractiveness of international financial services; and
- innovation.

11.15 The reforms introduced under FSMA 2023 implemented the FRF review. As set out in **DP4/22**, the PRA intends to take full advantage of the opportunities that the reforms create. In doing so, the PRA aims to address risks and opportunities in a responsive and dynamic manner, appropriately tailored to the circumstances of the UK.

11.16 The proposals set out in this CP are consistent with the aims above, in particular the MA reforms, both on liability and asset eligibility are designed to be more tailored to the business models of UK firms. Many of the proposals, for example the FS addition for HP assets and the implementation of notching are principle based rather than prescriptive and allow scope for firms to implement them in the most efficient way. Similarly on attestations, it is for firms to set out and justify why they believe the FS and MA are appropriate considering the risks within the asset portfolio.

11.17 In recent years, firms have made increasing use of **reinsurance** to free up capital and improve pricing in the annuity market. This could, in part, be due to reinsurers being able to invest in a wider range of high yielding assets than UK firms. The proposed reforms would increase the range of eligible assets for UK firms. This may reduce the propensity for firms to use reinsurance to transfer liabilities offshore, effectively increasing the competitiveness of the UK as an insurance centre.

Climate and environmental targets (FSMA 2023)

11.18 The consideration under this heading arises from FSMA 2023;

- The need to contribute towards achieving compliance by the Secretary of State with section 1 of the Climate Change Act 2008 (UK net zero emissions target).

11.19 The proposals do not directly seek to incentivise firm investment into 'green' assets; however, many insurance firms have indicated their view that the Solvency II reforms could improve the ability of the sector to contribute to the Government's net zero targets. The proposals on investment flexibility are designed to accommodate a wider range of asset types within firms' MA portfolios, and should therefore allow firms more flexibility to invest in long term sustainable infrastructure if they choose. This

includes asset features where there is a limited data on the expected cash flow variability, for example lending where the coupon is dependent on meeting environmental or operational targets. For small exposures to a new asset or new features/risks within an existing asset class, the streamlined approach for MA approval could provide faster feedback over MA eligibility.

11.20 As part of the attestation process, firms will have to consider the extent to which the FS is sufficient compensation for all retained risks, including environmental risks related to climate change. This may encourage firms to invest in assets consistent with the UK Government's **net zero emissions target**.

Regulatory best practice (FSMA and LRRA)

11.21 The first three considerations under this grouping arise from s3(B)1 FSMA, and are:

- the need to use the resources of each regulator in the most efficient and economic way;
- publication of information relating to persons on whom requirements are imposed; and,
- transparent exercise of the regulator's functions.

11.22 In many cases, there may be a trade-off between upfront use of PRA resources, for example in scrutinising MA permission requests, and the cost of ongoing supervision of firms' compliance with the rules. This is most apparent in the investment flexibility proposals where the choice has been deliberately made to allow simplified modelling of FS additions and best estimate cash flows for assets with HP cash flows. This may mean higher ongoing supervisory resources to ensure the methodology remains appropriate but has been designed to give firms greater ability to move rapidly with their investment decisions. Further consideration of these issues is discussed in Chapter 10 of this CP.

11.23 The proposed attestation process is designed to place the responsibility on firms to justify the appropriateness of the FS and quality of MA. This is consistent with where the detailed knowledge of the asset risk profile lies and will allow the PRA to focus its supervisory resources more efficiently.

11.24 On notching, the PRA proposes to continue publishing technical information in respect of the FS at the level of CQS. This preserves the current FS calibration for assets where no adjustment for differences in credit quality by rating notch is required, and also allows firms some flexibility in terms of how a notched FS is implemented. Giving firms the ability to choose the level at which they apply notching reduces the

publication burden on the PRA and limits the need for firms to make extensive updates to their models.

11.25 The Government's proposed reforms to the MA also affect the treatment of SIG debt. The PRA aim to be transparent in this area and hence the policy proposals set out revised expectations for firms, specifically in respect of the prudent management of assets and the appropriateness of firms' internal models. The PRA has also engaged with firms via targeted information requests to understand the likely impact of the proposals.

11.26 MA reform will be a key topic of interest for many firms and the PRA has acted transparently in making policy in this area. Over the course of 2023 H1, a number of subject SEG meetings were held with **industry** covering; attestations, investment flexibility, and notching. The purpose of the meetings were to gather background and technical information on issues related to the implementation of the reforms announced by the November 2022 statement. Information gathered during the SEGs has been used to help shape the proposals in this CP and summary minutes of the meetings, and **associated plenaries** have been published on the Bank's website. The PRA has also taken into account comments made previously by firms when designing the new data collection template (Chapter 8 of this CP) and the data provided by firms will be used to help prioritise future policymaking.

11.27 Bringing together in one place a list of the key conceptual and technical assumptions underlying the MA and FS calculation should also help firms better understand the PRA's expectations when complying with the Solvency II requirements. These will be particularly relevant as part of the attestation process and where firms consider whether any addition to the FS is required to ensure it reflects compensation for all retained risks.

11.28 The PRA is committed to exercising its functions as transparently as possible and hence with this consultation the PRA is also publishing updated draft rules and supervisory statements. These updates cover notching, assets with HP cash flows, increased liability eligibility, the assumptions underlying the MA portfolio, the treatment of assets related below investment grade, the MALIR data request, attestations, and other consequential rule changes.

11.29 Principles within FSMA and LRRA state that regulatory activities should only be targeted at cases where action is needed. The PRA considers that this is the case here: the attestation measure is needed because applying the published FS calibration to all assets based solely on their rating introduces significant sector-wide model risk, requiring firms to consider the appropriateness of the FS and the level of confidence they have over earning the MA will reduce this model risk.

11.30 The attestation measure is also important to help mitigate the additional risks posed by the widening of asset eligibility. The PRA does not propose publishing detailed methodologies to calculate the FS addition for assets with HP cash flows and hence it is important that the governance and scrutiny within firms be appropriate to the risks posed by the assets.

11.31 Similarly, the MALIR data collection for MA firms is targeted at the areas where the PRA consider there is the greatest risk to its objectives.

Other 'have regards' (FSMA 2023)

11.32 FSMA s3B(1)(e.) also requires the PRA to have regard to the responsibility of firm's senior management for compliance.

11.33 The PRA considers that the proposals for attestation will lead to an increase in senior management responsibility for the level of MA claimed. The PRA also considers that this is appropriate to the materiality of the MA and its importance to ensuring that firms can meet and continue to meet their obligations to policyholders. The expected increase in senior management responsibility will also be proportionate to the complexity of firms' asset portfolios.