SLAUGHTER AND MAY/ BRIEFING

INSURANCE BRIEFING - JUNE 2023

UK Solvency II implementation - the risk margin and the matching adjustment

HM Treasury has published two draft statutory instruments which will allow it to implement reforms to the risk margin and the matching adjustment ahead of other proposed reforms to UK Solvency II.

In HM Treasury's November 2022 response document on the review of UK Solvency II, HM Treasury had stated that it planned to implement changes to the risk margin and certain changes to the matching adjustment through secondary legislation rather than PRA rules. This was partly to provide certainty to industry on key reforms.

> *HM Treasury has described the regulations as "early drafts" and is actively seeking engagement on them - interested parties should therefore consider whether they wish to provide feedback.*

HM Treasury has indicated that:

- reform of the risk margin will be in force by the **end of 2023** - this is a key priority as it is expected to allow a release of capital for insurers
- reforms of the matching adjustment will come into force by the **end of June 2024**
- the remainder of the new regime (to be implemented in PRA rules) will come into force by the **end of 2024**.

Headline points

The statutory instruments will entrench in secondary legislation the rules for calculation of the risk margin, some of the conditions for MA approval, and the basic requirements for calculation of the matching adjustment and the fundamental spread. They will implement proposed reforms to:

- the risk margin;
- the matching adjustment conditions, to provide for flexibility over fixity of cashflows and MA breaches;
- the calculation of the matching adjustment, to remove the cap on sub-investment grade assets; and
- the fundamental spread, to allow for an optional increase to ensure it covers all retained risks.

The risk margin

The Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations 2023 will amend the onshored Delegated Regulation to:

- substitute a new formula for calculation of the risk margin, including a tapering factor; and
- replace the 6% cost of capital rate with a 4% rate.

This is in line with the reforms announced in the November response document, although the precise cost of capital rate has not previously been specified.

The matching adjustment

The Insurance and Reinsurance Undertakings (Prudential Requirements) (No. 2) Regulations 2023 will set out the main requirements for matching adjustment approval, calculation of the matching adjustment and calculation of the fundamental spread.

Conditions for approval

Regulation 5 sets out the conditions for approval to apply a matching adjustment. This partly replicates and will replace Regulation 42 of The Solvency 2 Regulations 2015. The regulations provide for additional conditions to be set out in PRA rules, so these conditions can be expected to be supplemented. Key points are:

Fixity of cash flows	The regulation includes the exception to the requirement for fixity of cashflows for matching adjustment assets proposed in the HM Treasury November response document. This has been addressed by providing an exception to the fixity of cash-flows requirement where: • the risks to the quality of matching are not material (with materiality to be determined in accordance with PRA rules); and • only such limited proportion of the portfolio as the PRA may determine is affected. The materiality of risk concept is easier to apply than the original proposal that assets with “highly predictable” cashflows should be eligible, although how materiality is defined will be important.
Breaches of the MA	Current rules require the PRA to revoke a matching adjustment approval if a firm fails to comply with any of the conditions for two months or more. The new regulation will give the PRA the power (but not the obligation) to vary or revoke a permission for any failure to meet the conditions for approval and to impose a limit on the value of the matching adjustment benefit during the period of default.
Credit quality	A requirement that the credit quality of matching adjustment assets must be capable of being assessed (externally or internally to an appropriate standard) has been added. This has presumably been introduced to support other changes to the matching adjustment rules, in particular the proposed introduction of notched ratings in the fundamental spread calculation.
Liability eligibility	Among other omissions, Regulation 5 does not include a restriction on future premium payments or policyholder options among the conditions for matching adjustment approval. As the HM Treasury consultation did not propose changes to these requirements it is assumed that they will be provided for in PRA rules supplementing the regulations.

Calculation of the matching adjustment

Regulation 6 sets out how the matching adjustment is to be calculated. The chief change from the current rules is that there is no provision that the fundamental spread has to be increased where necessary to ensure that the matching adjustment for assets with sub-investment grade credit quality does not exceed the matching adjustment for assets of investment grade quality.

Regulation 7 sets out how the fundamental spread is to be calculated. The chief change from the current rules is that there is a provision allowing firms to optionally increase the fundamental spread where necessary to ensure that it covers all the risks retained by the undertaking. Although this doesn’t allow the PRA to require firms to increase the fundamental spread, there is potential scope for supervisory intervention if the PRA feels that a firm’s matching adjustment benefit is inappropriately high. The regulation does not address the issue of use of notched ratings, which will presumably be set out in PRA technical information (to be published in accordance with regulation 3).

The Financial Services and Markets Bill

The statutory instruments will be made under the Financial Services and Markets Act 2023, although this is yet to come into force. Amendments to the Financial Services and Markets Bill proposed by the House of Lords are due to be considered by the House of Commons in June.

“FundedRe” - preliminary feedback on the PRA’s thematic review

On 15 June the PRA published a letter sent to Chief Risk Officers of life insurance firms setting out insights from its thematic review of so-called “funded reinsurance” or “FundedRe” arrangements in the UK life insurance sector. We discussed this topic more broadly in our recent Insurance Newsletter.

The PRA continues to be concerned about the counterparty risks arising from these transactions. The likelihood of a recapture being necessary and the potential for disruption if a recapture is required during a period of market stress are key areas of focus. The PRA also explicitly comments that it sees “*significant potential risks to the PRA’s objectives from the systematic use of FundedRe to meet the increase demand for bulk transfer of defined benefit pension liabilities*”.

More general issues highlighted in the letter include:

- “wrong way” risk affecting both the reinsurer and collateralised assets at the same time
- availability of management actions on a recapture
- sub-optimal collateral portfolios
- robustness of internal risk frameworks.

The PRA intends to continue to scrutinise insurers’ use of funded reinsurance deals and is also considering whether it should develop specific policy proposals to address the topic. In addition, it requests firms to notify their supervisor promptly of any material FundedRe transactions entered into from the date of the letter.

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