BANK OF ENGLAND
PRUDENTIAL REGULATION
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PRA Statement to insurers on the application of the matching adjustment during Covid-19

Introduction

The PRA considers that the matching adjustment (MA) has functioned as intended thus far throughout the Covid-19 crisis. Nevertheless, the PRA has identified some areas where it may be useful to provide clarifications to ensure consistency in firms' interpretation of the PRA's policy. This statement should be read in conjunction with the PRA's expectations as set out in Supervisory Statement (SS) 3/17 'Solvency II: Illiquid and unrated assets'[1], SS 7/18 'Solvency II: Matching Adjustment'[2], SS8/18 'Solvency II: Internal models - modelling of the matching adjustment'[3], and SS1/20 'Solvency II: Prudent Person Principle'[4].

While the focus of this statement is on the MA, Covid-19 may affect firms' views of prospective risks. Where this requires a change in firms' internal models, they should refer to SS12/16 'Solvency II: Changes to internal models used by UK insurance firms'[5], particularly paragraph 2.8.

Matching adjustment: management of the MA portfolio

The PRA is aware that, in their MA applications, some firms indicated that their approach to managing the MA portfolio (MAP) would include occasionally removing certain assets despite their continued eligibility. This might lead, for example, to firms selling assets that were downgraded below a certain level. Although the level of MA benefit that can be derived from such assets may change, the PRA reminds firms that there is generally no requirement or expectation to sell downgraded assets as long as the MAP continues to comply with Regulation 42 of the Solvency 2 Regulations and firms' own governance and risk management systems.[6] The PRA recognises that, within what the legal framework allows, firms may wish to change their approach to managing the MAP in light of the financial turbulence caused by Covid-19. For example, it would be reasonable for firms to seek to avoid being forced sellers of assets. In particular, it may be reasonable for firms to reconsider their strategies for managing the MAP in the face of the current global pandemic and its effect on financial markets, particularly the timing of planned asset disposals. In each of these cases, firms should discuss their intentions with their supervisors, and in particular note whether the changed risk profile is consistent with the assumptions underlying their calculation of the Solvency Capital Requirement, for example, in their internal model specification.

Consistent with paragraph 9.4 of SS7/18, the PRA expects that any material change to the management or scope of MAP after approval has been granted will require a new application for approval. When deciding whether a new MA application is necessary, the PRA will

1 April 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss.
2 July 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-matching-adjustment-ss.
3 July 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-internal-models-modelling-of-the-matching-adjustment-ss.
4 May 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/solvency-ii-prudent-person-principle-ss.
5 July 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2016/solvency2-changes-to-internal-models-used-by-uk-insurance-firms-ss.
6 The Solvency 2 Regulations 2015 (2015/575): https://www.legislation.gov.uk/uksi/2015/575/made.

consider a range of factors, including the extent and duration of the change. When considering a change to their approach to managing the MAP, firms are encouraged to engage with their usual supervisory contact.

Matching adjustment: eligibility

The economic effects of Covid-19 have been mitigated by a significant amount of support provided to the economy, including to borrowers and tenants. Nevertheless, there may be an impact on the cashflows from loans or similar assets held in the MAP that may affect their ongoing appropriateness.

On Friday 22 May 2020, the PRA issued a statement with guidance for banks on the application of regulatory capital and IFRS 9 requirements to payment holidays granted to address the challenges of Covid-19.[7] While the statement is not targeted at insurers, some of the points may be relevant to them, particularly when they engage in direct lending. The PRA's view remains that use of Covid-19 related payment holidays or loan modifications would not automatically result in a loan being considered in default.

Following requests for and granting of a payment holiday or loan modification, insurers are expected to review the rating assigned to such a loan to ensure that the credit quality step (CQS) to which it maps still lies within the plausible CQS range that could have resulted from an issue rating given by an external credit assessment institution (ECAI), as per paragraph 2.4 of SS3/17. These ratings should continue to be reviewed on an ongoing basis, at regular intervals as well as in response to changes in market conditions or other factors that may affect the rating. In reviewing the rating assigned to these loans, firms should take a measured approach that makes use of all information available to assess borrowers for indicators of deterioration in credit quality, taking into consideration the underlying cause of any financial difficulty and whether it is likely to be temporary, as a result of Covid-19, or longer term. The PRA encourages firms to make well-balanced and consistent decisions that take into account the information they have regarding the borrower, the potential impact of Covid-19, and also the unprecedented level of support provided by governments and central banks domestically and internationally to protect the economy.

The follow-up note to insurers on the letter from Sam Woods ('Covid-19: IFRS 9, capital requirements and loan covenants')[8] includes guidance relevant to all insurers' internal ratings. Consistent with SS3/17, the PRA would expect ratings to be updated to reflect changes to market-related or issuer-specific credit factors. However, the PRA understands that firms may wish to consider the currently uncertain risk outlook when deciding on the pace of rating revisions.

Due to the disruption caused by Covid-19, some assets in the MAP may be experiencing short-term disruption to their contractual cash flows; in some cases the expected fixed cashflows may no longer be sufficiently reliable to be matched to the expected liability cashflows of the MAP, or may have temporarily ceased. The PRA understands that firms

7 May 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/statement-on-application-regulatory-capital-ifrs9.

8 April 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/follow-up-to-letter-from-sam-woods-covid-19-ifrs-9-capital-requirements-loan-covenants.

may wish to continue to hold such assets on the basis of their assessment of credit fundamentals. One way of doing so would be for the non-MAP to buy these assets out of the MAP and replace them with other MA eligible assets (within the scope of the firm's approval). The PRA also understands that as a result of the Covid-19 disruption, the volume of assets which may become temporarily distressed may be higher than normal, and therefore that buying all such assets out the of the MAP could result in a liquidity strain in the non-MAP.

If an asset's cashflows are no longer sufficiently reliable to be matched to the liability cashflows, or have ceased, then the asset should not be included in Component A.[9] It may be possible for firms to make a case for including the asset in Component B (for the purpose of demonstrating that the asset and liability cashflows are sufficiently closely matched)[10] if fixed cashflows are expected to resume within a reasonable timeframe.

Firms are reminded to apply sound risk management practices regarding the identification of defaults. Consistent with paragraph 4.13 of SS7/18, the PRA expects firms to have a policy that sets out their definition of default events and processes to identify different types of default events or the severity of distress and likelihood of recovery for an individual asset. In the current circumstances, these processes may be used to distinguish between borrowers who are unable to make full payments due to direct Covid-19 related issues that can reasonably be expected to be temporary, and borrowers who are unable to make full payments due to financial difficulty that is likely to be more long term. Where these assets are held in an MAP, firms should assess the consequences of different types of default events, including the implications for the MAP. In particular, firms should determine whether the resulting cash flows would still result in a matched position, and whether the cash flows from the asset would reasonably be expected to remain fixed until its repayment.

Regulation 42(4)(e)(f) of the Solvency 2 Regulations sets out that the expected cashflows from assets held in the MAP must replicate each of the expected cash flows of the insurance liabilities in the same currency, with any mismatch not giving rise to risks that are material in relation to the risks inherent in the insurance or reinsurance business to which the MA is applied. Where a firm is no longer in compliance with this condition, it must restore compliance within two months; otherwise, Regulation 42(3) would require the PRA to revoke MA approval. In their MA applications, firms have specified the approaches they will follow to monitor their matching positions.[11] Monitoring whether asset and liability cash flows remain matched is an important part of the governance of the MAP; the PRA expects that firms will continue to monitor their matched position against those approaches. A firm may adopt an alternative approach to demonstrate cash flow matching. However, it must explain why its current approach is no longer appropriate and justify the suitability of its alternative approach. It will also need to consider whether the change amounts to a material change to the management of its portfolio such that a new MA application is needed in line with paragraph 9.4 of SS7/18.

9 Component A is defined in SS7/18 as assets where cash flows replicate the expected liability cash flows after being adjusted for the component of the fundamental spread that corresponds to the probability of default.

10 Component B is defined in SS7/18 as additional assets that, when added to component A, result in the value of the assigned portfolio (ie components A and B combined) being equal to the BEL within an MA portfolio (when discounted at the risk-free rate plus MA).

11 Generally firms' approaches have adopted the tests set out in the appendix of SS7/18. The PRA continues to consider that those tests are an appropriate way to measure whether any mismatch between asset and liability cash flows gives rise to risks that are material in relation to the risks inherent in the insurance or reinsurance business to which the MA is applied.

Matching Adjustment: calculation

Rule 7.2 of the Technical Provisions Part of the PRA Rulebook requires that the fundamental spread be increased, where necessary, to ensure that the MA for assets with sub-investment grade credit quality does not exceed the MA for assets of investment grade quality of the same duration and asset class. For these purposes, firms need to map their assets to asset classes. The PRA's expectations for this mapping are set out in paragraph 5.11 of SS7/18. Specifically, firms should allocate their assets to the asset class or category identified in the technical information (adopted by the Commission in accordance with Article 77e of the Solvency II Directive[12]) that most closely reflects that asset. For clarity, the currently available asset classes or categories are: exposures to central governments and central banks, exposures to financial institutions, or other exposures.

As explained in paragraph 5.5 of SS7/18, the PRA does not otherwise have a preferred approach for how firms should apply the cap on the MA for sub-investment grade assets. Firms should discuss any change to their approach with their supervision team in the first instance, and be prepared to demonstrate the suitability of the proposed change.

Technical Provisions 7.2 in the PRA Rulebook also requires that the MA does not include risks retained by the firm. The Effective Value Test (EVT) set out in SS3/17 provides one method by which firms can ensure that the risks they retain from embedded 'no negative equity guarantees' (NNEGs) are allowed for in the valuation of restructured equity release mortgages (ERMs) and their calculation of the MA. The PRA reminds firms that there is no requirement or expectation that ERMs necessarily be restructured if a firm is unable to meet the EVT. Firms are reminded of the guidance in paragraph 3.22 of SS3/17, which provides several potential actions that firms may undertake to ensure that they are not deriving inappropriately large MA benefit from restructured ERMs. In accordance with paragraph 3.24 of SS3/17, firms are expected to contact their supervisor as soon as possible in the event that the EVT result indicates that an inappropriately large amount of MA benefit may be derived from restructured ERMs.

Given the disruption in the property market caused by Covid-19, some firms have identified difficulties in conducting physical inspections due to social distancing measures, obtaining reliable property valuations, and determining appropriate approaches to suspended or unreliable house price indices. Consistent with the PRA's Q&A on Capital Requirements Regulation (CRR) requirements for banks' property valuations,[13] where a house price index (HPI) used in the calculation of the cost of NNEG is unavailable or unreliable, a firm may use the most recently available reliable HPI until the point at which the HPI becomes available and reliable again. The PRA would not expect firms to use the out-of-date index for more than two quarters. Firms should notify their supervisor and provide evidence that an HPI has become unavailable or unreliable before changing its approach. The PRA will keep this guidance under review.

The PRA reminds firms that, in cases where only part of an asset's cash flows are taken into account for the purposes of demonstrating cash flow matching, firms should attribute the full

[12] At the end of the Transition Period, this power will be onshored by Regulation 4B of The Solvency 2 and Insurance (Amendment,etc.) (EU Exit) Regulations 2019 (2019/407): http://www.legislation.gov.uk/uksi/2019/407/made.

[13] May 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2020/crr-requirements-property-valuations-qanda.

market value of the asset to a matching portfolio, and take the full asset value into account when calculating the MA, as set out in paragraph 2.16 of SS7/18.

Matching Adjustment: reflection in the Solvency Capital Requirement

The PRA is also aware that internal model firms may use limits or caps within their calculations of the MA in the Solvency Capital Requirement. As noted in paragraph 4.31 of SS8/18, the PRA places most weight in the detailed modelling undertaken when assessing internal models against the relevant tests and standards. Firms are always welcome to discuss improvements to their models with their supervisors, but such changes cannot be considered in isolation, and the PRA will need to reconsider the firm's detailed modelling work in order to determine whether, in the PRA's view, it is warranted to revisit any limits or caps present in the model.