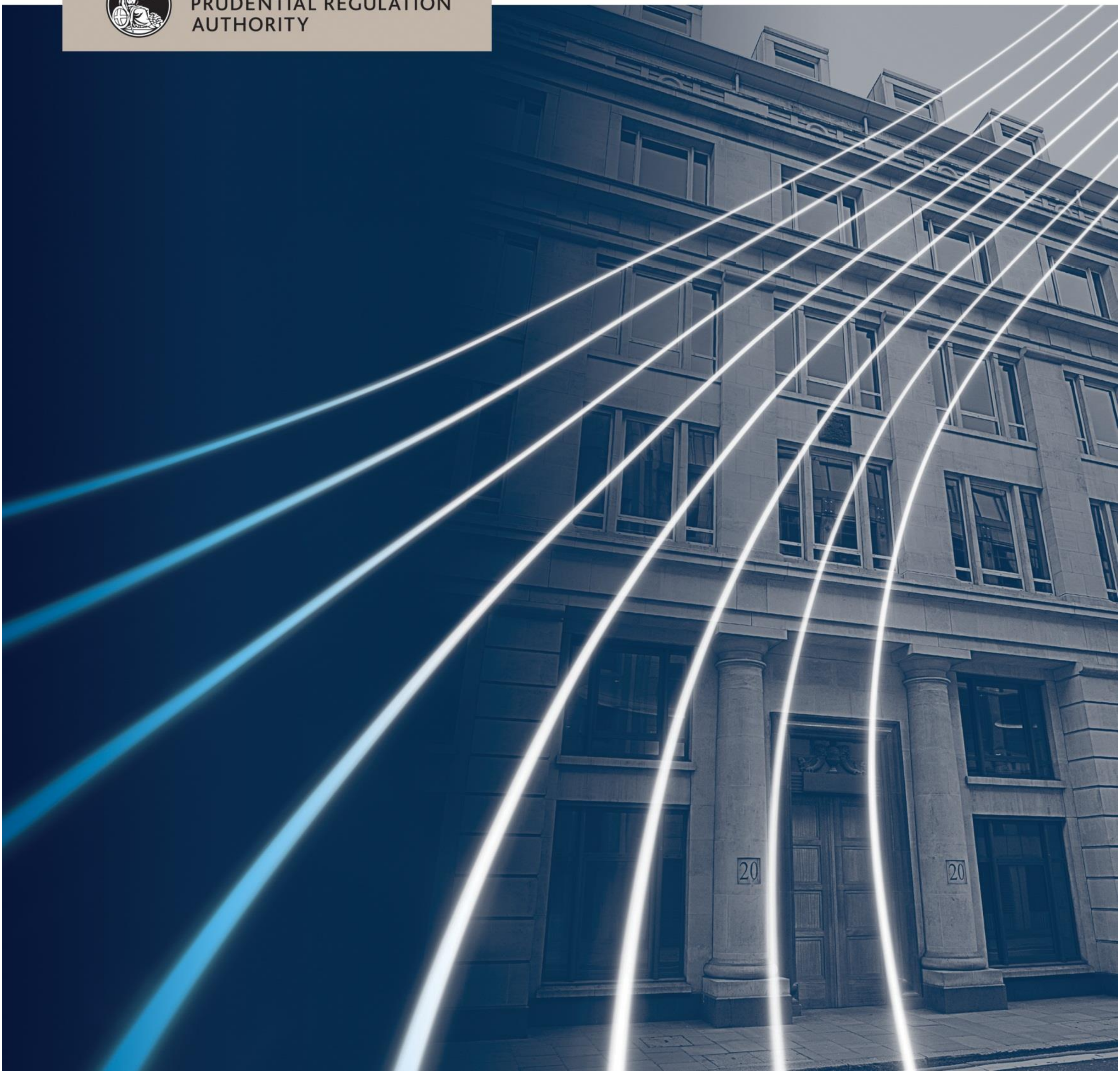
Policy Statement | PS18/18

Solvency II: Matching adjustment

July 2018

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback on responses to Consultation Paper (CP) 21/17, 'Solvency II: Matching Adjustment' (the CP) and provides the final Supervisory Statement (SS) 7/18, 'Solvency II: Matching adjustment' (see Appendix), which sets out the PRA's expectations in respect of firms seeking to apply the matching adjustment (MA) to an eligible portfolio of assets and liabilities.

1.2 This PS is relevant to all UK Solvency II firms and to the Society of Lloyd's and its managing agents where they are applying or have applied to use the MA.

1.3 In CP21/17 the PRA consolidated and updated material previously set out in letters from Directors and Executive Directors (ED), and feedback statements ('Directors' letters') published in the period 1 April 2013 to 15 February 2016, and also proposed some areas of updated guidance in light of experience following the introduction of Solvency II for UK firms. The CP proposed to incorporate all the guidance in a draft Supervisory Statement (SS).

1.4 The PRA has made changes to the draft SS after considering responses to the consultation and further analysis. Details of the changes are included in Chapter 2. The PRA does not consider these to change the substance of the guidance, but rather provide additional clarification where requested and therefore considers neither that the impact of the changes for firms is significant, nor that the impact is any different in respect of mutuals.

Implementation and next steps

1.5 The expectations set out in the attached SS will come into effect on the publication of the PS on 13 July 2018.

1.6 The policy contained in this PS has been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including changes arising once any new arrangements with the European Union take effect.

2 Feedback to responses

2.1 The PRA solicits comment on policy proposals and carefully considers the representations made to it in response.

2.2 The PRA received eleven responses to the CP. Respondents noted that the MA provides a material benefit to UK insurers writing long term business and to the wider economy by supporting firms' investment in illiquid assets, including infrastructure assets. Given the importance of the MA, respondents welcomed the PRA's consolidation of its guidance on the application of the MA and the opportunity to respond to this in the CP. Some respondents raised concerns that, while the additional guidance set out in the CP was a 'step in the right direction', it did not go far enough to make a material change to firms' ability to increase their investment in some asset classes.

2.3 The PRA is mindful of the value of the MA to UK insurers and to the wider UK economy. Application of the MA results in a large benefit for firms through an increase in capital resources and corresponding reduction in capital requirements. The Solvency II regulations set out strict conditions for the eligibility of assets and liabilities to be included in a MA portfolio. Legislation also specifies the process for supervisory approval.[1] The SS sets out the PRA's expectations in relation to these requirements. The PRA, however, does not have discretion to deviate from the requirements.

2.4 The sections below have been structured broadly corresponding to the sections of the draft SS appended to the CP. The responses have been grouped as follows:

- the PRA's process and consistency with previously issued guidance;
- asset and liability eligibility;
- calculation of the MA and management of the MA portfolio;
- ongoing compliance with requirements and making changes to MA portfolios

The PRA's process and consistency with previously issued guidance

2.5 As noted in the cost benefit analysis (CBA) in CP21/17, some proposals contained in the draft SS clarify the PRA's expectations and do not impose additional requirements, correspondingly, there are no associated additional costs to the firms. The overall economic effects of the Solvency II requirements in this area have been considered previously, in the Financial Services Authority's (FSA's) CP11/22[2] and the PRA's CP16/14,[3] and also in the impact assessment (IA) undertaken by HM Treasury.[4] In areas of the draft SS where the PRA updated its guidance, the PRA considered the cost and benefit implications and concluded that they should not result in significant additional cost to affected firms.

2.6 Two respondents suggested that the PRA should carry out an updated CBA, noting that much of the material contained in the draft SS and the final version of Regulation 42 had not been published at the time that previous CBAs and HMT's (IA) were carried out. The

1 Solvency 2 Regulations 2015/575 and Commission Implementing Regulation (EU) 2015/575.
2 'Transposition of Solvency II: Part 1', November 2011: www.bankofengland.co.uk/prudential-regulation/publication/2013/transposition-of-solvency-2-part-1-and-2.
3 'Transposition of Solvency II: Part 3', August 2014: www.bankofengland.co.uk/prudential-regulation/publication/2014/transposition-of-solvency-2-part-3.
4 HM Treasury Impact Assessment, 'Transposition of Solvency II Directive (2009/138/EC) and Omnibus II', December 2014, RPC11-HMT-1094(3); www.legislation.gov.uk/ukia/2015/143/pdfs/ukia_20150143_en.pdf.

respondents also noted that CP16/14 covered only the transposition of Article 77b into the PRA Rulebook, and not the more detailed guidance set out in the PRA's letter of 13 June 2014. The respondents were also of the view that changes to the wording of the guidance (citing paragraph 2.2 as an example) included in the draft SS represented a clear shift in the PRA's expectations of firms. Conversely, one respondent stated that because firms would already be familiar with much of the guidance contained in the draft SS which had been published in 2014 and 2015, and also the PRA's intentions for the additional guidance in the draft SS, that the PRA did not need to consider and explain why it had not carried out a further CBA.

2.7 We have considered this feedback carefully. The PRA acknowledges that HM Treasury's 2014 IA preceded publication of Regulation 42. However, Regulation 42 is an intelligent copy-out of the MA eligibility conditions set out in Article 77b of the SII Directive (as amended by the Omnibus II Directive (OMD)) which itself was within the scope of the HMT's IA. Every Member State has a legal obligation to transpose the requirements set out in Article 77b of the SII Directive. CP16/14 set out proposed changes to the PRA's rules which were required in order to implement those provisions of the Solvency II Directive (as amended by the OMD) for which the PRA was responsible, including in relation to certain aspects of the MA, but those rules do not transpose the MA eligibility conditions in Article 77b of the SII Directive (which are transposed in Regulation 42).

2.8 As noted in CP21/17, CP16/14 included a CBA based on the information and data available to the PRA at that time. CP21/17 consulted on a supervisory statement setting out the PRA's expectations of (among other things) how firms should comply with the MA eligibility conditions. The PRA does not have a statutory duty to conduct a CBA for supervisory statements although it has a public law duty to act proportionately. The PRA does not consider that the draft SS in CP21/17 imposes any requirements that go beyond what is required under Solvency II, and on this basis considers that the consideration of the economic effects of the proposed guidance in paragraph 3.6 of CP21/17 is sufficient to demonstrate that the policies underling the guidance is proportionate.

2.9 The PRA is aware that there are some differences in the wording between the previously published guidance and the draft SS. These are not intended to change materially the PRA's expectations for firms. This is discussed in more detail in paragraphs 2.10 to 2.14 below.

2.10 Four respondents noted that while Appendix 2 of the CP referenced the guidance (ED letters), this did not contain a detailed analysis and did not indicate the location in the draft SS of the previously published guidance. The absence of guidance on intra-group reinsurance set out in the August 2015 ED letter from the table in Appendix 2 was also noted. Respondents also noted that in some case the wording of the earlier guidance had been updated and therefore it was not clear whether this represented a policy change from the PRA beyond those specifically noted in CP21/17. The respondents requested that the PRA add a mapping between the SS wording and text of the ED letters to the final PS so that firms can be assured that they are complying with the most up to date guidance and also be made aware of any guidance that may no longer be applicable.

2.11 The PRA acknowledges that there have been some updates to the wording of previously issued guidance in the text of the draft SS. The wording reflects current PRA practice. For example, the sections on restructuring of assets in order to meet MA eligibility criteria have been broadened beyond the specific focus on equity release mortgages in the February 2015 letter, to reflect that firms have used restructuring for other asset types.

2.12 One respondent commented that interchangeable use of both ‘requirements’ and ‘conditions’ in the draft SS could be confusing. The wording of the SS has been reviewed and updated so that where appropriate ‘conditions’ has been used.

2.13 The PRA has carefully considered the feedback in respect of the mapping between the SS and previously issued guidance and wording changes. The August 2015 letter has now been added to the table together with the sections of the draft SS which should incorporate the guidance from the various letters. The PRA does not consider that it would be efficient to include a more detailed (line by line) mapping between the texts of the letters and SS. Some specific areas of the text of the SS which were raised by respondents are covered in the paragraphs below.

2.14 Two respondents sought clarification that firms with existing MA approvals will not need to submit new applications for MA approval as a result of the updated guidance. The PRA does not expect firms should need to do so.

Asset and liability eligibility

2.15 Two respondents commented that the wording of section 2.2 of the draft SS had changed to ‘the PRA expects firms to demonstrate that portfolios meet the eligibility criteria’ whereas previous guidance stated that firms must apply their judgement, and consider carefully whether they are compliant with the criteria laid out in the Directive. Another respondent said that they agreed with the substance of the guidance but suggested that the SS set an expectation that firms should be able to demonstrate rather than be required to demonstrate in order to avoid unnecessary reporting requirements.

2.16 The guidance given in the 9 March 2015 letter on screening of asset holdings stated that ‘the PRA expects firms to have a robust screening process in place to identify those asset features that could affect MA eligibility’. The PRA would expect a firm to be able to evidence its screening process. The wording of the SS has been updated to make it clear that firms are not expected automatically to report their eligibility assessments, but should be able to evidence that the eligibility criteria are met.

2.17 One respondent considered that the inclusion of paragraph 2.4 represented a strengthening of PRA requirements for firms as in previously issued guidance this expectation was limited to liabilities. The PRA does not consider this to be a strengthening of requirements as in practice firms need to have processes in place to assess asset eligibility, and these processes would need to consider all features of the assets.

2.18 Three respondents suggested that the PRA’s interpretation of the requirement for asset cash flows to be fixed (paragraph 2.13 of the draft SS), ie that cash flows should be fixed in time and amount, was overly restrictive and that an interpretation of ‘not inherently variable’ would also meet the requirements of Regulation 42(4)(k). The respondents commented that, in their view, this would be consistent with the intent of the MA as set out in Recital 31 of OMD which refers to the requirement for asset and liability cash flows to be matched but not explicitly that they should be fixed. Some respondents also suggested that ‘fixed’ could be interpreted to allow cash flows which were linked to events which were certain to occur, rather than being limited to specified date(s) and monetary amounts.

2.19 The PRA still considers that the most natural interpretation of the requirement for ‘fixed cash flows’ is ‘fixed in time and amount’. Recital 31 sets out the rationale for including the MA as part of the Long Term Guarantees (LTG) package of measures within OMD, and also notes the need for strict requirements on the assets and liabilities to ensure that firms can hold assets to maturity, but it does not seek to set out all the detailed requirements which need to be met. These are set out in Article 77b which is implemented by Regulation 42. The PRA does not consider that because Recital 31 does not explicitly mention that cash flows should be fixed, that this in any way changes the meaning of the condition that cash flows must be fixed, as set out in Article 77b(1)(h) of the Solvency II Directive and as transposed in Regulation 42(4)(k) of the Solvency 2 Regulations 2015.

2.20 The PRA does not consider that interpretation of 'fixed' could be extended to include cash flows linked to events which are certain to occur but where the timing or amount is not fixed. The PRA's guidance is that firms may consider cash flows where the timing or amount varies within a contractually fixed period or limits, to be eligible provided the cash flows are assumed to occur on the latest date and/or minimum amount, ie so that a cash flow of at least this amount by the latest date can be relied on (other than in the event of default) and therefore have the same degree of certainty as a fixed cash flow. An extension of the interpretation of fixity to cash flows contingent on events certain to occur but where the timing or amount does not have a fixed limit, would not result in the same degree of certainty, and the PRA considers that this would not be consistent with matching requirements.

2.21 One respondent proposed that senior notes of Collateralised Loan Obligations (CLOs) should be considered for MA eligibility. The PRA does not operate a closed list of asset for MA eligibility. It considers that firms should assess each asset's features against the conditions of Article 77b as transposed in Regulation 42. Such assets could potentially be included in the matching portfolio of assets where the application demonstrates that they satisfy those eligibility conditions.

2.22 One respondent queried the change of wording in paragraph 2.23, suggesting that earlier guidance indicated that assets with extension on default clauses would be eligible to be included in an MA portfolio. Another respondent, however, commented that the updated guidance was welcome as it set out the circumstances under which termination clauses could be considered to be consistent with the eligibility criteria. The PRA considers that assets with such terms could be eligible, but that firms should still consider the particular terms of the asset in their screening process, and that the terms of the trigger for the extension of cash flows are particularly relevant in making this assessment.

2.23 Two respondents noted that previous guidance in respect of cash flows dependent on morbidity risks was specific to ERMs, whereas the guidance in paragraph 2.27 applied this more broadly. One of the respondents suggested that the paragraph was not needed and that it should be removed. The PRA acknowledges that previous guidance was given in the context of assessing the likely eligibility of ERM assets, but notes that Regulation 42(4)(h) (ie that this does not include morbidity risk) is applicable to all asset classes and therefore considers that the updated wording is appropriate and should remain in the SS.

2.24 With reference to paragraph 2.28 of the draft SS, one respondent sought confirmation that FX forwards could be paired with shorter dated assets, ie where there is no need to roll on expiry. The PRA is able to give this confirmation that provided the MA conditions are met, and the wording of the SS has been updated to reflect this. The respondent also commented that the wording of paragraph 2.31 could suggest that firms were using rolling FX forwards in their MA portfolios, contrary to PRA guidance. The PRA has amended the wording of this paragraph to make it clearer that the use of rolling FX forwards would be unlikely to meet the eligibility criteria.

2.25 The additional guidance in paragraphs 2.32 to 2.34, that firms could consider cash flows where the timing and/or amount is bounded to be fixed provided that the matched cash flows assume receipt at the latest timing and also exclude any additional amounts conditional on the timing, was generally welcomed. Two respondents requested confirmation that this could also be used to demonstrate eligibility of sinking fund assets. The PRA can confirm that firms could apply this guidance to sinking funds where the liability matched asset cash flows could be earned with certainty based on the bounding conditions included in the terms and conditions (paragraph 2.32).

2.26 One respondent considered the wording of the draft SS paragraph 2.32 that the PRA would assess eligibility on a case-by-case basis, could be confusing for firms if it implied that a firm would need to make an application for all new investments of this type even if they had the same features as assets already included in its MA portfolio. The PRA can confirm that a new application is only required if a firm wishes to include an asset with new features. The wording of 2.32 has been updated to confirm that this assessment applies to new applications (including applications to add assets with new features to an existing MA portfolio). Another respondent suggested however, that the PRA should show wider flexibility more generally in its interpretation of cash flow fixity; this point has already been considered above in paragraphs 2.19 and 2.20

2.27 Two respondents requested that the PRA reconsider its guidance on callable bonds and specifically that exclusion of a 'yield to worst' approach (paragraph 2.35) resulted in a penal treatment of these assets. The respondents also suggested that as an alternative, firms could assume that at least the risk free rate could be earned between the dates of first call and final legal redemption, where the risk free return after the next call date is only included in component B.

2.28 The PRA has carefully considered this feedback on the treatment of callable bonds, and remains of the view that a 'yield to worst' treatment exposes the firm to the risk that the assumed pattern of cash flow receipts could change over time and/or with changes in operating conditions and the risk of cash flows being lower than expected, which is problematic in demonstrating that cash flows are matched.

2.29 The PRA considers that firms will find it challenging to demonstrate the fixity of any cash flow assumed to be earned between the next call date and the final maturity date, particularly where the asset has multiple call dates before final legal maturity. It is for firms to demonstrate that any cash flows matching MA liabilities are certain (other than for credit risk). The PRA observes that including the lower of the bond's coupon and the risk free rate between the next call date and final legal maturity in component B would not meet the MA requirements as this would be a cash flow linked to variable interest rates and not fixed. The PRA also notes that allocating part of an asset's cash flows to component B would give rise to considerable challenges in valuing the bifurcated asset cash flows in each component.

2.30 One respondent sought clarification that paragraph 2.36 of the draft SS (cash flows dependent on realisable property values) is not intended to apply to a No Negative Equity Guarantee (NNEG) applicable to an ERM. The PRA's view is that paragraph 2.36 is not intended only to refer to the NNEG feature of ERMs. The NNEG, however, is one example where the cash flow is directly dependent on the realisable value of property, as the contractual repayment will be the lower of the accumulated mortgage balance and the value of the property, which is uncertain. The PRA recognises, however, that the uncertainty could result from a dependency on the realisable value of a wider range of assets than property, and the wording of paragraph 2.36 has been updated to clarify this.

2.31 Another respondent commented that a number of assets including some commercial real estate loans could require refinancing at maturity, and that it was unclear whether the guidance in paragraph 2.36 was therefore that these cash flows should be regarded as not fixed and therefore ineligible to match MA liabilities. The PRA considers that a dependency on refinancing at maturity would not necessarily be a 'direct dependency' for loans where there is no contractual relief for the borrower in the event that refinancing cannot be secured. Firms should, however, satisfy themselves that the risk of not being able to refinance, for example in a scenario where property prices have fallen hence increasing the loan-to-value ratio, is appropriately reflected in the rating of the loan and hence the amount of any MA benefit claimed.

2.32 Two respondents asked for guidance on holding defaulted assets in the MA asset portfolio. Where a borrower has defaulted on its payment obligations, the PRA considers that such defaulted assets should not be used to match liabilities within component A of the MA portfolio. Uncertainty around potential recovery value also means that it may not be appropriate for such assets to be held in component B. However, the exact treatment of any defaulted asset will depend on the type and severity of the default event – for example default triggered by the failure of the borrower to meet its contractual payments to the lender(s) could be treated differently to a technical event of default where payments are still expected to be made in future. With that in mind, firms should develop their own definitions of default together with the associated consequences of different types of default event occurring in practice, including implications for the MA portfolio. The SS has been updated to include this additional guidance.

Sufficient compensation

2.33 One respondent sought confirmation that reference assets other than gilts could be appropriate in order to demonstrate sufficiency of compensation. The PRA can confirm that firms should set their own criteria for determining whether compensation is sufficient, and that reference assets would not necessarily be limited to gilts and has updated the wording of the SS to clarify this. It is important, however, that firms are able to demonstrate with a sufficient level of confidence (as set out in the SS) that the asset's cash flows can be replaced in order to ensure liabilities remain matched.

2.34 The proposal (paragraph 2.41 of the SS) that firms could widen their sufficient compensation criteria by referencing the liabilities which could be matched by the replacement cash flows was welcomed by respondents. The PRA can confirm that firms should notify their supervision teams of any changes that they make to their criteria for assessing sufficient compensation, but that this will not necessarily be material enough to require a new MA application (see paragraph 9.4 of the SS).

2.35 Two respondents asked for further clarification on the range of assets to which the proposal in paragraph 2.41 could be applied. The PRA considers that the approach of recognising only part of the asset's cash flows up to the level of contractual compensation payable could potentially be applied to a broad range of assets provided that the assets otherwise meet the MA eligibility conditions and that the level of compensation is contractually established. If a firm used this approach, it would not be exposed to the risk of not being able to replace the asset cash flows which have been matched to MA liabilities. The PRA considers, however, that the application of prudence or a 'haircut' to the cash flows used to match liabilities is not an acceptable alternative to demonstrating compliance with the MA conditions, for example as an alternative to demonstrating that cash flows are fixed when their timing and/or amount are not bounded.

2.36 Two respondents asked the PRA to comment on approaches that would be acceptable to adjust asset cash flows to ensure that the 'sufficient compensation' guidance could be met. The PRA considers that this is an area of emerging practice and we will review applications on a case-by-case basis. The PRA notes that the callable bond approach is the closest similar case and an aligned approach may be to restate the cash flows to be used for matching purposes, and then to perform the de-risking.

2.37 One respondent queried how the guidance in paragraph 2.41, that firms should be able to ensure that matching continues in the event cash flows are changed by the issuer, should be interpreted, ie whether matching should be to the same degree as previously or whether the firm should ensure that it would meet the PRA's matching tests. As the respondent noted, the PRA has set out cash flow tests (included in the appendix to the SS) which firms should carry out on a regular basis in order to demonstrate that the assets and liabilities of the MA portfolio remain matched. The PRA expects that firms' matching positions may fluctuate over time but that firms should manage the portfolio to remain within these limits. The PRA would not, however, expect that any margin between a firm's matching test result and the limits set out in the PRA's cash flow tests should materially be used to increase the proportion of an asset's cash flows used to match liabilities as this would likely reduce the level of confidence in being able to maintain a matched position.

2.38 As set out in the SS, firms should ensure that their MA portfolios continue to meet the MA conditions, including those for asset eligibility, on an ongoing basis. In the event of an asset being upgraded, the PRA expects that the firm's internal credit assessment process should confirm whether or not to follow the external credit assessment in mapping the asset to the improved credit quality step (CQS) (and hence apply the FS associated with this improved CQS), and if necessary to make use of the approach set out in the SS to ensure that the asset continues to meet the MA eligibility conditions. If the firm's internal assessment does not concur with the higher mapping then the existing mapping and assessment of the sufficiency of compensation should be maintained. The PRA expects, however, that the decision to map to the higher CQS or not, should be led by the firm's credit assessment process.

Asset eligibility – ERMs and cash items

2.39 Two respondents queried the guidance of paragraph 2.47 that the cash flows of ERMs with a NNEG are dependent on the realisable value of property. The respondents considered that for ERMs where the NNEG is out of the money, then the dependency is on the timing of the property being sold or refinanced (in order to repay the loan) rather than amount being dependent on the property's value. It was noted that industry experience suggested that for most expired ERMs, the repayment amount was the accumulated loan plus interest rather than the property value, ie that the NNEG did not bite.

2.40 The PRA considers that the before repayment cash flow from an ERM with NNEG does have a dependency on the uncertain realisable value of the property and hence is unlikely to meet the eligibility conditions requiring cash flow fixity. The PRA understands that, at the point of investment or inclusion in a restructuring special purpose vehicle (SPV), the NNEG is expected to be out of the money in order for the ERM to be considered a suitable investment for a portfolio of annuity liabilities. The ERM cash flows nevertheless remain exposed to the risk that assumptions about expected future growth in property values are not realised, and/or the risk of falls in property values, and therefore will have a dependency on the realisable value of the property. While it may be the case that for the majority of ERMs which have matured to date the NNEG did not bite, this could be the result of higher historical growth in property prices than may be sustained in future.

2.41 One respondent further suggested that (for ERMs where the NNEG is out of the money), it should be possible to agree a definition of the term of the loan such that ERMs could be included in MA portfolios. The timing of the ERM repayment cash flow is, however, dependent on longevity and morbidity experience and hence the PRA does not consider that it is possible to identify a point at which this could be considered to be fixed, consistent with the conditions of Regulation 42.

2.42 Four respondents asked for clarification whether individual assets within cash funds need to be MA eligible if the fund is sufficiently liquid. The MA regulations do not recognise a concept of 'sufficiently liquid'. The PRA considers that the fund itself must meet the conditions of Regulation 42, and the firm should bear in mind that in the case of the fund defaulting, resulting in MA ineligible collateral being received, MA compliance would need to be restored within two months.

2.43 Two respondents further asked for confirmation that cash interest paired or grouped with a suitable contract could meet the conditions of Regulation 42. The wording of the SS has been updated to clarify this.

Asset restructuring

2.44 The response to the additional guidance on asset restructuring was mixed. Some respondents commented that it went against the expected direction (to mitigate the challenges faced by insurers with MA portfolios), and that it would in their view create barriers to entry. The PRA's intention in including the additional guidance in the SS is to provide further clarity for all firms on how the PRA assesses the suitability of firms' proposals. The guidance reflects existing PRA practice, and therefore the PRA does not consider that it creates barriers to entry, nor that existing approved restructures should need to be revisited as a result.

2.45 A number of respondents asked for clarity over the intention of the guidance that restructuring arrangements should only be used exceptionally (paragraph 2.55). The PRA agrees that for some assets where cash flows would otherwise be suitable to match annuity type liabilities, some form of restructuring may be required in order for these to be included in an MA portfolio and, as such, restructuring is an important tool for insurers. The PRA proposed the guidance that this should only be used exceptionally as it would expect firms to consider whether alternative approaches to meeting the MA conditions including pairing/grouping or partial recognition of cash flows, would be viable before embarking on any restructuring arrangement given the additional complexity and risks, including liquidity and operational risks which can result from the latter, and also the risks arising from the need to value the individual tranches or components of the structure. The PRA also recognises that for some specific asset types, for example ERMs, firms have not to date been able to identify a viable alternative approach, and hence a number of firms have used restructuring in this case. The number of asset types for which this is the case, however, is small, and therefore 'exceptional' in the context of the universe of investment opportunities. The proposed guidance was not intended to be understood that ERMs should only be restructured on an exceptional basis. The wording of the SS has been updated to clarify this point.

2.46 Respondents queried the PRA's view that restructurings give rise to additional complexity and risks. One respondent commented that regardless of the eligibility of the underlying assets, the restructuring could be designed or combined with risk mitigation features and that the benefit of these could outweigh any additional risks arising from the restructure itself. Another noted that some of the risk characteristics typically associated with securitisations, for example spread widening, were not applicable to the internal restructurings which firms have typically used. The respondents also commented that the additional risks and complexity could be removed by interpreting the MA conditions in a way that would allow the underlying assets of the SPV to be included directly in the MA portfolio.

2.47 The PRA has considered cash flow fixity as set out above (paragraphs 2.20 and 2.21). Firms would therefore only be expected to propose restructuring arrangements for otherwise ineligible assets. It is unclear why a firm would seek to restructure eligible assets (ie in a structure where the firm holds all the tranches) in order principally to mitigate risks rather than ineligibility of the underlying assets. The PRA has also previously given guidance (PS14/17 and SS3/17)[1] that (internal) securitisations where the firm holds all the tranches do not result in a reduction in risk to the firm and that in principle risks may increase. While it may be possible for a firm to put in place additional risk reduction measures to mitigate the risks from the underlying assets, the PRA considers that these could be implemented whether or not there is a restructuring arrangement in place, ie the restructuring does not of itself result in risk reduction or greater transparency.

2.48 One respondent further requested that the guidance on asset restructuring be made consistent with that in paragraph 2.53 about the use of derivatives, ie that firms should be permitted to use either approach when they can demonstrate that this is for risk reduction or efficient portfolio management. The PRA considers that the use of derivatives contracted with a suitable regulated and capitalised counterparty and appropriately collateralised is less complex than the use of restructuring, and that for the reasons set out above, restructuring of itself does not result in risk reduction and hence the guidance that firms will use the latter infrequently.

2.49 The PRA agrees that the inclusion of senior notes from an internal securitisation arrangement within an MA portfolio would mitigate the firm's exposure to some elements of spread risk. The PRA does not, however, accept that the absence of IFRS recognition of some restructuring arrangements implies a mitigation of spread risk on the notes issued by the structure, or the underlying assets.

2.50 Two respondents commented on the references to the prudent person principle (PPP) in paragraphs 2.53, 2.56 and 2.59, and specifically that OMD explicitly notes that investment decisions should not be subject to prior approval by regulators. The guidance in these paragraphs does not set an expectation that firms should seek prior approval of their investments by the PRA, nor systemically notify the PRA of their investment decisions and therefore the PRA does not consider that the guidance is inconsistent with Article 133 of OMD (Freedom of Investment). These references in the SS have been retained.

2.51 Some respondents commented that the wording in paragraph 2.56 that firms should demonstrate that restructures were not being used to circumvent the MA eligibility conditions, was confusing, as the restructuring was necessary because the underlying assets did not meet the MA eligibility conditions. The intention of the guidance is to clarify that firms need to ensure that the design of any restructure needs to be such that it can ensure the cash flows included in the MAP satisfy the MA eligibility conditions, including fixity of cash flows. In practice the structure will need adequate buffers to sustain the fixed cash flows over time and under stressed operating conditions. It is unlikely that sufficient reliance could be placed on the cash flows where the restructure is attempting to transform substantially the nature of the underlying assets, for example to restructure assets which would otherwise not be an

1 PS14/17 'Equity release mortgages', July 2017: www.bankofengland.co.uk/prudential-regulation/publication/2016/equity-release-mortgages, and SS3/17 'Solvency II: Matching adjustment - illiquid unrated assets and equity release mortgages', July 2017: www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss.

appropriate match for annuity liabilities. As set out above, the PRA would only expect restructuring to be undertaken in cases where the underlying assets do not meet the MA eligibility conditions. The wording of paragraph 2.56 has been updated to clarify this point.

2.52 Two respondents asked the PRA to confirm whether specific asset types would be suitable for restructuring. It is not possible to set out a definitive list of suitable asset as suitability will depend on the individual asset's features. Restructuring proposals will be assessed on a case-by-case basis.

2.53 Paragraph 2.58 of the draft SS proposed that firms need to assess the appropriateness of the unrestructured assets over the expected lifetime of the restructuring arrangement and also how this might vary under different operating conditions. This guidance prompted a number of comments, including whether the assessment needed to be revisited after assets had been restructured potentially resulting in the need to remove assets from the restructuring arrangement. One respondent commented that firms' rating mechanisms should be expected to address the issue of some assets being higher risk and that the need to identify assets which may need to be excluded from the restructuring would cause operational difficulties for firms. There were also concerns raised by another respondent that this guidance was creating additional requirements for ERMs compared with other asset classes for example infrastructure or investments in other securitisations.

2.54 The purpose of the initial screening is to ensure, where possible, that only assets that are suitable in unrestructured form (and are expected to remain so) are included in the restructuring arrangement, hence supporting the ability of the structure to meet the MA conditions. The PRA is therefore retaining this guidance, while clarifying that the assessment should be carried out at the time the restructure is being established albeit on a forward-looking basis and testing a range of potential operating conditions. Given that firms will need to have processes to assess the risk exposure of the underlying assets to support their rating mechanisms, the PRA does not consider that initial screening should result in a material operating burden.

2.55 The PRA agrees that once the restructure has been put in place, any subsequent deterioration in the quality of the underlying assets, for example following a stress event, should be reflected through the rating mechanism and firms would not be expected periodically to remove assets from the structure. Paragraph 2.58 of the SS has been updated to clarify this.

2.56 The PRA does not consider that the guidance on initial screening of assets is putting assets such as ERMs at a disadvantage. All firms would be expected to screen assets for their suitability to match the liability characteristics; for unrestructured assets this would include an assessment of the ability to sustain fixed cash flows as a match for predictable annuity cash flows. When a firm invests in an external securitisation it would be placing reliance on there being an appropriate initial screening of the underlying assets being included in the structure.

2.57 Clarification was also sought over how the screening process could be consistently applied to further loan advances on a property. The PRA is aware that firms have taken a range of approaches to including additional lending in their restructuring arrangements and expects that the application of the screening process would be consistent with the approach taken. If the additional loan advances are segregated from the initial lending then the incremental lending can be separately screened. Where this is not the case then it may be more appropriate that it is allowed for through the rating mechanism.

2.58 One respondent asked the PRA to confirm that, in light of the guidance given in paragraphs 2.59 and 2.60, it does not rule out the use of a total return swap (TRS) instead of a securitisation for ERMs. The respondent also contended that in their view a TRS arrangement has a number of risk management advantages over a securitisation type structure, including greater flexibility when it is issued and/or updated.

2.59 The PRA can confirm that it does not have a preference for a particular form of restructuring and that all forms of restructure should be assessed on their ability to meet (and to be able to sustain meeting) the MA conditions including cash flow fixity. The relative advantages and disadvantages of securitisation, TRS, or another form of restructure will depend on the individual design of the arrangement. The PRA considers, however, as set out in paragraph 2.60, that a TRS transaction entered into with an unfunded, unrated and unregulated SPV would be unlikely to provide sufficient assurance as to the SPV's sustained ability to satisfy its obligations to make fixed payments under the TRS on an ongoing basis.

2.60 Another respondent commented on the guidance in paragraph 2.59 that firms should ensure that there is a robust rating process of any restructuring arrangement, noting that the cost of obtaining an external rating could be disproportionate for smaller firms. The respondent further asked the PRA to suggest ways in which the concerns about TRS arrangements set out in 2.60 could be addressed in a cost effective manner. The PRA notes that it is not requiring firms to obtain an external rating, but that it is necessary for firms to be able to demonstrate that sufficient reliance can be placed on the ability of any restructure arrangement to produce fixed cash flows to be included in the MAP. The PRA has set out more detailed guidance on ratings processes in PS14/17 and SS3/17.

2.61 One respondent noted that the guidance in paragraph 2.63 was previously (February 2015 ED letter) specific to ERMs and asked the PRA to explain why the scope had been broadened. Since the 2015 guidance was published, firms have sought to restructure a wider range of assets and hence, as noted in 2.45 above, the aim of the SS is to provide further clarity for all firms on the PRA's expectations in respect of proposed structures.

2.62 Two respondents noted that the draft SS (paragraph 2.66) included additional guidance on the use of liquidity facilities, and in one respondent's view this created a competitive disadvantage for smaller firms. The additional guidance reflects the feedback given to individual firms in the context of reviewing individual applications to restructure assets, and specifically relates to firms' ability to demonstrate that sufficient reliance can be placed on the ability of the structures to support fixed cash flows. The need to demonstrate that the MA conditions are being met is a requirement for all firms, irrespective of size. The PRA notes that firms do not need to design a restructure to include reliance on a liquidity facility, but where this is a feature then the firm should be able to demonstrate it is sufficiently reliable.

2.63 One respondent commented that the need to develop a partial internal model (PIM) (paragraph 2.72) could create a barrier to entry and hence limit potential competition and growth in the market. The PRA acknowledges that firms seeking approval for a PIM will need to demonstrate that the model meets the tests and standards as set out in the Solvency II Directive and the Solvency 2 Regulations. Firms will need to develop sufficient expertise and risk management capabilities if they are to invest in these more complex asset classes which may not be immediately available to market entrants. The development of a PIM should build on this expertise, hence the PRA does not consider that the need to develop a PIM of itself would create barriers to entry.

Liability eligibility
2.64 One respondent asked the PRA to clarify the Best Estimate Liability (BEL) to be used when assessing the potential impact of surrenders. The PRA considers that assessing surrender values against a BEL including the MA is a reasonable approach. The PRA understands that assigning the MA at a contract level may not be computationally straightforward and has accepted a number of approaches that include appropriate approximations such as the use of the portfolio level MA at a contract level.

Matching, Calculation of the MA and Management of the Portfolio

Demonstrating matching
2.65 One respondent asked for the wording of paragraph 4.8 to be clarified, specifically noting that in the event that a firm falls outside the threshold of any of the three tests set by the PRA, the firm would have two months to restore compliance with the matching requirements. The wording of the SS has been updated to reflect this.

Collateral management
2.66 Two respondents commented that in their view the guidance on collateral management was unduly onerous for firms, and that the guidance was effectively requiring segregated arrangements which one of the respondents believed to be costly and complex. The respondents said that although OMD specifically requires that the assets of the MA portfolio cannot be used to cover losses outside the portfolio, the converse is not the case, ie assets outside the MA portfolio can be used to cover losses within the portfolio.

2.67 The PRA notes that there are two distinct elements of the MA conditions which need to be satisfied. Firms need to demonstrate both how the MA portfolio of assets is separately managed, and also that it will not be exposed to external (to the portfolio) losses. The guidance in paragraph 7.2 is that separate collateral arrangements would be the most obvious way to demonstrate separate management of the portfolio, but this is not a requirement. The guidance leaves open the possibility of firms' fulfilling this requirement, and also that the MA portfolio would not be exposed to other losses without separating the collateral arrangements. The PRA agrees that assets outside the MA portfolio may need to be used to cover losses within the portfolio, for example to rebalance the portfolio under stressed conditions, but this by itself would not be sufficient to demonstrate that the MA conditions are being met. The PRA has therefore retained the guidance on collateral management in the SS.

2.68 One respondent asked for further clarity on the meaning of 'collateral call' in the draft SS. This refers to provisions for variation of the initial collateral, either in quantity or substance. Firms should ensure that such changes cannot cause the MA eligibility conditions to be breached.

Asset re-balancing
2.69 The additional guidance on asset rebalancing was welcomed by respondents, although some noted that the examples focused too much on de-risking and felt that the guidance could be more streamlined. One respondent's view was that the guidance 'specifically for the purpose of good risk management' (paragraph 7.15) was confusing and that the guidance should instead accommodate asset trading which was consistent with good risk management.

2.70 The PRA does not consider that firms' simply demonstrating consistency with good risk management would of itself be sufficient to meet the constraints of Regulation 42(4)(b). 'Consistency with good risk management' could include trading activities which did not breach risk appetite, but were not undertaken with the purpose of facilitating replication of the expected asset and liability cash flows as required by Regulation 42. The existing wording has therefore been retained. The PRA also notes that the guidance also specifically refers to circumstances where trading could result in re-risking and managing the portfolio in line with the credit risk appetite.

2.71 One respondent asked the PRA for clarification of the example given in paragraph 7.15 of trading ‘a higher-yielding asset for the same risk’. The intention was to indicate that trading an asset for another with the same expected cash flows, but with a higher yield, could be consistent with the constraints of MA conditions. The wording of the SS has been updated to make this clearer.

2.72 The PRA has also been asked to give guidance on the extent to which firms have flexibility to diverge from the investment practices set out in paragraphs 7.17 and 7.18. The PRA notes that these have been given in the SS as examples of good practice, and are not a requirement for firms. Firms can take an alternative approach provided they can demonstrate that it is consistent with the conditions set out in Regulation 42.

Extraction of surplus

2.73 One respondent commented on the guidance given in paragraph 7.19, about the extraction of surplus from MA portfolios, and that the primary focus should be on the ability to continue to meet the MA conditions rather than the P&L attribution and determining materiality thresholds. The PRA agrees that the focus should be on maintaining the MA portfolio on an ongoing basis, which should be supported by the P&L analysis etc. The guidance has therefore been retained, although the wording has been updated to clarify this.

Ongoing MA compliance, and changes to MA portfolios

2.74 The guidance on breaches of MA conditions given in Chapter 8 was welcomed by respondents. One asked for clarification of whether the inadvertent inclusion of an asset or liability with new features in the portfolio (ie outside the scope of the existing approval) could be remedied by removing it from the portfolio rather than losing MA on the whole portfolio.

2.75 It is not practical for the PRA to set out the potential remedies which could be applied in the range of circumstances which might result in a breach of the MA conditions. It is possible that removing the asset (or liability) which contains new features from the portfolio could remedy such a breach, and this has been included as an example in the text of the SS. In practice, the PRA would need to discuss the appropriate course of action with the firm on a case-by-case basis and the firm will need to take action to restore compliance with the MA conditions within two months in order not to lose MA completely.

2.76 Most respondents commented that the process for making changes to MA portfolios was too onerous and needed streamlining. One respondent commented that the PRA has still not defined ‘features’ in the proposed guidance. A number of respondents suggested the possibility of a more narrowly focused application for example ‘asset only’ application in the case of more ‘vanilla’ asset types. One respondent asked whether some asset types could be pre-approved in order to streamline the process. Another respondent raised a concern that the need for a new application in order to make changes to an existing approval gave rise to the risk (albeit remote) that a firm could lose its MA approval altogether if the new application were not approved.

2.77 The PRA is not able to given an exhaustive definition of ‘features’. The draft SS listed examples of circumstance which might result in new features; a number of respondent commented that the infrastructure example was confusing. This example has been removed in response to this feedback. Some respondents also commented that the need to make a new application for different reinsurance arrangement was onerous. The PRA is not mandating that all new reinsurance arrangements will require a new application, but rather giving guidance that as reinsurance arrangements are often bespoke, there is a higher likelihood that a new arrangement will include new feature(s).

2.78 One respondent queried the draft SS reference to 'same features as assets/liabilities already within the MA portfolio' and whether this should refer to 'features for which the firm has approval'. The PRA considers that the scope of the firm's approval should reflect the actual assets and liabilities in the portfolio (or imminently to be included) and therefore this distinction is not necessary. The wording of paragraph 9.4 of the SS has been updated to clarify the circumstances under which firms need to make an approval application.

2.79 The PRA has carefully considered the responses about the change process, and options to make the application process more streamlined within the constraints of the Implementing Technical Standards (ITS) requirements. The wording of paragraph 9.7 has been updated to clarify that the PRA's approach to assessing applications will be proportionate and appropriate to the circumstances. The firm will need to provide sufficient information to demonstrate that the changed portfolio will continue to meet the MA requirements. Alongside this PS, the PRA published a letter to Chief Actuaries of life insurers with practical ideas for streamlining administration of the process in particular for simpler changes to the portfolio.[1]

2.80 The PRA does not consider that 'pre-approval' of some asset types is consistent with the requirements of Solvency II or directly applicable provisions in the ITS,[2] nor that it would be practical. For simpler changes to the portfolio, however, for example adding a non-restructured asset which meets the MA conditions but has new features, assuming the appropriate information is included in the application, the PRA would aim to process the application much more quickly than the six months maximum.

2.81 One respondent requested that the PRA permit firms to make overlapping new applications for changes to an MA portfolio where the applications have minimal interdependency. The PRA is looking into the feasibility of how to accommodate multiple change applications in more detailed guidance. As the respondent noted, the PRA is open to a firm making more than one new MA application per year (ie unlike model change applications), and exceptionally overlapping applications. For example, a firm may have made an MA application to include senior notes from a restructuring arrangement in the MA portfolio: as restructuring arrangements are more complex then this application is likely to need most of the six month assessment period. In the meantime, the firm might want to include an unrelated asset with new features but which otherwise meets the MA conditions in the portfolio. In this case the PRA considers it may be feasible for the firm to make a second application to include this asset while the first application is still open, and that approval could be given more quickly than the maximum six months. In the event of the second application being approved, the firm would then need to update the first application in order to reflect the updated MA portfolio although this would not necessarily mean that it would be treated as a new application.

2.82 Where an MA application covers a number of separate requested changes, a respondent asked whether it would be possible for some of the changes to be accepted even if others are not without the entire application being rejected. The PRA can confirm that where applications

1 'Solvency II: Two and a half years on', July 2018: www.bankofengland.co.uk/prudential-regulation/letter/2018/solvency-2-two-and-a-half-years-on.
2 Commission Implementing Regulation (EU) 2015/575.

cover a number of proposed changes, some of which may mean that the application as a whole does not meet the eligibility conditions, the firm may wish to notify the PRA of changes to that application as envisaged in Article 6 (10) of the Implementing Regulation (EU) 2015/500. These changes may not necessarily mean the application is treated as a new application.

2.83 One respondent asked the PRA to confirm whether the matching tests included in Appendix 1 have changed substantially from previous guidance. The PRA confirms that no substantial changes have been included and firms following the existing guidance should be compliant with the SS guidance.

Appendix

Supervisory Statement 7/18 'Solvency II: Matching adjustment' available at: www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-matching-adjustment-ss.