Strengthening Confidence in Matching Adjustment: The Role of the Attestation Report

Solvency UK Taskforce

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Introduction

The Prudential Regulation Authority (PRA) is in the process of introducing significant reforms concerning the Matching Adjustment (MA), as outlined in CP19/23 issued in September 2023. A key component of these reforms is the requirement for firms to provide an attestation, aimed at ensuring the sufficiency of the Fundamental Spread (FS) and the quality of the resulting MA. This article provides an overview of the requirements outlined in the CP and focuses on the supporting attestation report.

Requirements of the supporting report

The attestation must be provided for each MA portfolio, demonstrating a firm's accountability for the level of MA benefit being claimed. However, it is expected that analysis is performed at a more granular level as discussed in a prior article by the taskforce: 'How granular do you go?'. The Senior Management Function (SMF) holder responsible for the production and integrity of the firm's financial information is tasked with responsibility for the attestation, in most firms this is likely to be the CFO. The attestation must be provided annually, with an effective date aligned to the Solvency and Financial Condition Report (SFCR), and no later than 14 weeks after the financial year end. Additionally, an out-of-cycle attestation is required upon any material change in the firm's risk profile. The PRA provided some examples for triggers of out-of-cycle attestation which include:

- Following a large bulk annuities transfer where assets transferred contains materially different profile to those currently held;
- Merger of two MA portfolios; and
- A significant shift in economic outlook for assets that make up a large proportion of a MA portfolio.

Scope

The scope of the attestation appears to cover the illiquid and unlisted assets, those with highly predictable cash flows, and assets requiring adjustments by rating notch. However, there are differing views within the profession as to whether any attestation is required for listed vanilla assets where the firm has concluded that the addition to the FS will be zero.

While the regulatory framework sets out broad parameters for the attestation process, there remains ambiguity regarding the treatment of vanilla assets and equity release mortgages; and the level of attestation required for such assets, given that the existing regulatory regime has been designed and calibrated to accommodate such assets. There's consensus in the profession that any assertion of a zero add-on for non-vanilla assets, requires robust justification and evidence. The process of determining the threshold for FS add-ons and the level of risk assessment required to justify the fundamental spread is still not clearly defined. This was explored further in the first article by the taskforce,' What is a high degree of confidence?' with a more detailed article to follow.

Assessing the sufficiency of the FS for vanilla assets involves considerations such as market conditions, credit spreads, and potential implications for policyholder protection. A robust risk assessment framework is of paramount importance to justify FS provisions for vanilla assets within the attestation process.

Content of the Supporting Attestation Report

The supporting attestation report, which is only shared with the PRA is expected to include a detailed list of evidence relied upon in making the attestation, providing transparency and justification for the firm's attestation to the PRA.

The draft regulations (Section 12 of the MA part of the PRA rulebook) specify that the attestation report must incorporate the following key elements:

1. **Copy of the Attestation Policy:** The attestation report should include a copy of the latest version of the firm's own attestation policy (or confirmation that it is unchanged from the previous submission).

2. **Confirmation of Policy Compliance:** A crucial aspect of the attestation report involves confirming that the attestor has complied with the established policy, (or details of any deviation from the policy including reasons for divergence).

3. **Detailed Evidence Listing:** The draft proposals in SS7/18 provide some helpful guidance on the evidence that is required. While the full evidence underlying the attestation is not required in the report, suitable signposting to the evidence used is explicitly required by the draft regulations. The actual evidence may then be requested by the firm's supervisors on an ad-hoc basis, and promotes accountability without compromising commercial sensitivities. The attestation report must contain a detailed list enumerating the evidence supporting the sufficiency of the FS and the quality of the resulting MA. This evidence is expected to include:

- Description of the process for credit ratings or assessments, and evidence for all assets of their accuracy, reliability, and that the assessment is up-to-date.
- Analysis of credit risk exposure, comparing it to the risks underlying the assets used to calibrate the FS and the assumptions underlying the MA.
- Justification for methodology and adjustments applied to assets with highly predictable cash flows remains appropriate.
- Details of, and rationale for, assets significantly contributing to the MA, (Step 3 assets as proposed in the 3-step process by the PRA in CP19/23 Draft SS7/18).
- Explanation of how any voluntary FS additions were determined. This is likely to require further reference to the MALIR, the testing involved in the assessments and the governance processes around the judgements. Further, discussion of the approach to determining FS add-ons will be covered in a separate article.

4. **Assets with FS add-on:** The attestation report should include a list of all assets where the firm has elected to apply an FS add-on together with the reason of the increase, the amount of the increase and MA resulting from these assets.

Practical Implications

In practice, the production of the evidence listed above is the most onerous part of the attestation process and this entails:

- Providing insights into the credit rating sourcing methodology.
- Explaining the process followed for identifying any risks that are not captured within the credit ratings, and the outcome of such determinations.
- Describing the approach to the analysis of the credit risk exposure by asset class.
- Documenting methodologies and amount of FS additions for HP cash flow assets.
- Producing evidence and analysis, and potentially documenting expert judgement panels or any modelling that has been relied upon to demonstrate the sufficiency of the FS and quality of the MA for the assets which are material contributors to the MA.

Conclusion and summary

The attestation report is a regulatory requirement that aims to provide the PRA with clear documentation of the analysis and evidence supporting the MA attestation, which in itself is not expected to be difficult for firms to produce. However, some of the items required by the report will be more labour intensive to source, this is most likely to be production of the evidence and analysis needed to demonstrate the sufficiency of the FS and quality of the MA for the illiquid Step 3 assets (excluding equity release mortgages), and there will remain an element of judgement involved in the determination.

We welcome feedback and discussion on your expectations for the content of the supporting attestation report.

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