# Matching Adjustment Attestation Policy - A Key Piece of the Puzzle

## Solvency UK Taskforce

**Authors:** Cath Hodges, Joyeeta Kanungo FIA, Natalia Mirin

As part of the latest series of our articles around the Solvency UK reforms, we look at the requirements for a policy and governance on Matching Adjustment (MA) attestation. The PRA's draft rules require that firms have an attestation policy which must be submitted to the regulator along with the supporting report to the attestation (or provide confirmation that the policy is unchanged since the last version submitted). To comply with this, insurers need to make sure there is an efficient governance framework in place, covering the MA attestation policy and process. Below, we discuss some key components of the governance framework and contents of the attestation policy.

### Governance surrounding the policy

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 and MA in accordance with the attestation. All of these components together form the governance framework for the MA. The firm must ensure that its governing body has approved that policy. The Audit Committee is responsible for the overall financial results and would be a natural governing body for ensuring the MA compliance and approving the policy, although different firms may choose different governance paths according to their own risk governance arrangements, where they see the ownership for the policy sitting and where review and challenge of the policy content takes place.

### Content of the policy

Within this policy the PRA expects firms to include:

(1) Who the firm has determined is the PRA senior management function holder (SMF) responsible for the attestation;

(2) the triggers that may result in a material change in risk profile of the firm for an out-of-cycle attestation;

(3) the process by which the attestor should review the FS and MA, including any criteria for subjecting assets to a more detailed review; and

(4) an approach for determining the amount of any addition to the FS.

## (1) Determination of the responsible SMF

The senior manager with the prescribed responsibility for the production and integrity of the firm's financial information and its regulatory reporting (PR Q) will be responsible for the attestation. This SMF should have ultimate governance responsibility for the calculation of the FS and MA (regardless of delegations of any of their responsibilities), and therefore has the authority to implement an increase to the FS if required. In many cases, this will be SMF 2, the Chief Financial Officer, but this could be another SMF depending on how responsibility is allocated within the firm. A firm should approach its usual supervisory contact, in the first instance, should its governance arrangements mean that an alternative SMF would be more appropriate to undertake the attestation. Where more than one SMF holds Prescribed Responsibility Q (PR Q), the PRA would expect all those SMFs to attest. PRA considers that the supervisory guidance in respect of accountabilities and shared responsibilities, contained in SS35/15 (the Supervisory Statement on Strengthening individual accountability in insurance of June 2021) would also apply.

As an example of complying with this requirement, the policy document can contain a section on the allocated responsibilities in line with the firm's governance framework, which would outline the logic for determining the appropriateness of the SMF. This section can also contain delegation structure and additional information in cases where there is more than one SMF.

## (2) Triggers for an out-of-cycle attestation

The PRA rules require a firm to provide an annual attestation with the same effective date as its Solvency and Financial Condition Report (SFCR), which will be 31 December of any given year for most firms. If a firm has any concerns in providing the annual attestation, it should approach its usual supervisory contact. If there has been a material shift in a firm's risk profile, then additional out-of-cycle attestation will be required. Materiality is not defined in the rules and the PRA expects a firm to enter into discussion with it before concluding whether or not any change in risk profile has been material. A firm should agree the timescales for the completion of an out-of-cycle attestation bilaterally with the PRA.

Events that may trigger an out-of-cycle attestation could include:

- a large bulk purchase annuity transaction where the assets transferred have a materially different profile to those currently held;
- the merger of two MA portfolios; or
- a significant shift in the economic outlook for assets comprising a material proportion of the MA portfolio.

The trigger events that each firm details in this section should be appropriate to the nature and the operations of the firm. We believe it would be a good practice to refer to the firm's risk management framework and risk appetites when determining the events and materiality that could trigger an out-of-cycle attestation.

**(3) Process by which the attestor should review the FS and MA**

The PRA expects firms to consider both the conceptual assumptions and the technical assumptions when assessing whether the MA being applied is consistent with the assumptions underlying the MA. The assumptions are based on existing Solvency II framework and have been restated in section 1A of SS7/18.

The policy should contain a description of the FS and MA review process the firm adopts. This is likely to be a high level summary of the process since this is a Board level policy, with the detail contained in a lower level Attestation Methodology document, this point is discussed further later in this article. SS7/18 gives an example of a three steps process that each attestor could follow and is outlined below.

Step 1 – Description of the approach to establishing and justifying the risk profile of the assets in question is consistent with the assumptions underlying the. For example, corporate bonds or private placements with similar characteristics to bonds. This could consider the following, non-exhaustive, list of points:

- Historical long term data that is relevant for the asset by duration, credit quality and asset class.
- The method for calculating the expected default and downgrade losses is transparent, prudent, reliable and objective and consistent both over time and between assets of different currencies and countries.

- Risk assessments of these assets and how these map to a well-diversified portfolio of externally rated corporate bonds for the purpose of determining if addition to the FS calculation is required. For example, levels of diversification and analysis of concentration risks could be considered to the extent these differ to those reflected in the FS already, or have not been captured historically.
- Firms should consider the approach to risks which may not be captured in the historic data that underpins the published FS, such as political and legal risks, and their potential impact on the MA for those assets. In the event that the these risks are considered material, firms may make an FS add-on.
- Documentation and justification of increases to the FS, where applied, to these assets.

Step 2 – Description of the approach taken to analysing the assets in the portfolio whose risk profile is not consistent with the MA assumptions. For example, such assets could be internally valued and rated, restructured or have HP cashflows assets. The approach to the FS review, documentation and justification of FS additions for such assets could cover:

- Risks that are common to the assets covered in Step 1 and the additional risks that may result in a higher level of uncertainty. This higher uncertainty could include, for example, complex features of the assets as well as political, reputational, conduct and other risks.
- Documented consideration in respect of additional risks arising from cashflow variability and the methodology of reflecting these risks in FS additions.
- Approach taken to collateral and any risks identified within it, including illiquidity and reinvestment risks.
- The use of own models where proportionate, including explanation and justification for how the risk translates to FS addition.

Step 3 – Approach to review of all assets in the MA portfolio and explanation for the material contributors to the MA. The criteria used for identification of material contributors to the MA are identified need to be articulated and can include step by step:

- The X largest contributors to the MA.
- Assets where the spread is more than a certain defined threshold, including a link to the threshold setting methodology.
- Assets with an MA greater than a certain threshold, potentially linked to equivalent corporate bonds.

## (4) Approach for determining addition to the FS

It is noted that for most of the assets on insurance company's balance sheet, no addition to the FS will be required. Therefore, we would anticipate that the approach for determining the addition to the FS would also require explanation of the parameters by which assets are identified as requiring an addition. FS add-ons will be required for assets with highly predictable cashflows, and in certain instances for assets where the underlying risk exposures include risks that may not have been allowed for in the internal credit rating methodology of these assets. For those assets, and assets with highly predictable cashflows, firms can take different approaches to modelling the FS add-on. Examples of where the risk exposures may be different and an FS add-on may be required could include:

- Any retained risk not reflected in the credit rating methodology;
- Any additional risks such as legal, regulatory or political risks which may not be reflected in the historical data and are hard to model;
- Modelling the recovery amount from the underlying collateral and comparing it to the assumed 30%;
- Modelling the downgraded loss as the cost of replacing the downgraded asset with an asset having the same cashflow profile, same asset type, and greater or same credit rating.

The policy (or associated process) may refer to, or include a description of the methodology for determining the FS add-on as well as details of any models used for the determination.

Firms may want to consider how much of the process is documented in the policy - any revision to the methodology would be expected to require an update to the policy which has to be (re)approved by the Board. An alternative approach could be to ask the Board to delegate review and approval of process changes to a subsidiary committee with greater technical expertise, with the policy describing a process whereby the policy and process are reviewed (at least) annually.

The adoption of different approaches by different firms has the potential to create disparities in how regulatory guidance is implemented across the industry (similar to the experience when EVT framework was rolled out for ERMs) and we expect it take some time for a common approach to emerge.

## Conclusion

The taskforce welcomes comments from the actuarial community on the content of this article. In particular, the taskforce considers further discussion around the following points would be beneficial for practitioners:

- Examples of SMFs other than Chief Financial Officers that would be considered appropriate in your firms for the MA attestation.
- Other examples of out-of-cycle attestation triggers.
- Additional content for inclusion into the FS and MA assessment approaches.
- How firms intend to structure the policy and process documents to fit with their governance models.

***With thanks to the peer and Life Board reviewers: Tim Stedman, Tom Kenny***

**References:**

CP19/23: Appendix 2 - PRA Rulebook: Solvency II Matching Adjustment Reform Instrument 2023 (bankofengland.co.uk)

CP19/23 - Appendix 3b – Draft amendments to supervisory statement 7/18 – Matching Adjustment (Marked-up version) (bankofengland.co.uk)



## Published by

This is the fifth article from the Institute and Faculty of Actuaries Life Board sponsored Solvency UK Taskforce focussed on the Matching Adjustment attestation policy.