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Securitisation in Matching Adjustment Portfolios Under Solvency UK Reforms


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Introduction

The presence of UK insurers as investors in securitisation markets has in recent years been limited, with one of the key contributing factors considered to be the penal regulatory capital treatment of securitisations under the Solvency II regulatory framework. Solvency II imposed significantly higher capital charges on insurers in respect of securitisation positions than were imposed for comparable assets with similar risk profiles, such as corporate bonds, effectively penalising investments in securitisations.

The UK's reworking of the Solvency II regulatory framework for insurers ("**Solvency UK**"), the core elements of which were brought in over the course of 2024 (the "**2024 Reforms**") and, in particular, the reform of the Matching Adjustment ("**MA**"), has revised certain aspects of the capital rules applicable to UK insurers. As further discussed in this expert chapter, the 2024 Reforms have provided UK insurers with greater flexibility to include securitised assets – such as residential and commercial mortgage-backed securities and other asset-backed securities ("**ABS**") – in MA portfolios, which may help reverse some of the factors behind the relative absence of insurers in securitisation markets.

Discussed below is the background to the MA, certain elements of Solvency UK that are relevant for the purposes of considering securitisations in MA portfolios, and the interplay of the MA with the capital treatment of such positions under the Solvency Capital Requirement ("**SCR**") framework.

Background to the MA

The MA allows life insurers to increase the discount rate used to value long-term policyholder liabilities. In summary, if the insurer has predictable, long-term liabilities (such as fixed annuity payments) and assets with matching, reliable cash-flows (such as long-dated bonds), then the MA, in broad terms, allows the insurer to:

- take the spread on the asset above the risk-free rate (meaning the rate achievable from, for example, UK government bonds);
- deduct a "Fundamental Spread" ("**FS**") – the estimate for regulatory purposes of the return needed to cover expected credit risk and unavoidable uncertainty, such as model risk or structure risk in some assets; and
- add the remainder (the MA) to the discount rate for its liabilities.

This discount rate, as increased by the MA, lowers the insurer's "technical provisions" – the assets it must hold to meet its ongoing obligations to policyholders – thereby reducing its capital requirements. The aim of the MA is to allow insurers to recognise upfront, in the form of capital relief, a proportion of the spread expected to be earned on the asset, on the basis that the asset is intended to be held to maturity and hence the insurer is not materially exposed to the risk of price movements (due to being a forced seller of those assets), but only to the risk of the issuer's default.

The 2024 Reforms to the MA

The 2024 Reforms relating to the MA were made pursuant to, among others, the Insurance and Reinsurance Undertakings Regulations 2023 ("**IRPR Regulations**") and amendments to the UK Prudential Regulatory Authority ("**PRA**") rules and guidance, following the PRA's consultation on the MA (the "**MA Consultation**"), which culminated in Policy Statement (PS10/24) – Review of Solvency II: Reform of the Matching Adjustment.

Certain 2024 Reforms of particular relevance to UK insurers considering securitisations for MA portfolios are discussed below.

Expansion of MA asset eligibility to HP assets

A key element of the 2024 Reforms was the expansion of the MA asset eligibility rules, which previously restricted MA assets to those with fixed cash-flows, to include also those with "highly predictable" ("**HP**") cash-flows. This allows certain securitisation tranches – which often have structured cash-flows that, while bounded and predictable, are not strictly fixed (and were historically precluded from MA eligibility) – to qualify for MA portfolios, subject to certain conditions.

HP assets – contractual bounding

The PRA has emphasised that HP cash-flows must be "contractually bounded" to count toward the MA. This means that the contractual terms of the asset must provide for a bounded range of variability in respect of the timing and amount of the cash-flows and failure to meet such terms must constitute a default.

Insurers had requested more flexibility during the MA Consultation – proposing "bounded" but not strictly contractually fixed flows and that junior tranches of internal securitisations should be eligible, subject to notional restructuring or cash-flow haircuts. However, the PRA maintained that contractual bounding is necessary to be confident that the MA can be earned in practice. This is intended to ensure the cash-flow profile of HP assets cannot materially change in a way that undermines the upfront recognition of MA benefit. In practice, this may mean features such as prepayment, extension or call options in securitisations must be considered as to whether they would achieve a sufficiently predictable pattern to qualify for MA treatment.

HP assets – 10% MA cap

The 2024 Reforms impose a cap on the contribution of HP assets to the MA – the aggregate MA benefit attributable to HP assets is limited to 10% of the total MA benefit for the portfolio. This means that only a small portion of an insurer's MA benefit can come from assets that are not strictly fixed, with the remainder of the portfolio comprising fixed cash-flow assets.

This 10% "bucket" may create space for insurers to include some senior or mezzanine securitisation tranches (or other structured assets), but prevents extensive reliance on them. The cap reflects supervisory caution that assets with any cash-flow variability (however bounded) carry additional risk.

Feedback to the MA Consultation highlighted that some existing MA assets, deemed to have fixed cash-flows under PRA guidance in SS7/18, might have had to be reclassified as HP assets under initially proposed amendments to such guidance, potentially consuming the 10% capacity. However, these amendments were ultimately not taken forward, with the PRA confirming its agreement that existing fixed cash-flow assets would not require reclassification on account of the 2024 Reforms.

HP assets – FS additions

To allow for the additional risks to matching compared to assets having fixed cash-flows, HP assets categorised as such will be subject to an FS addition aimed to capture all identified sources of uncertainty regarding the timing and amount of cash-flows from HP assets.

Other 2024 Reforms

In addition to the new category of HP assets, the 2024 Reforms included certain other amendments to the MA regime likely relevant for the purposes of including securitisations in MA portfolios, as discussed below.

Credit quality and ratings

All MA assets, including securitisations, must have a credible credit quality assessment. Typically, this means an external credit rating or a rigorous internal credit assessment of equivalent standard. Under the new rules, the PRA has clarified the regulatory standards applicable to internal ratings used for MA assets, including that the rating must be subject to independent external assurance.

Furthermore, the PRA introduced "notched" credit ratings, replacing the letter approach of credit quality steps with more granular increments, to ensure better alignment of ratings with fundamental risk, and to smooth out the impact of rating transitions.

Removal of sub-investment grade MA cap

Under Solvency II, there was a limit on how much MA benefit could be derived from sub-investment-grade ("**SIG**") assets to limit risk concentration in higher-yield, higher-risk assets. This was particularly relevant for assets close to the borderline between investment-grade and SIG, known as the "BBB cliff".

The PRA has eliminated the cap on MA from SIG assets, meaning insurers can now include more SIG tranches. However, the regulator has made clear that firms must have robust risk management if they venture into lower-rated territory, and keep holdings of SIG assets to prudent levels.

Attestation requirement

A cornerstone of the 2024 Reforms is the introduction of annual senior management attestation requirement. Insurers must attest at least annually, and following any material change in the firm's risk profile, that their MA portfolios meet regulatory requirements, that assets and liabilities are appropriately matched and that the FS deductions are sufficient to cover all retained risks in the MA portfolio. The firm must also disclose publicly (in its Solvency and Financial Condition Report) whether it has provided such an attestation.

The attestation means senior management must explicitly consider any risk not fully captured by credit ratings (which for securitisations may include structural risks, prepayment variability or correlation in the underlying collateral) and, if needed, apply a more conservative FS.

In practice, if an insurer includes a mezzanine ABS tranche, senior management might need to attest that the assigned FS adequately reflects the higher uncertainty of the timing and amount of its cash-flows (perhaps adding a further margin to the FS). This attestation requirement heightens governance as a named Senior Manager will effectively have to "sign off" that an asset's cash-flow uncertainty or a tranche's credit risk is within tolerances and covered by the MA's retained risk allowance.

Streamlined regulatory approval process

A fundamental part of the MA rules is that the inclusion of new types of assets in an MA portfolio requires regulatory approval via an MA permission variation, in which firms must demonstrate compliance with all MA conditions for each asset type to obtain approval from the PRA. Whilst the PRA has streamlined the application in some respects, including the introduction of a triage process and simplifying documentation requirements, the process can still take up to six months.

However, since the 2024 Reforms, the PRA has published a further consultation on enhancing the MA approval process – the Matching Adjustment Investment Accelerator ("**MAIA**"). The MAIA, as proposed, would remove the current requirement that firms obtain prior PRA approval before claiming MA benefit on assets, provided certain conditions are met. The aim of the MAIA is to enable insurers to respond more rapidly to investment opportunities, with a view to enhancing their competitiveness and stimulating economic growth, by facilitating faster deployment of capital into productive investments.

The proposals for the MAIA, in removing the delay associated with obtaining prior PRA approval to vary their MA permission, and facilitating more timely investment decisions, may also provide a further boost to insurers' flexibility to participate in securitisations.

In summary, the new framework would allow firms to apply for a "MAIA permission", enabling them to include a limited quantity of self-assessed MA eligible assets (with features for which the firm does not already hold an MA permission) in their MA portfolio without prior PRA approval and claim immediate MA benefit on such assets. The firm would then have 24 months to submit an MA application for approval of the MAIA assets.

The PRA is proposing a number of controls that insurers would need to establish to mitigate the potential risks of claiming MA benefit prior to approval, including the maintenance of a MAIA policy, contingency plans for each MAIA asset in the event it is subsequently deemed not to be MA-eligible, an exposure limit for assets in the MAIA and new reporting requirements.

SCR Treatment of Securitisation Assets

Allowing securitisations in the MA portfolio does not exempt them from capital requirements – insurers must hold additional capital to meet the increase to their SCR due to the market, spread and/or credit risks these assets may introduce.

Accordingly, insurers considering the inclusion of securitisations in their MA portfolios will need to weigh the capital benefits afforded by the MA treatment against the corresponding increase in their SCR. A significant factor in this regard will be whether the insurer applies the Standard Formula or an Internal Model for SCR purposes.

Standard Formula

Under the Standard Formula, securitisations are dealt with in the "spread risk" sub-module. The Standard Formula applies a stress-factor approach – the capital charge is determined by applying a prescribed percentage shock to the market value of the asset, intended to represent a 1-in-200 year widening of spreads or credit loss.

Solvency UK distinguishes securitisation positions from ordinary corporate bonds, generally assigning higher stress factors to reflect complexity and credit structure. Senior, high-quality securitisations (such as senior tranches meeting the simple, transparent and standardised (STS) standards) are assigned lower capital factors, whereas non-senior or non-STS tranches face punitive charges – in extreme cases, a 100% capital charge (total loss) for certain unrated or re-securitisation positions.

This means, for example, if an insurer holds a deeply subordinated ABS tranche that does not meet quality criteria, the Standard Formula assumes the entire investment could be wiped out in a stress scenario, requiring pound-for-pound capital. The UK has not fundamentally recalibrated these factors – the PRA chose to maintain the existing calibration for securitisation spread risk.

Smaller UK insurers that employ the Standard Formula have historically tended to avoid securitisations due to these steep capital charges, focusing on less complex MA assets (such as corporate bonds). This is likely to continue unless such firms find securitisation structures where the risk-return is attractive enough to justify the capital impact.

Internal models

The largest UK life insurers typically use internal models to calculate their SCR. While requiring supervisory approval, internal models can more finely tailor the capital assessment of securitised assets, and potentially result in more risk-sensitive capital treatment than the Standard Formula's stress approach allows.

Since MA assets also reduce the insurer's best-estimate liabilities (via the MA in technical provisions), the inclusion of higher-spread securitisations may improve an insurer's solvency ratio by increasing available capital (from the MA benefit) more than it increases the SCR – if the assets are high-yielding but still low-risk. This is why insurers may be interested in securitisations: they often offer extra spread (yield) for a given rating compared to corporate bonds (due to complexity or liquidity premia).

The MA lets insurers capitalise part of that extra spread upfront. However, the 2024 Reforms ensure that if that extra spread comes with hidden risks, either the MA benefit is reduced (through higher FS) or additional capital must be held.

Conclusion

In line with the broader growth and competitiveness aims of the Solvency UK reforms, the 2024 Reforms and, in particular, the introduction of the HP category of assets and removal of the cap on SIG assets, have created greater flexibility for insurers to deploy capital into a broader range of assets in their MA portfolios, and that may include exploring a broader range of securitisation investments.

However, these reforms come with enhanced systems, controls and accountability – in particular, the Senior Manager attestation requirements may temper risk appetites and encourage conservative FS treatment for HP assets. Insurers will also need to balance MA benefits with the SCR impact of any securitisation investments they make, whereas larger insurers employing more risk-sensitive internal models may be better placed than smaller Standard Formula firms to reap the benefits of the reforms.

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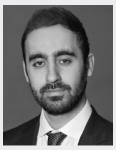

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Sidley's securitisation lawyers in the UK, Europe, the US and Asia have a longstanding practice in all areas of securitisation, asset-backed and structured finance and derivatives, with market-leading experience of the full gamut of asset classes and structures, including: securitisations and secured financings involving corporate (mid-market and broadly syndicated) loans, consumer assets such as personal loans, auto loans and leases, student loans and credit cards and residential mortgages; trade, film/media and other more specialised receivables; and, more recently, the emerging market for financings involving online marketplaces and peer-to-peer lending, blockchain and distributed ledger technology and fund financing utilising structured finance and asset-backed technology.

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