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L&G

New investment opportunities for life insurers in assets with highly predictable (HP) cashflows under Solvency UK reforms

All investing involves risk

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Contents

Executive summary

The recent Solvency UK reforms[1] are providing new investment opportunities for UK life insurers under the Matching Adjustment (MA) framework. Previously, MA insurers had very onerous restrictions on the types of assets they could invest in and, in particular, were restricted to investing in bond-like assets with cashflows that were fixed in terms of timing and amount[2]. However, since 30 June 2024, some of these restrictions have been relaxed. The Solvency UK reforms introduce greater flexibility, acknowledging that certain asset types may have contractually predictable, though not fixed, cashflows that still support liability matching portfolios. **This may enable life insurers to access a broader investment universe without materially compromising the alignment between asset and liability cashflows.** In this whitepaper, we focus on the opportunities created for life insurers that are now able to invest in assets with 'highly predictable' cashflows (HP assets). We also set out some regulatory and portfolio management implications of investing in these assets. Investors should consider and assess the regulatory and portfolio management implications of investing in these assets themselves and seek advice where relevant. This whitepaper does not contain an exhaustive list of considerations or implications.

HP assets can have cashflows that are more variable than those of the fixed-income assets traditionally held in MA portfolios. They are, however, still subject to various additional requirements, restrictions and limits, and must meet other existing MA eligibility requirements. Allowing MA insurers to allocate to these assets is one of the two key initiatives aimed at improving investment flexibility, the other being the removal of the restriction impeding the investment into sub-investment grade (SIG) assets which we discussed in our previous white paper **'Sub-investment grade private debt investment opportunities for life insurers under Solvency UK reform'**.

Insurers have been able to invest in some HP assets previously but only by foregoing all the MA benefit arising from the variable cashflows and often with additional prudence. As well as gaining the MA benefit, we believe that life insurers will be able to improve portfolio diversification, enhance credit characteristics and support the UK productive economy by accessing these assets. While the primary motivation of the reform is to open up opportunities for MA insurers, we believe investing in HP assets doesn't have to be a radical departure from existing investment approaches given many of the asset classes already invested in can come with additional HP features.

The Matching Adjustment (MA) is an adjustment to the risk-free interest rate used to discount long-term insurance liabilities (eg annuities) by incorporating part of the spread from eligible fixed-income assets. This adjustment represents the spread over the risk-free rate, less an allowance for the retained risks, for credit default and downgrade known as the Fundamental Spread (FS). This is often referred to as an illiquidity premium, which is earned from holding an asset over the long term. The MA reduces the present value of the liabilities and lowers capital requirements.

[1] The Prudential Regulation Authority (PRA) policy statement PS10/24, published on 6 June 2024

[2] Article 77b(h) the cashflows of the assigned portfolio of assets are fixed and cannot be changed by the issuers of the assets or any third parties, Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast) (Text with EEA relevance)

Under the revised Solvency UK framework, HP cashflows are defined as asset cashflows that, while not strictly fixed, are contractually bound within a finite range of variability in both timing and amount[3]. This classification aligns with the PRA's goal of ensuring that insurance companies maintain adequate reserves and liquidity, thereby safeguarding policyholders and ensuring financial stability.

In this whitepaper, we'll highlight the potential HP asset opportunities along with the challenges that life insurers may face in implementing the regulatory framework required to permit their use.

We'll consider examples from both the public (eg securitised bonds) and private markets (eg fund financing, real estate debt and UK/European productive finance such as infrastructure debt).

Whilst HP assets may bring the diversification benefits mentioned above, many suggest[4] that the MA benefit on the types of HP assets that are the most straightforward to seek permission for is marginal. In addition, firms are yet to find a 'game changer' asset class. Asset classes such as CLOs and other ABS may offer additional value – but the additional complexities and idiosyncrasies of these types of assets means that more work is required up front to prepare MA applications and develop operational capabilities, especially if a broad range of underlying asset types is desired*.

Assets with Highly Predictable Cashflows

Assets with cashflows capable of being changed by issuer or 3rd parties.
Contractually bounded *(and failure of contractual bounds must be a default event)*
Bounding includes both cashflow timing and cashflow amount.

[3] Source: definition based on Prudential Regulation Authority, Supervisory Statement SS7/18 – Solvency II: Matching Adjustment, Bank of England, 2.12.
[4] Based on our discussions with MA portfolio investment professionals

*It should be noted that diversification is no guarantee against a loss in a declining market.

HP asset investment opportunities

In this section, we consider a range of investment opportunities for UK life insurers resulting from the HP reforms, both in public and private markets. Although this paper focuses on investment opportunities for UK life insurers' MA portfolios, we believe many of the investment opportunities may also work well for UK non-life insurers and insurers outside of the UK.

We believe Investing in assets with HP cashflows under the Solvency UK MA framework brings both the familiar risks associated with MA-eligible assets and increased risks specific to HP properties/features. These include reinvestment and liquidity risks arising from cashflow variability. The table below outlines notable risks to consider. This is not an exhaustive list, and a full risk assessment should be undertaken prior to investment. Risk management considerations are discussed in detail in the "HP Assets: Insurer Considerations" section of this paper.

Risk	Definition
Default risk	The risk that the issuer fails to meet contractual payment obligations, resulting in a loss of principal or interest. Together with downgrade risk (see below) this remains a core component of the Fundamental Spread (FS) under MA
Downgrade risk	The risk of deterioration in the credit quality of the asset, which can increase capital requirements and lead to reduced proportion of spread claimed as MA benefit.
Spread risk	The risk of market-wide changes in credit spreads that affect asset valuations and the MA benefit.
Prepayment risk leading to reinvestment risk (increased)	HP assets may be prepaid earlier than expected, triggering reinvestment risk if replacement assets offer lower yields. PRA's Test 4 assesses worst-case MA loss from early cashflows.
Extension risk leading to liquidity risk (increased)	Delayed cashflows can create liquidity shortfalls if liabilities fall due before assets mature. PRA's Test 5 evaluates the impact of late cashflows on liquidity coverage.
Complexity risk (potentially increased for some HP)	HP assets may involve structural features that increase modelling, governance, and attestation complexity. This can challenge MA compliance and risk oversight.

Public markets

Within public markets, we'll focus on securitised bonds with a brief consideration of callable corporate bonds.

Securitised bonds

Securitised bonds are fixed-income instruments that aggregate (somewhat uncertain) cashflows from pools of underlying financial assets and transform them into tradable securities with contractually defined cashflows. The underlying assets can include consumer loans, residential and commercial mortgages, credit card receivables, auto loans, student loans, or leases. Through securitisation, the future cashflows from these underlying assets are repackaged into securities with defined characteristics, enabling investors to gain exposure to diversified asset pools. The underlying assets act as collateral for the securitised note and the payment flows are based on well-defined criteria for each tranche.

By structuring these securities into tranches with varying levels of risk and return, issuers aim to appeal to a broad investor base, from those seeking high credit quality and stability to those targeting the enhanced yield seen in subordinated tranches. The process also allows originators to free up capital and manage balance sheet risk, while creating an efficient means of risk transfer to the capital markets.

These bonds often have prepayment or extension risk, as well as being floating-rate based. As such they don't qualify as 'fixed-rate' bonds, but many would potentially qualify as HP assets.

> ! Please note: Case studies included in this paper are illustrative and based on assets in 2025. Current market dynamics favour short-dated spread assets. Case studies reflect these recent market dynamics and may not be appropriate in a future market dynamic.

The main categories of securitised bonds include:

- **Asset-backed securities (ABS):** Typically backed by pools of consumer or commercial receivables, such as auto loans, credit card balances, equipment leases, or student loans. These instruments tend to have shorter durations and predictable amortising cashflows.

- **Residential mortgage-backed securities (RMBS):** Backed by pools of residential mortgages. In the US, RMBS are often issued by government-sponsored enterprises (GSEs) such as Fannie Mae, Freddie Mac, or Ginnie Mae (referred to as agency RMBS), while private-label RMBS are issued by banks or non-bank originators. Key risk drivers include borrower credit quality, geographic concentration, and prepayment behaviour.

- **Commercial mortgage-backed securities (CMBS):** Backed by loans secured against income-generating commercial properties, such as office buildings, hotels, and retail centres. CMBS cashflows may be more volatile than RMBS due to reliance on tenant occupancy and property valuations.

- **Collateralised loan obligations (CLOs):** Most CLOs are backed by broadly syndicated loans (BSL) and are usually securitisations based on sub-investment grade loan portfolios of senior secured corporate debt. CLOs are actively managed, with portfolio managers able to trade loans within defined eligibility criteria, and tranches structured to absorb varying levels of credit risk. There are also CLOs based on private credit and middle-market loans.

In the US, public securitised assets are a core constituent of both life and non-life insurer portfolios. In Europe, insurers have been discouraged from investing in most securitised assets by high Standard Formula capital charges. However, this may change, with EU policymakers seeking to stimulate growth in the market, including an EIOPA review of Solvency II treatment of securitised assets during the second half of 2025.

CASE STUDY 1

A fixed-rate CMBS transaction with an expected maturity of 8-10 years backed by a portfolio of well-located, commercial properties.

Sector	Commercial real estate – diversified properties
Deal size	$315m
Income	6.05%
Expected Maturity	8-10 Years
Credit rating	AAA
Geography	US
Return	4.7% p.a. (yield to maturity)

Investment rationale

This investment provides exposure to senior debt through an AAA-rated tranche with a spread of c.80 basis points over US. Treasuries as of 10 September 2025. The transaction is supported by a sponsor with a robust tenant base and benefits from diversified underlying property collateral, including industrial, hospitality, self-service storage office and retail anchor properties.

HP features

At inception most of the underlying loans prohibit voluntary principal prepayments during a specified period, but permit the borrower after an initial "lockout" period (two years) to make voluntary principal repayments. (Note: lockout periods prevent borrowers from prepaying their loans for a specified time). This means that the timing of the cashflows of the CMBS are contractually bound but not fixed and so may be considered to be HP.

Case studies shown are for illustrative purposes only.
The information does not constitute a recommendation to buy or sell any security.

Size of the market

The global securitised credit market represents a substantial and well-established component of the broader fixed-income universe:

- **The US** market remains the most developed and liquid globally, with over $13 trillion in outstanding issuance across RMBS, ABS, CMBS, and CLOs (as at the end of 2024)[5]. Agency MBS alone accounts for roughly $9 trillion of this total. The depth, scale, and secondary liquidity of the US market support active investor participation across the capital structure.
- **The European** securitised market is smaller with a market size of $0.6 trillion[6]. While issuance has been more subdued post-financial crisis, select opportunities exist in RMBS, consumer ABS, and SME loan securitisations. Notably, the market has seen growth in sustainable securitisation themes.
- **The UK** securitised credit market is relatively small, with a market size of $0.2 trillion[7], concentrated in prime and non-conforming RMBS, auto ABS, and consumer ABS. Although more limited in scale and liquidity than the US, the UK market remains relevant for specialist investors and provides access to high-quality assets.

Beyond traditional asset classes, securitisation is being applied to new forms of cashflows, such as income from data centres, renewable energy projects, or revenue-based SME financing. These developments broaden the investable universe while offering exposure to secular growth themes.

While securitised credit has the potential to offer compelling risk-adjusted returns, we believe it requires specialist expertise. Deal structures can vary significantly, and investors must assess collateral quality, structural features, servicing capabilities, and legal documentation. Active management, thorough due diligence, and an understanding of the underlying asset pools are essential for effective participation in the asset class.

[5] Source: Bank of America, December 2024
[6] Source: Morgan Stanley, December 2025
[7] Source: Morgan Stanley, October 2025

Key features of securitised bonds

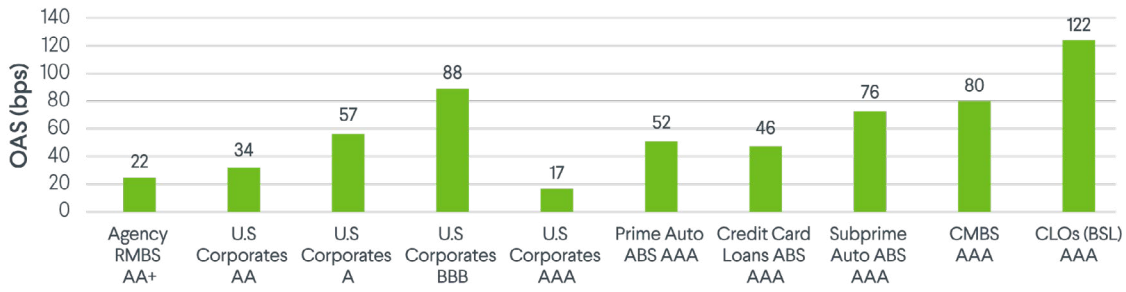
Securitised bonds offer several structural and economic characteristics that differentiate them from traditional corporate credit:

- **Diversification:** Exposure to thousands of underlying loans within a single security may help mitigate idiosyncratic risk. Pools often span geographies, industries, and borrower types.
- **Low correlation:** Performance of securitised bonds tends to be driven by consumer or real estate fundamentals rather than corporate balance sheets or equity market developments, supporting diversification benefits[8].
- **Structural credit enhancement:** Many securitisations include credit enhancement features such as subordination, over-collateralisation and excess spread. These mechanisms are designed to absorb losses in the underlying pool and protect more senior bondholders.
- **Customisable risk profiles:** Tranching allows investors to select exposures with a range of credit ratings - from AAA to below investment grade - and to tailor exposure to prepayment, default, and extension risk.
- **Alignment of interests:** In many jurisdictions, issuers are required to retain a portion of the risk (eg, 'risk retention rules'), aligning their incentives with those of investors. In the US and EU, this is where issuers must retain 5% 'skin in the game'. Some securities in the US are exempt to the 5% risk retention rule, such as those issued or guaranteed by GSEs, open-market CLOs, qualified residential mortgages, federally guaranteed student loans and seasoned loans.

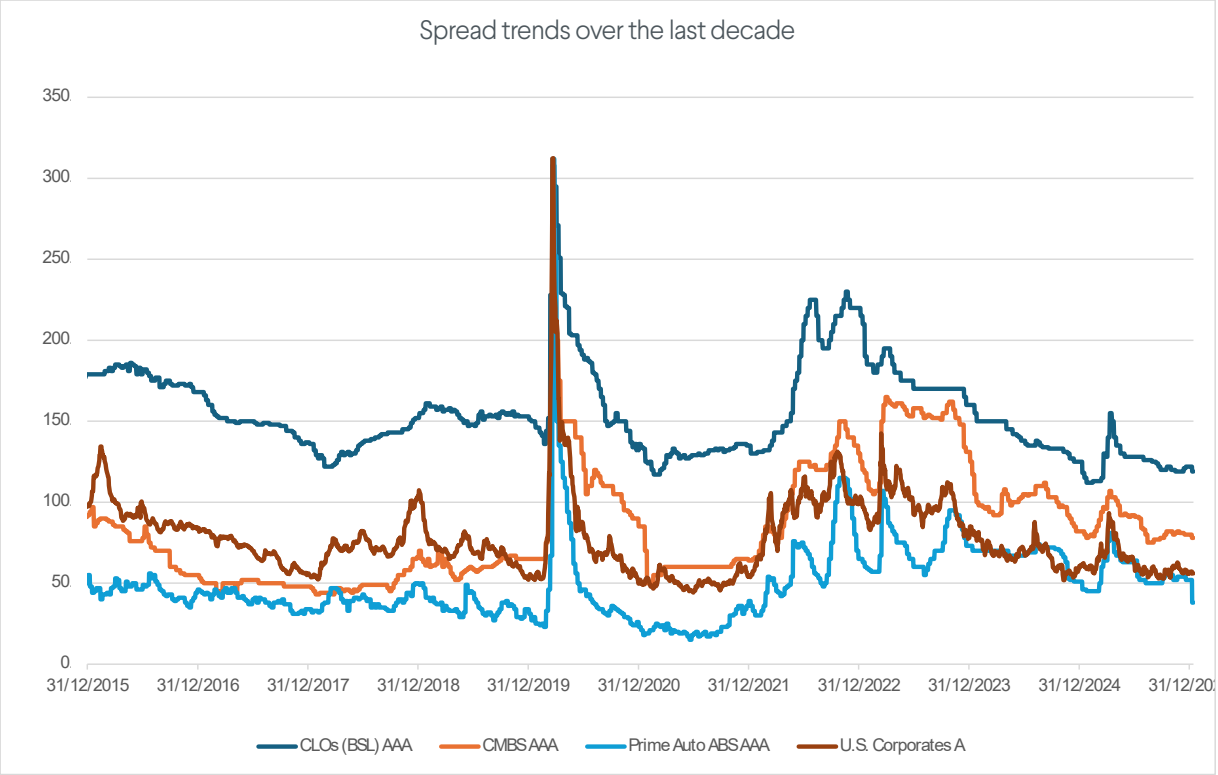
Spreads

On a like-for-like rating and duration basis, securitised bonds typically offer a spread pick-up over corporate bonds. This reflects a combination of complexity premium and historically lower liquidity. As illustrated in the first chart below, securitised assets generally provide higher spreads than many other credit instruments, despite often carrying stronger credit ratings. The second chart highlights the spread trends over the past decade for A-rated US corporates, AAA-rated prime auto ABS, AAA-rated CMBS, and AAA-rated broadly syndicated loan (BSL) CLOs. Pre-2020, the credit environment was benign characterised by stable growth and low expected defaults, causing credit spreads to generally compress together. Post-2020, spreads diverged as market stress highlighted differences in liquidity and complexity across asset classes with the market offering additional spread to compensate.

Securitised assets often deliver higher spreads for comparable or high credit quality vs traditional corporate bonds as at 16 May 2025



[8] Past performance is not a guide to the future. It should be noted that diversification is no guarantee against a loss in a declining market.



Source: Barclays Trading and L&G, as at 16 May 2025. Note: US Corporate AAA not illustrated due to concentration of index. Spreads shown for US credit asset classes with maturities up to 6 years.

Past performance is not a guide to the future.

In addition, our observations from Moody's default studies following the Global Financial Crisis and the Dodd-Frank Act industry changes, suggest that the average default rates of investment-grade securitised assets are comparable to investment-grade corporate bonds at around 0.2% annually. For higher credit rated tranches this is even lower. The table below details the breakdown of impairments by original rating and region of issuance from 2009 to 2023 for various securitised assets. As can be seen in the table, there were no impairments (eg defaults or losses) to AAA-rated securitised assets during this period. 2025 saw headlines about the bankruptcy of two corporates with loans underpinning some US CLO issues (Tricolor Holdings, a subprime auto lender and Frist Brands Group, an auto parts supplier). In both cases, senior tranches (eg AAA-rated tranche) of CLOs affected were well insulated due to robust subordination and credit enhancement, providing substantial protection to investors.

Material impairments by original rating and sector

Principal impairments

Original rating	US ABS	US RMBS	US CMBS	Global CDOs ex CLOs	Global CLOs	EMEA SF ex CDO & Other	Intl SF ex CDO & Other	Other SF	Total
Aaa	0	0	0	0	0	0	0	0	0
Aa	0	0	2	0	0	0	0	0	2
A	0	0	5	0	0	0	0	0	5
Baa	0	0	15	0	1	0	0	0	16
Ba	2	0	35	0	10	0	1	0	48
B	5	0	42	0	15	3	2	0	67
Caa	0	0	3	0	0	3	5	0	11
Total	7	0	102	0	26	6	8	0	149

Interest impairments

Original rating	US ABS	US RMBS	US CMBS	Global CDOs ex CLOs	Global CLOs	EMEA SF ex CDO & Other	Intl SF ex CDO & Other	Other SF	Total
Aaa	0	0	0	0	0	0	0	0	0
Aa	0	0	0	0	0	0	0	0	0
A	0	0	2	0	0	0	0	0	2
Baa	0	1	0	0	0	1	0	0	2
Ba	1	1	1	0	3	0	0	0	6
B	0	2	0	0	4	5	0	0	11
Caa	0	0	0	0	0	4	0	0	4
Total	1	4	3	0	7	10	0	0	25

Source: Moody's Ratings, Impairment and loss rates of structured finance securities: 2009-2023.

Maturity and duration

Securitised bonds generally have shorter-weighted average lives than corporate bonds, particularly in senior tranches. For instance, auto ABS may have weighted average lives of 2-3 years, while agency RMBS can extend to 5-7 years depending on prepayment speeds. CLOs typically have a reinvestment period of 4-5 years and a legal final maturity of 7-10 years, although they will often be refinanced or the terms reset much earlier. A key feature of securitised bonds is that their cashflows are amortising and often exhibit front-loaded principal repayments. Investors must account for optionality features (such as prepayment or extension risk) when assessing effective duration and portfolio impact.

Callable corporate bonds

Callable bonds are a variety of traditional fixed corporate bonds, the mainstay of MA portfolios. These are bonds, typically issued by corporates, where the issuer can redeem (or 'call') the bond before final redemption. Callable bonds feature in MA portfolios (pre-HP reforms), albeit with 'worst-case' cashflow assumptions (eg coupons cease at first call date with principal returned at final maturity). Some insurers may choose to categorise callable bonds as HP, with resulting benefits from using more realistic call assumptions.

Private markets

Opportunities in private markets can be more esoteric than their public counterparts, for example transport financing, solar leases and music royalties. There are, however, areas where the sub-asset classes are well established. Within private markets, we'll consider three areas i) fund financing ii) real estate debt and iii) UK/ European productive assets, with a focus on infrastructure debt.

i. Fund financing

Fund financing is a growing sector, and one where we see considerable interest from insurers to provide financing facilities to alternative investment funds including, private equity, private credit, infrastructure and real estate strategies. There are broadly two types of financing. Capital call facilities provide short-term financing – most are under one year - secured on the underlying investor commitments (who are often highly rated institutions) and Net Asset Value (NAV) financing which provides 1-5-year financing typically to private equity and infrastructure funds whereby the loan is secured on the underlying assets of the portfolio. In both cases, these facilities typically help to drive operational efficiencies which are financially beneficial to investors and the general partner of the fund.

L&G's Asset Management business research estimates the global demand for fund financing is around $1 trillion per year. Traditionally, banks have dominated this market, but financing provided by non-bank lenders is growing.

NAV financing is typically BBB / BB rated and L&G's Asset Management business tends to see these offering spreads in the region of 250-350bps. These securities typically have prepayment features and are floating rate. Being able to invest in these as HP assets may make fund financing comparatively more attractive for UK life insurers.

ii. Real estate debt

Real estate debt is one private asset class where insurers with MA approval could benefit from the HP reforms. Previously, where there was a material prepayment option in the underlying transaction without compensation for this via a 'make-whole' (such as a Spens clause), a significant haircut would need to be made to the cash flows contributing to the MA, often making the transaction unattractive for MA portfolios. Treating these as HP assets allows insurers to make a risk-based assessment of the haircut and hence allow a higher portion of cashflows to contribute to the MA. More detail on these points can be found in the "insurer considerations" section of this report. This expands the range of assets available for insurers to invest in. Below we highlight three areas of opportunity that we see.

- **Stabilised real estate debt:** For stabilised, typically investment-grade rated debt, having the ability to structure debt with the option for the borrower to prepay in some circumstances will meaningfully increase the opportunity set currently available to insurers. Research by L&G's Asset Management business estimates this could equal an additional £3 billion per year from UK issuers. For example, a 5-year facility could now have no prepayment fees in the latter two years, and some MA benefit will be received for these cash flows. Under the previous rules, no MA benefit would have been received for these cash flows, making such an investment inefficient from a capital perspective. The flexibility could be valuable to borrowers, potentially allowing insurance lenders to compete with banks. We've observed recent real estate debt transactions have a spread (over swaps) of 1.8-2.5%[9].

- **Development real estate debt:** The UK has around £30 billion of outstanding debt[10] in real estate development loans. Proceeds are typically used for acquisition or construction financing across both commercial and residential properties. This is a market where insurers haven't participated to the same extent as other institutional investors, as there is little demand for real estate development loans with make-whole since banks provide flexible floating-rate facilities. The relaxation of the requirements will enable some deployment in this area, but we still expect it to remain a bank-led space. Development loans can achieve gross IRRs of 8.5-10% (at the time of publication), with risk equivalent to a BB-rating.

- **Loan-on-loan financing:** Loan-on-loan real estate debt lending involves one lender providing funds to another lender, who then uses these funds to make loans to the ultimate borrower for real estate transactions. By doing so, risk is distributed across multiple parties, with some transactions receiving investment-grade ratings. These instruments are typically more complex to structure than traditional stabilised lending, which is evidenced by higher spreads.

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[9] Source: L&G, 2025. Past performance is not a guide to the future.

[10] BAYES Business School Commercial Real Estate Lending Reporting YE 2024

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iii. UK/Europe productive finance

Infrastructure assets have played a significant role in improving productivity and driving economic growth. In a UK context, the Government has increasingly emphasised the importance of productive finance in supporting the development of a modern infrastructure asset base that's needed to secure resilient growth and foster innovation, all in a sustainability-consistent fashion.

Private debt markets play a significant role in financing infrastructure of the future for a number of reasons:

- financings are often for unlisted (sponsor-backed) businesses or projects
- the cashflow structure of the asset (eg amortising) might not meet the requirements of public debt issuance
- the size of financing is below benchmark size for public bond markets (conversely, traditional private infrastructure financings tend to be in the billions)

Historically, private infrastructure debt has been backed by mature and/or highly contracted assets, but the opportunity set has widened in the past decade reflecting the type of new infrastructure needed and greater constraints on governments to fund its development.

These assets, that benefit from a long-term concession (a contractual agreement that grants an entity the right to operate, maintain and/or collect revenues from an infrastructure asset for a defined period), or a robust regulatory framework, have been a mainstay of insurers MA portfolios to match liabilities. However, for new infrastructure in sectors such as low-carbon energy, transport electrification and digital connectivity, long-term customer contracts or government concessions/subsidies are not yet available and infrastructure borrowers need more flexible debt capital (eg ability to prepay early without penalty) to support their efforts to develop, expand and/or modernise their asset-base.

The flexible debt capital need is estimated by L&G's Asset Management business to be £10 billion p.a. across Europe. The risk profile of this debt tends to sit in the BBB- to BB rating range, so carries incremental credit risk versus the traditional long-dated, fixed-rate investment-grade universe, with spreads typically 100-200bps higher. Tenors range from 3-10 years.

CASE STUDY 2: Development real estate debt

Construction financing to a well-regarded UK real estate developer to build a Grade A industrial warehouse property in South-East England

Sector	Industrial
Deal size	£50 million
Income	Fixed
Expected Maturity	2.5 years
Credit rating	BB
Geography	UK, South-East England
Margin*	350-375bps

Investment rationale

Construction loans have a unique risk profile; due to the uncertainty involved with the assets' construction phase they are typically considered 'higher risk' versus lending against a stabilised income-producing property. However, once built, the lender often benefits from high-quality new-build collateral. An example like this, in a sought-after location with good transport links demonstrated high tenant demand at completion. It provided some diversification to stabilised income-generating properties and attractive risk-adjusted returns with an estimated IRR at 9-10% for a BB rated asset.

HP features

While post-construction cash flows are contractual and predictable, timings of the construction loan drawdown may be quicker or slower than anticipated. In this example, the borrower wanted a flexible prepayment structure post asset completion with no make-whole provision. Previously this would have meant the assets was non-MA eligible, but now both features can be accommodated within the HP bucket.

**Definition of margin: Spread over swaps*

Case studies shown are for illustrative purposes only.
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CASE STUDY 3: Productive finance

Financing of a district heating platform in the Nordics

Sector	Infrastructure, district heating
Deal size	~€75million
Income	Floating
Expected Maturity	5 years
Credit rating	BB/BB+
Geography	Nordics
Margin	~400bps

Investment rationale

Investing in junior debt that sits above a portfolio/ platform of operating district heating assets. The company undertakes hedging of both input (fuel) and output by the company as well as having a supportive regulatory environment. Placing a layer of junior debt allows the borrower to optimise the capital structure, with the senior debt benefiting from an investment-grade profile albeit at a materially lower margin.

The debt structure is secured and highly covenanted (financial and business restrictions), ensuring strong alignment as well as recovery prospects in case of a severe downside scenario. Considering the downside resilience, we believe junior debt in this type of structure provides for attractive risk-adjusted returns.

HP features

The asset is callable but could potentially be structured with call protection for the first three years to make it more suitable for an insurer.

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HP asset characteristics

Having looked at the HP asset investment opportunities, we now address some of the regulatory and portfolio management implications. Investors should make a full assessment of regulatory and portfolio implications before investment. In the following graphic we highlight features of the HP assets together with the requirements placed on their management so that firms can take steps to meeting regulatory requirements specific to HP assets. Note this section is focused on the additional considerations due to the use of HP assets, and not the standard considerations of the traditional MA regime, which is assumed knowledge for readers.

Features consistent with traditional MA assets

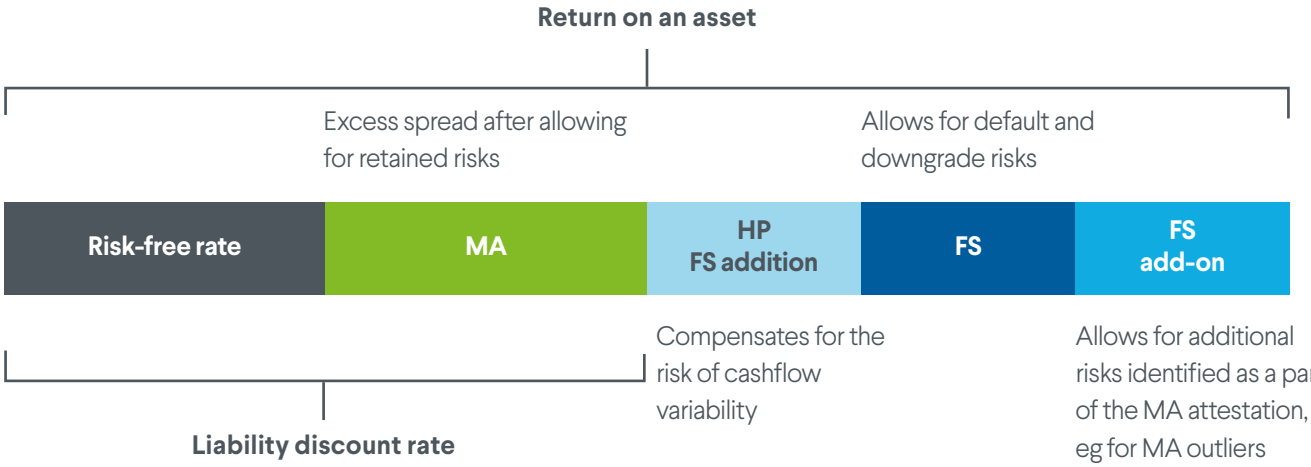
- Bond-like: HP assets should consist of bonds and other assets with similar cashflow characteristics.
- Credit Rating: The credit quality of the assets in an MA portfolio must be capable of being assessed through a credit rating or the undertaking's internal credit assessment of a comparable standard (ECAI equivalent).
- Risk Identification: Firms must identify all sources of uncertainty in cashflows, and risks associated with HP assets, regardless of materiality.
- Due diligence: Firms will be required to conduct thorough due diligence when investing in HP assets, ensuring alignment with their investment strategies and operational capacity to manage these assets. Firms will want to monitor the performance of these assets and compare with modelling assumptions.
- Approvals required: The firm needs PRA permission to apply HP treatment for a particular asset class or HP feature. Initial approvals being sought are for a variety of asset classes such as callable bonds and structured finance with prepayment risk.

Specific features of HP assets

- Impact of variability on matching: Firms must satisfy themselves that the risks to the quality of matching are not material and are consistent with the Prudent Person Principle (PPP). Ultimately, HP assets with very significant variations in cashflows may still not be suitable to match annuity liabilities.
- Cap on benefit: HP assets cannot contribute to more than 10% of the overall portfolio MA benefit (in £m) capping the amount of HP assets that can be held.
- Safeguards: HP assets may also be subject to additional safeguards to manage and mitigate the additional risks introduced into the MA portfolio. The most common safeguards observed to date are limits on the amounts invested in HP asset classes (£ amount limits, or single digit % proportions of the MA portfolio) and prudent assumptions when modelling these assets to calculate the MA.
- New PRA Tests: Firms holding HP assets will need to add two new matching tests to their existing MA compliance frameworks. Tests 4 and 5 measure and limit reinvestment and liquidity risk respectively by assessing the minimum amount of MA that could be earned and the maximum accumulated shortfall that is possible.
- More complex modelling: To calculate the HP FS addition and comply with the new matching tests, firms must be able to assess and understand the cashflow variability of individual HP assets in all potential scenarios.

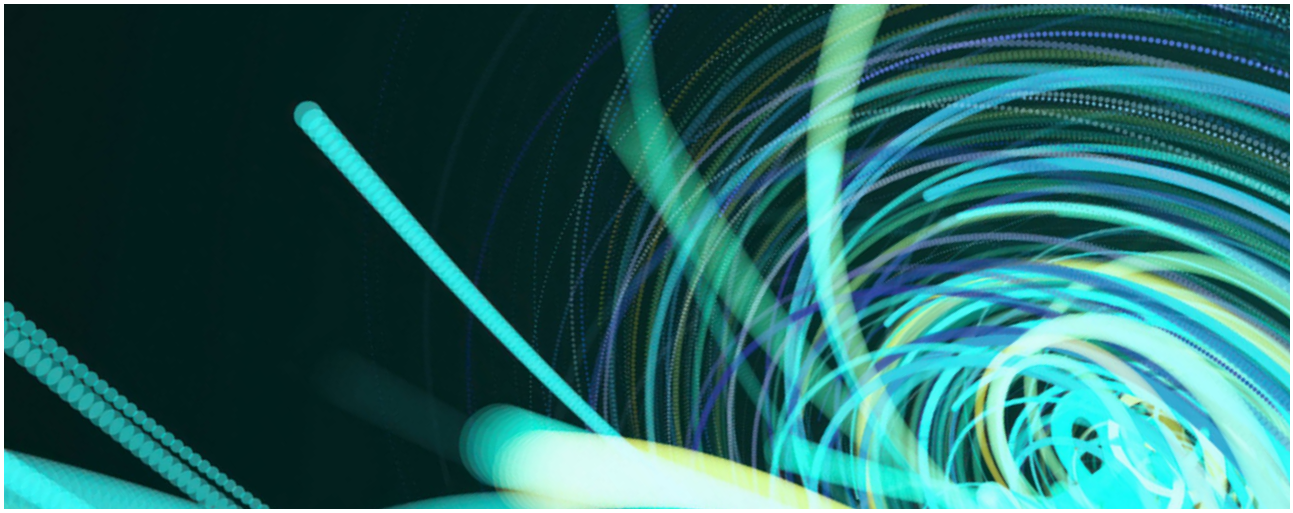
Source: Hymans Robertson based on Prudential Regulation Authority, Supervisory Statement SS7/18 – Solvency II: Matching Adjustment, Bank of England and Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations 2023 (IRPR), particularly Regulation 4.

Along with higher spreads, HP assets may also introduce additional risks into the MA portfolios. Insurers cannot take MA benefit from any additional spread that compensates for the cashflow uncertainty from HP assets. They will have to take off another deduction called a **Highly Predictable Fundamental Spread (FS) addition** to account for this risk.



Source: Hymans Robertson based on Prudential Regulation Authority, Supervisory Statement SS7/18 – Solvency II: Matching Adjustment, Bank of England

The HP FS addition for HP assets reduces the MA obtained by an amount to cover the additional risks being introduced, particularly with regards the reinvestment and rebalancing activities required due to the uncertainties in timing and amount of cashflows. **Firms are also restricted to generating no more than 10% of the total MA benefit on their portfolio through HP assets.** Insurers holding such assets will also have to comply with **two new matching tests** which will limit the extent of the cashflow uncertainty.



Implications for investment portfolios

There is no one single approach to how firms will choose to allocate to HP assets, which will depend on the particular assets they invest in, and their motivations for doing so. There is a strategic choice to be made as to how much to use the opportunity to extend their existing asset classes, or to use it to access new opportunities.

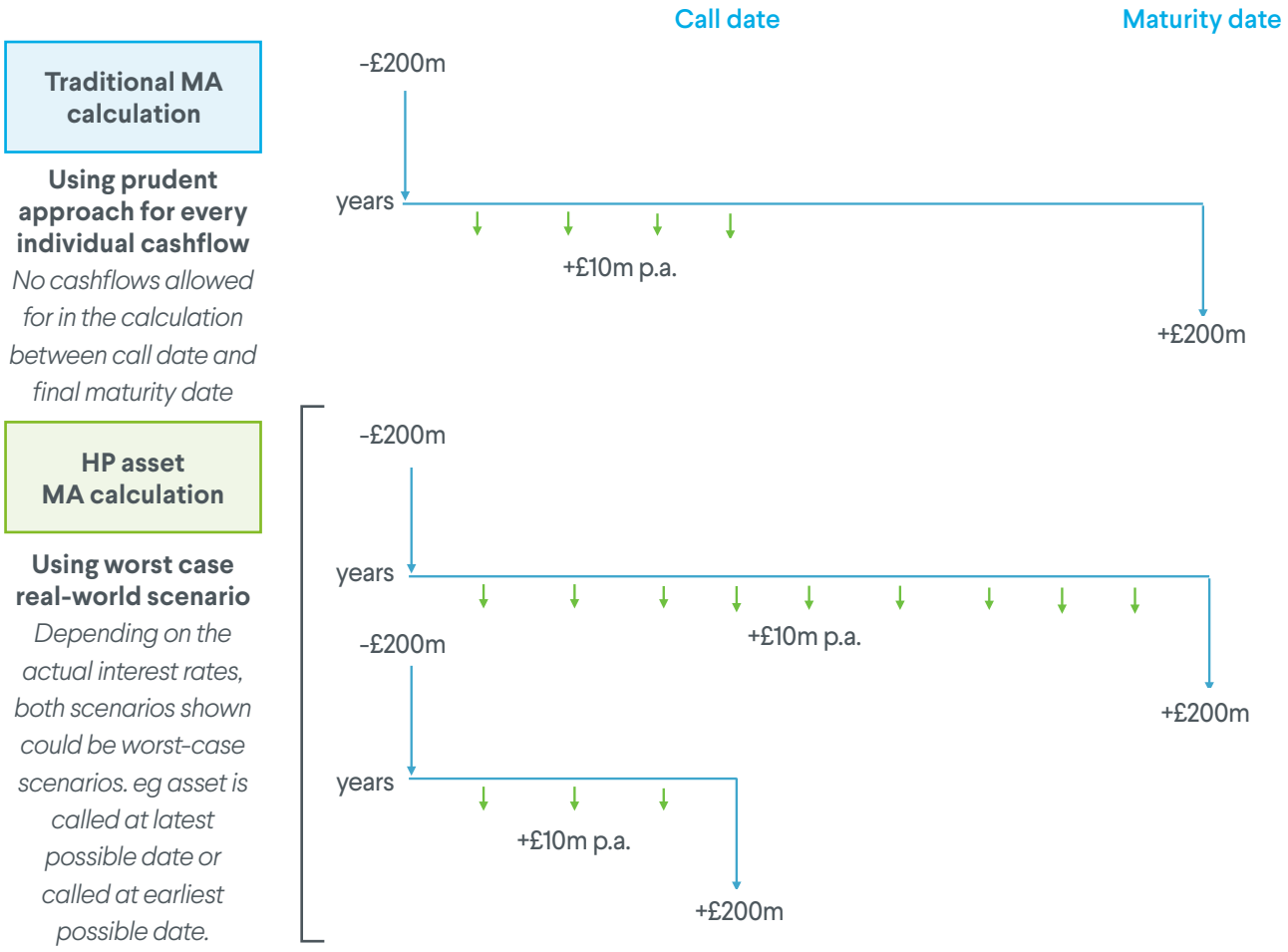
Existing asset classes but with extra features which fall foul of existing MA requirements.

Some insurers were already investing in assets that meet the new HP definition but treating them as "fixed" under the previous regulations by making extremely prudent 'worst-of-all-worlds' assumptions about the cashflow variability. For example, for a callable bond firms assumed that coupons cease at the earliest call date, but that the maturity payment was not received until the latest possible maturity date.

Some insurers use a similar approach for construction phase assets. For both these types of assets, HP treatment should improve the MA generated by allowing more realistic assumptions to be made, albeit some prudence will remain under the HP regime particularly under the easier approaches as described in the later section "Best estimate cashflow modelling and FS additions".

The change in approach to the cashflows is illustrated in the graphic below. This shows, for a callable bond which doesn't default, which cashflows can be considered under the previous (prudent) non-HP treatment, and under the new (risk based) HP approach. The former assumes the coupon payments stop at the call date, but the maturity payment occurs at the last possible date. This is not a valid real-world outcome and delivers lower MA benefit than either actual possible real-world scenario; the HP approach allows you to consider both real-world outcomes and choose the one with the worst yield.

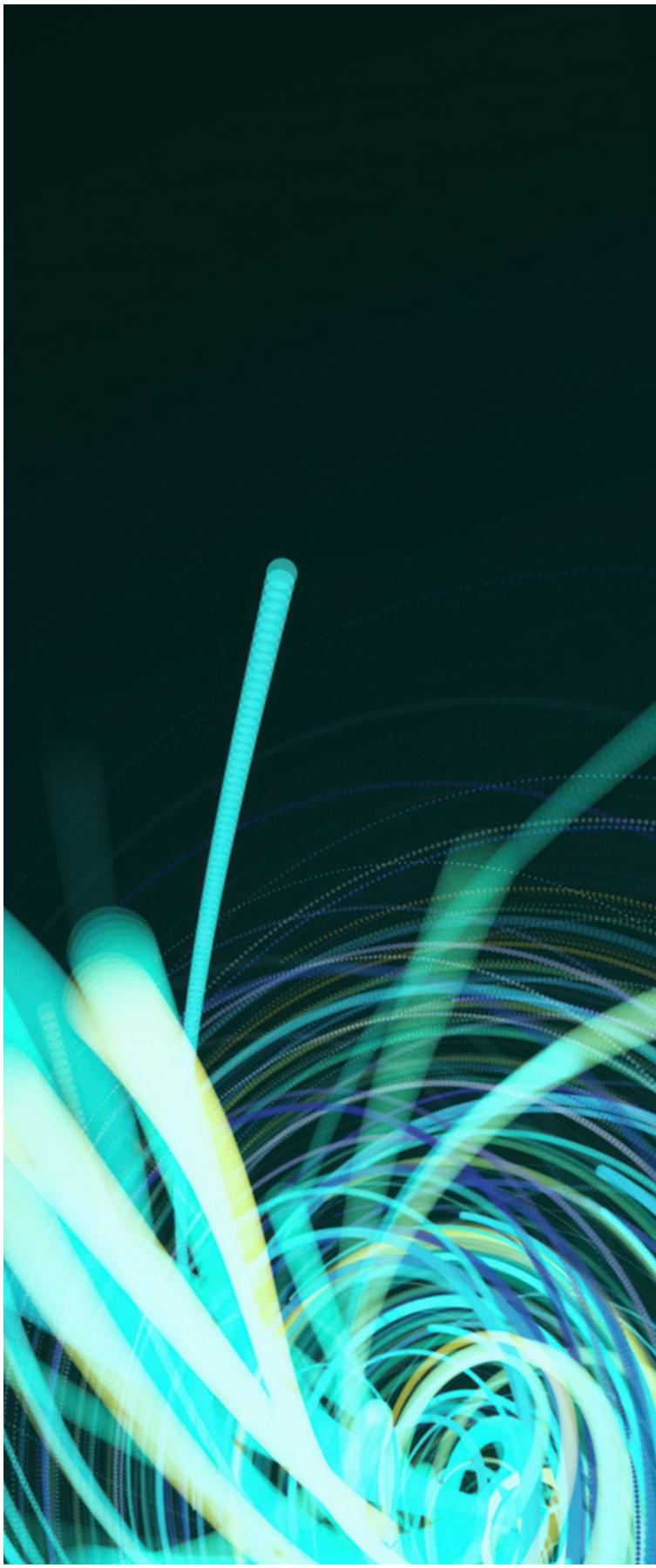
MA calculation for a callable bond – Traditional vs HP asset treatment
Illustrative values



Source: Hymans Robertson

Certain asset features - such as redemption or termination clauses, default-driven extension provisions, and cashflows with uncertain but bounded timing - were previously considered ineligible for MA treatment. Eligibility was only possible if specific contractual mechanisms were in place to ensure that lost cashflows could be replaced by proceeds from the asset, such as through a make-whole agreement, or if the variability was strictly limited to short durations. Assets with such features, such as the securitised debt discussed previously, can now be treated as HP assets without such stringent provisions being required.

Whilst HP treatment should provide a modest benefit from increasing the MA on assets already held, the motivation for the new framework was to extend the universe of MA-eligible assets for insurers to invest in rather than to facilitate one-off benefits on existing assets. For some existing asset classes, asset originators may be mindful of the HP flexibilities when designing the terms built into the financing on behalf of the issuers. This might mean some existing asset class opportunities such as construction-phase assets could become more available as HP assets and less as traditional fixed assets.



New opportunities

Insurers now have the opportunity to invest in a broader range of assets previously not considered, such as additional types of securitised credit or financing for UK/European productive assets.

Historically asset markets with HP features are more mature outside the UK – structured credit in the US, for example. However, now that UK insurers can invest in such assets, the UK market may develop, and last year we have already seen the first European reinvesting CLO issued, which is comprised of UK mid-market loans. Work being conducted by the Association of British Insurers (ABI) and individual insurers with the National Wealth Fund could lead to the development of more UK-orientated HP asset opportunities.

Insurers can now invest directly in assets that previously needed restructuring to meet MA rules. While insurers may be unwilling to collapse existing structures that they have spent considerable time and cost developing, such as for Equity Release Mortgages, firms that are looking at these asset classes for the first time may consider investing in them as HP assets, particularly given the PRA's comments around expectations that MA assets are only restructured where necessary.

Beyond MA benefit, HP assets may improve portfolio risk-adjusted yield through higher spreads, greater diversification across risk factors, and by investing in assets with stronger risk characteristics outside of their rating, such as those with better covenants or loss-given-default characteristics. However, these higher spreads also reflect compensation for increased risks associated with HP assets, such as reinvestment and liquidity risk. Firms may need to review their existing suite of risk/return metrics to ensure that they are sufficient to capture the new features of HP assets.

The next box provides an estimated additional MA benefit (a greater MA leads to a lower liability value (benefit)), assuming the HP investments generate a higher spread after deducting any FS additions (including the FS HP addition and FS add-on) for an assumed MA portfolio:

How extra spread from matching HP assets could translate into MA benefit for an MA insurer

10 to 50 bps Extra spread × **10%** MA limit × **10 year** Avg. duration × **£50bn** Portfolio size

= an additional benefit of **£50m to £250m** (MA benefit)

Note: The above example is for illustrative purpose only and oversimplifies the modelling and calculation. The extra spread is after deductions for an allowance needed for the FS additions to cover the cashflow variability risk. Actual investment results will vary depending on the assets and economic conditions.

Differing incentives to invest

While we believe the benefits of investing in HP assets should be sufficiently compelling for all MA firms in the long term, we're seeing firms move at different speeds with regards to their HP asset propositions. For instance, insurers with smaller portfolios may prioritise expanding their existing MA permissions for non-HP assets before spending the effort needed to develop their HP opportunities.

Insurers have been evolving their investment approaches in light of the lower spreads available for current assets. Recently, insurers have shifted from longer-dated securities, to shorter maturities with higher spreads using derivative-related strategies to obtain the required duration. ABS is a way for insurers to access this shorter-maturity, higher-spread requirement.

Headroom management

Only 10% of the total MA benefit can come from HP assets. While most insurers won't be near this limit for some time, they'll need a plan for managing it as allocations grow. If the HP contribution goes over 10%, the excess is removed by applying extra Fundamental Spread (FS) deductions.

The PRA expects firms to avoid relying on these extra FS deductions as a routine fix—doing so could signal weak risk management. To stay on track, insurers could consider:

- Set up early-warning indicators when HP contributions approach a set threshold
- Identify pre-agreed actions to manage the contribution before it breaches the limit.

There's no formal penalty for going over the 10% threshold, so unlike other MA tests, firms don't need to set a lower internal buffer.

> The portion of the portfolio with HP cash flows is limited in aggregate to creating **10%** of the MA benefit for the MA portfolio. We'd expect firms to aim to maximise their HP allocation by managing as close to the limit as possible.

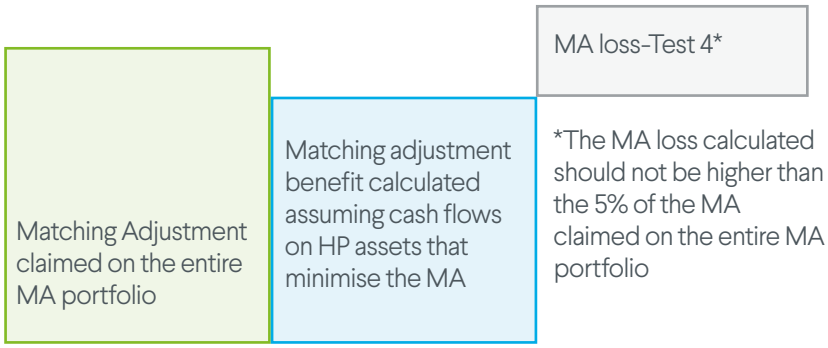
As HP allocations grow, insurers will need a strategy to optimise holdings and reclassify some assets as non-HP to stay within the 10% limit. This may mean developing MI to identify the optimal assets for reclassification such as monitoring the MA benefit and other key metrics for both HP and non-HP treatment. For reclassified assets, insurers will require an approved non-HP treatment, which will likely resemble previous prudent partial cashflow recognition approaches such as those applied to callable bonds.

The new regulation does explicitly allow such reclassification so long as the insurer can justify the change and implement it in a controlled manner. This flexibility should enable insurers to avoid breaching the limit or having to move assets to other portfolios. As thinking on HP assets develops, and more interesting and economically beneficial asset opportunities emerge, insurers might even explore structuring HP assets into fixed tranches to free up HP capacity.

Additional tests for HP assets

The PRA has implemented two MA tests (Test 4 and Test 5) to manage the reinvestment and liquidity risk that HP assets bring to an MA portfolio. Test 4 checks the worst-case loss in MA benefit that could be experienced across the whole MA portfolio. The loss must be smaller than 5% of the total MA benefit claimed to ensure that insurers are not excessively impacted should all the cashflows from HP assets arrive in such a way that the actual MA would be minimised.

Test 4: MA Loss Test for assets with HP cash flows



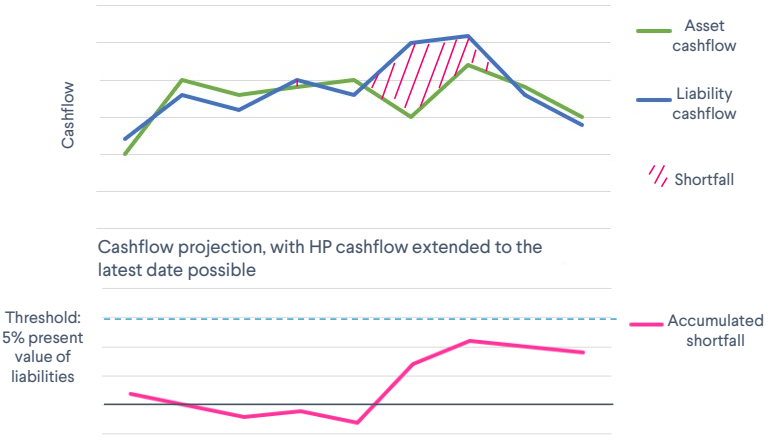
Source: Hymans Robertson - for illustrative purposes only

For HP assets that have a worst-case MA that's small, such as those that could be prepaid in the short term, then the Test 4 limit effectively becomes the binding constraint on the percentage of the MA that such assets could provide. Depending on the minimum MA of those assets Test 4 (although it's a portfolio test) may effectively cap the MA benefit at a level below the 10% HP limit, with a theoretical minimum of 5% because such assets may use up the full Test 4 limit.

For some HP assets, Test 4 could form a cap on MA benefits as low as **5%.**

Test 5 is a "modified" accumulated cashflow shortfall test, and it's designed to ensure insurers won't need to sell assets if HP cashflows arrive late or are smaller than expected. It requires a projection of asset and liability cashflows on a best-estimate basis, other than for HP assets whose cashflows are to be considered as occurring at the latest possible date. The net cashflows are accumulated at the risk-free rate, and the possible shortfall in cash in each period of the projection must be smaller than 5% of the present value of liabilities. This test is illustrated in the graphic on the right. The severity of these additional constraints will depend on how aggressive the firm is in managing its Test 1[12] . This test is based on all cashflows being projected on a best estimate basis with the shortfall limited to 3%. Firms with conservative Test 1 positions will get more flexibility for HP assets, while firms that are using the maximum 3% mismatch under Test 1 will only have an additional 2% available for HP assets. We'd expect insurers to evolve their approach to the matching tests to better maximise their MA potential.

Test 5: Modified Accumulated Cash Flow Shortfall Test



Source: Hymans Robertson - for illustrative purposes only

[12]Test 1 for a MA portfolio under the UK PRA framework is called the Accumulated Cash-flow Shortfall Test. It is designed to assess the adequacy of cash-flow matching between assets and liabilities in the MA portfolio. The maximum accumulated shortfall in any time interval must not exceed 3% of the present value of liabilities in the MA portfolio.

Best estimate cashflow modelling and FS additions

Under Solvency UK reforms, HP assets - those with predictable but non-fixed cashflows - require an FS addition to account for risks related to those HP assets not captured by the standard Fundamental Spread. These include cashflow uncertainty, reinvestment risk (eg from prepayment risk), and liquidity risk (eg for extension risk).

Insurers must project best estimate asset cashflows to assess matching quality and to calculate the MA for HP assets. They should use as much relevant historical data as possible and assume rational third-party behaviour. The PRA acknowledges this is easier for some asset classes than others and insurers can make reasonable assumptions about how issuers may behave in different economic conditions. However, for assets with scarce data, or where the uncertainty is related to the occurrence (or non-occurrence) of an idiosyncratic event, the PRA accepts that more judgement may be required. For example, construction project events may be unique, so historical experience on completion timelines may not always be relevant.

Firms must develop an approach for calculating the HP FS addition for cashflow uncertainty, including reinvestment and/or rebalancing costs. The regulations specify a standard approach for calculating the FS addition which contain simplifications, as detailed below. This may be sufficient for initial exposures, but the PRA expects firms to develop more sophisticated approaches for material holdings. Firms may propose a more sophisticated approach from the outset.

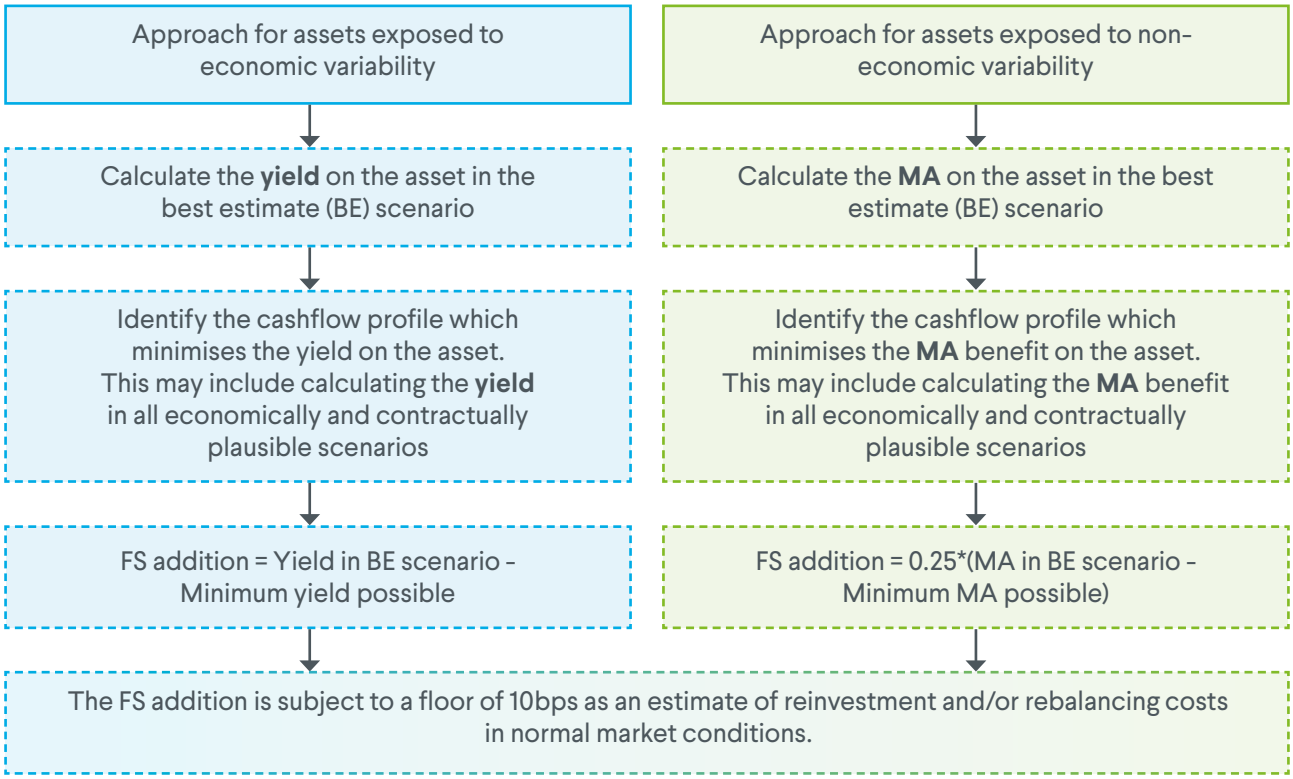
Standard approach

The PRA identifies two types of asset variability:

- Economic variability: Where the payment profile may vary under different economic conditions. It's more likely there is relevant and credible historical data for this variability. For example, callable bonds.
- Non-economic variability: Where the payment profile is based on an event or behavioural consideration. For example, variability dependent on meeting operational targets in infrastructure projects. A greater level of expert judgement may be required for this variability.

For assets with both exposures, insurers should follow the approach for the dominant risks with further nuances for pooled asset exposures.

The standard approach differs between these two types, and the graphic below summarises the stages required for each.



For some asset classes the 10bps floor to the FS addition may not have a material impact, but we're aware of some assets, such as callable bonds with coupon step-ups, where the application of the floor may lead to a prudent level of MA; however the full economics of the asset will still benefit the portfolio over the longer term. Examples of assets with both economic and non-economic-driven variability include some real estate or infrastructure debt where the prepayment could be driven by economic conditions such as interest-rate and credit spread as well as events such as construction completion and project performance.

The PRA allows the use of the non-economic approach for pooled assets with predictable cashflows, even if the underlying assets technically fall under the definition for economic optionality. The standard approach for non-economic variability often results in a lower FS addition than that for economic variability. However, the approach used should be based on the specific features of the asset and the data available. It's not guaranteed that the non-economic approach would result in a higher MA benefit as the risk-free rate may also vary if the potential cashflow profiles have different terms.

Sophisticated approach

Insurers can propose a more sophisticated approach for calculating the FS addition and they should plan, where possible, to move from the standard approach as holdings grow.

Key principles for developing any such approach are:

- FS addition should cover a target percentile of potential losses in a diversified portfolio.
- Include a minimum level to reflect reinvestment and rebalancing costs.
- With credible data, firms may justify lower FS additions for remote risks, considering costs.
- Firms should explain the material strengths, weaknesses, and limitations of their method and the extent to which these could lead to the FS addition being inadequate.
- Consider how the FS addition changes under different market conditions.
- Methods must be data-supported, not heavily reliant on expert judgement.

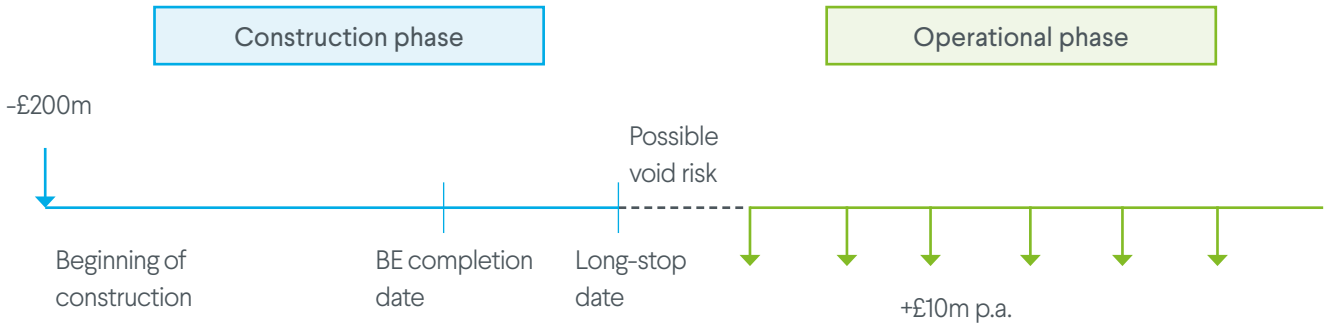
The PRA doesn't prescribe a specific method, but a reasonable approach might be to stochastically model the key drivers of the cashflow variability. For instance, the expected term of a callable bond, subject to economic variability, might be modelled using interest rate distributions.

There are some general benefits of developing a more detailed/granular sophisticated approach that we would expect to apply in most cases:

- Insurers could justify a lower FS addition.
- Improved risk management and a better understanding of how the asset may behave under stress. For example, in determining the FS addition under stress, or arguing that no further uplift to the addition is required under stress.
- A more detailed understanding of how the asset behaves in stress will support decisions around PPP compliance and aid the MA Attestation in assessing the sufficiency of the FS.
- Using the sophisticated approach may not be too onerous given much of the work will already need to have been done under the standard approach (insurers may need to model the asset in many scenarios to identify the lowest yield or MA scenario).

The graphic below shows an example construction phase asset along with some considerations with regards to the approach to be used. In this example, an initial amount (capital invested) is lent and construction begins with the anticipation that a single tenant will lease the asset. No cashflows for the asset are generated during the construction phase. The construction phase is expected to complete at the best estimate completion date, but flexibility is granted until a long-stop date, beyond which buyer has the right to rescind the contract. There is the possibility of a period before the tenant is contracted which creates some void risk before payments start. Once the asset is operational, a contractually defined annual cashflows will be generated.

MA and FS addition calculation approaches – A worked example: Construction phase assets



For illustrative purposes only.

Developing a more sophisticated FS approach comes with challenges, including the up-front costs of development and implementation and the uncertainty of new requirements. The PRA may not have its own view of what an appropriate sophisticated approach is for a specific HP asset, so additional regulatory back-and-forth may be unavoidable. We note the PRA appears to be conducting many of its approvals to date in a timely manner.

Moreover, according to the PRA requirements, firms should not propose a sophisticated approach if they do not have sufficient data to justify it. This could be problematic for assets such as real estate-based loans with construction periods. These assets can be highly idiosyncratic, significantly reducing the relevance of historical data. We expect that in some cases there may need to be compromises or exceptions made on data expectations else firms will have no option but to retain the simplistic and more punitive standard approach. This could lead to the unfortunate effect that US assets are preferred to UK ones given the significantly better availability of data.

Most initial HP applications to date have used the standard approach for calculating the FS addition, however we'd expect firms to be thinking about more sophisticated approaches and setting out a framework or set of guidelines for when they'd expect to move from the standard approach to a more sophisticated one (or an approach lying in between). This framework may consider criteria such as modelling complexity, operational effort, subjectivity, extent of the variability of cashflows and the availability and relevance of underlying data. Sophisticated modelling helps understand risk better and may lead to greater potential MA benefit once approved, so the sooner it can be implemented, the better.

Capital implications

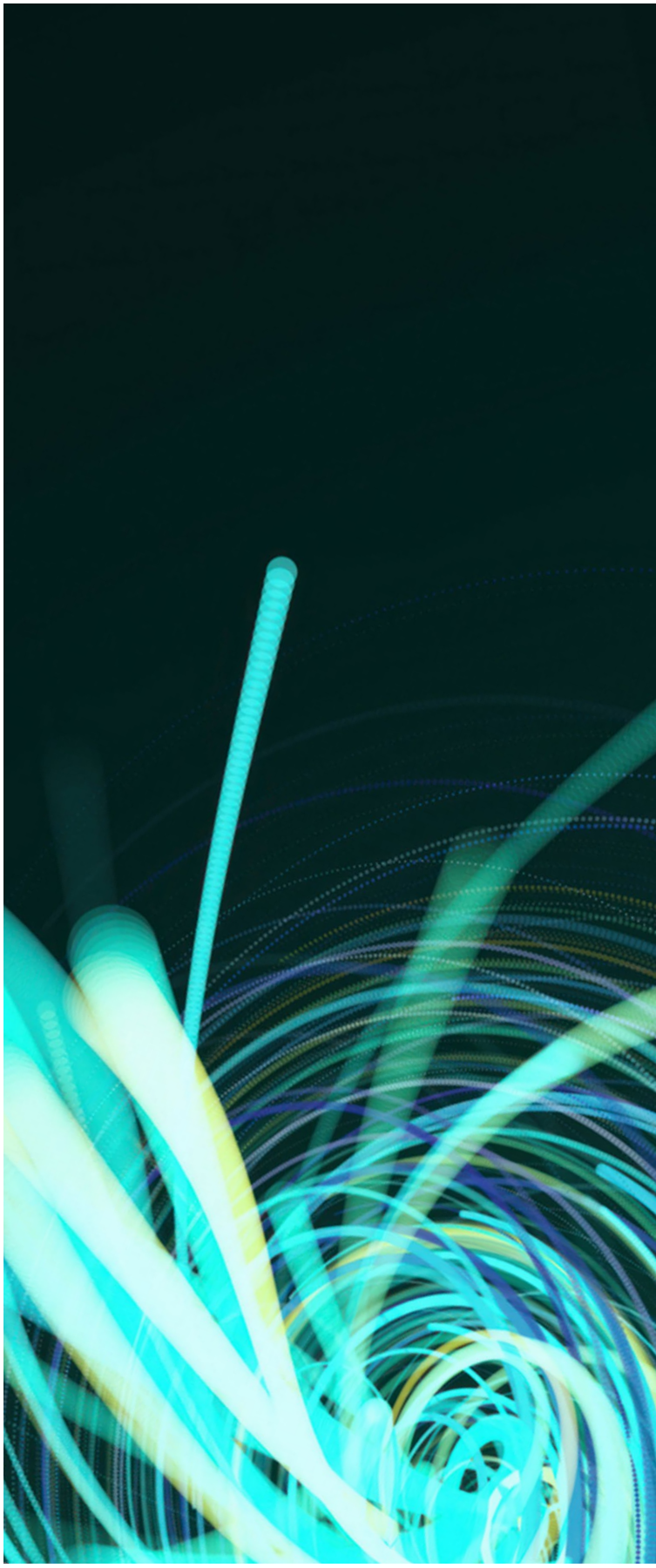
Most BPA writers use an internal model to calculate the Solvency Capital Requirement (SCR) for spread and default/downgrade risk. These models allow for changes to the FS and MA under stress. Unlike fixed-cashflow assets, best estimate cashflows for HP assets can change for reasons other than default/downgrade. Firms will need to consider how the FS addition may change under stress, such as reflecting changes in likelihood of early repayment and potential loss of future MA benefit.

The PRA is not expecting the FS addition to automatically change in stress. However, firms will need to consider:

- How to update HP cashflows for stressed conditions and the potential for the cashflow profile to change materially.

> The FS addition calculated in normal market conditions could already be adequate under stress, as the representative scenario in the SCR calculation is not by definition a bad scenario for the FS addition calculation. For instance, the SCR scenario can include a high spread, where the prepayment risk and as a result the FS addition is lower, given the lower refinancing cost.

- The materiality of liquidity and reinvestment risks/costs and whether these are adequately allowed for in the internal model capital.
- Whether taking a prudent approach for FS additions in the base balance sheet might allow a simplification for the FS addition in stress.
- The level of uncertainty around the stressed cashflows. Expert judgment may be needed, rather than a purely mechanistic approach, to assess stressed cashflow projection and level of uncertainty of projections.
- A lack of reliable data may make it challenging to model the stressed cashflows of assets that are exposed to event-driven variability. Firms may prudently set the FS addition higher under stress or cap the MA benefit.
- Correlations with the wider economic environment, noting that some HP assets may have different risk profiles compared to typical corporate bonds.



Additional considerations

We expect by now that most BPA insurers have submitted at least one MA application which includes HP assets, and indeed there may be a handful of firms that will have submitted several.

In addition to general challenges around how the HP assets and their FS additions will be modelled, firms should consider how they are allowing for HP asset risks within wider risk frameworks and policies such as liquidity frameworks. Should firms wish to pair HP assets with derivatives, such as converting foreign cashflows to GBP, we'd also expect the PRA to challenge how they will do this given the variability of the cashflows.

An interesting further development is the proposed MA Investment Accelerator (MAIA) framework which would allow firms to invest in new MA-eligible opportunities in advance of seeking PRA approval, subject to certain limits and restrictions. It doesn't expand eligible assets but helps firms act more quickly. The MAIA should aid firms in investing in new HP asset opportunities provided they have a framework for managing the risks.

For some HP assets, there may be a need for more pre-application engagement with the PRA eg via the Application Readiness Assessment Process (ARAP), to explain features of HP cashflows and demonstrate MA eligibility.

For other HP assets, such as bonds similar to those already held but with an additional HP characteristic, the MAIA could enable insurers to recognise any extra MA benefits sooner.

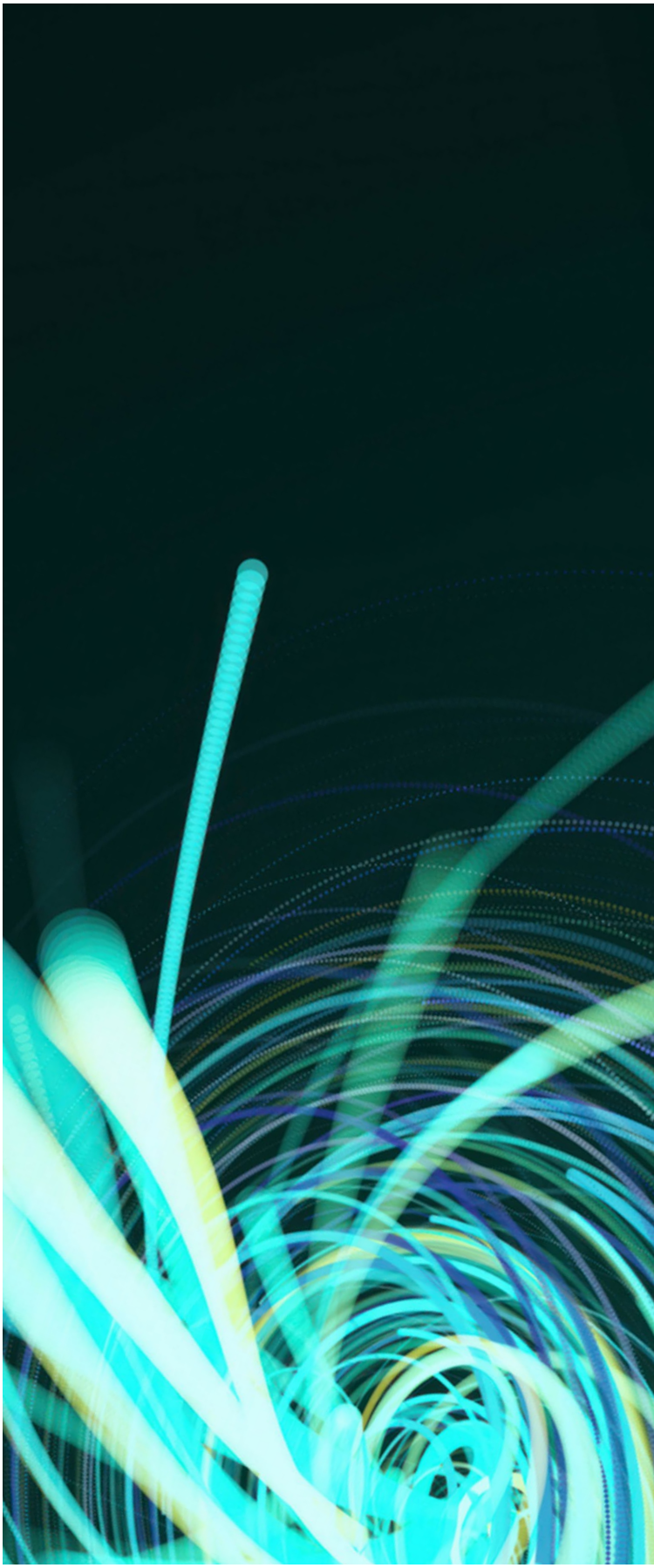
MA insurers completed their inaugural MA Attestations at year-end 2024, and we'd expect HP assets to bring additional considerations for future Attestations. Firms must confirm that the FS covers all asset risks; if not, they must apply an FS add-on. While there may be some prudence in the HP FS addition (particularly if following the standard approach), we'd not expect firms to be able to rely on this to offset a weak basic FS. However, they could offset any deficiency in the FS addition by applying an FS add-on.

Conclusions

The recent Solvency UK reforms are opening new investment opportunities for UK life insurers under the Matching Adjustment (MA) framework. These reforms extend MA eligibility to the broader range of highly predictable (HP) assets. Within public markets, the new regulation opens up a diverse set of securitised bonds, at relatively high spreads and additional benefits such as portfolio diversification. In the private markets, insurers can now extend their portfolio to fund financing, real estate debt, and UK/European productive finance, all of which aligns well with the requirements of the new framework.

To mitigate the risks introduced by these expanded asset classes, the updated regulatory requirements impose stricter portfolio management constraints and introduce new challenges in risk modelling. Insurers must now comply with enhanced tests aimed at managing reinvestment and liquidity risks. Additionally, no more than 10% of the total MA benefit can be derived from HP assets. Firms are also required to calculate an HP Fundamental Spread (FS) addition to account for cashflow uncertainty, including reinvestment and rebalancing costs. While the regulator provides a standard approach, we examined both the opportunities and challenges associated with developing more sophisticated, bespoke methodologies.

Finally, we noted that although the HP treatment may offer only modest uplift to the MA on existing assets, the reforms significantly broaden the universe of MA-eligible investments. This expansion not only enables insurers to enhance portfolio diversification but also encourages the development of new HP assets, potentially unlocking economically beneficial investment opportunities.



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Appendix – List of Abbreviations

ABI: Association of British Insurers
ABS: Asset-backed Security
ARAP: Application Readiness Assessment Process
BE: Best Estimate
BPA: Bulk Purchase Annuity
Bps: Basis Point
BSL: Broadly Syndicated Loan
CLO: Collateralised Loan Obligation
CMBS: Commercial mortgage-backed Securities
EIOPA: European Insurance and Occupational Pensions Authority
FS: Fundamental Spread
GSE: Government-Sponsored Enterprise
HP: highly predictable
IRR: Internal Rate of Return
LP: Limited Partner
MA: Matching Adjustment
MAIA: Matching Adjustment Investment Accelerator
NAV: Net Asset Value
PPP: Prudent Person Principle
PRA: Prudential Regulatory Authority
PS: Policy Statement
RMBS: Residential mortgage-backed Securities
SCR: Solvency Capital Requirement
SIG: sub investment grade
SME: Small Medium Enterprise
SS: Supervisory Statement

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