Comparing asset classes in light of the 2024–2025 Solvency II UK reforms

Achmea Mortgages

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- After the reforms to the Solvency UK matching adjustment (MA) by the Prudential Regulation Authority (PRA) assets with highly predictable (HP) cashflows, like whole loan residential mortgage portfolios, can be considered for matching adjustment portfolios
- Compared to other assets with highly predictable cashflows Dutch residential mortgages offer excellent risk characteristics, while having good duration matching and substantial diversification benefits
- The capital efficiency of residential mortgage portfolios means they can provide a solid MA benefit uplift, improving insurers' solvency position

Introduction

Since the UK's withdrawal from the European Union, the Solvency II directive, which is the regulatory framework for insurers, has been renamed Solvency UK. The framework ensures insurers hold sufficient capital to withstand economic or market shocks. The contents of the Solvency regulations have also begun to diverge post-Brexit.
One example of this is the reforms the PRA has made to the matching adjustment, which is an instrument that allows insurers to adjust the discount rate used for valuing insurance liabilities. This is based on the additional yield that is earned on assets, which are often illiquid, held to maturity.

Before the reforms by the PRA only assets with contractually bound cashflows were eligible for inclusion into the matching adjustment portfolios of insurers. The scope has been broadened to include assets with highly predictable cashflows. As a result, insurers can now consider new asset classes such as construction phase infrastructure debt, unsecuritised equity release mortgages, amortizing consumer debt, and Dutch residential mortgage portfolios.

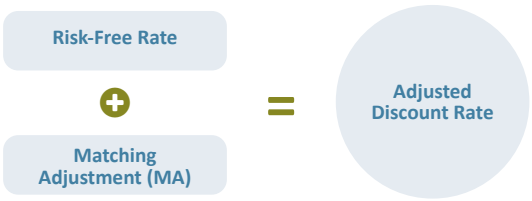
Achmea Mortgages has published two papers about the eligibility of assets and the matching adjustment mechanism. We kindly refer to these two papers for additional details on how the matching adjustment works.

The matching adjustment: a refresher

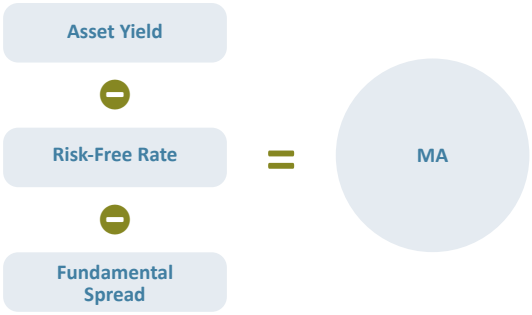
As mentioned, the matching adjustment is a way for insurers to increase the discount rate of their liabilities, improving their capital efficiency and their solvency. There are specific criteria that insurers must meet to be able to use the matching adjustment:

- Portfolio of eligible assets: Assets must have predictable and stable cash flows, such as high-quality corporate bonds or residential mortgages.
- Matching cash flows: There must be close matching between the liabilities and the cash flows from the assets.
- Illiquid assets held to maturity: The insurer must hold these assets to maturity to ensure that short-term price fluctuations do not affect solvency.

The way the matching adjustment increases the discount rate is visible in the following image:



This matching adjustment is calculated as the difference between the yield on the assets and the risk-free rate, minus the fundamental spread:



The fundamental spread is formed by the credit default risk and the downgrade risk. For assets with highly predictable cashflows, a top-up of at least 10 basis points is necessary, accounting for the uncertainty regarding timing and amount of cashflows, for instance due to potential changes in prepayment speeds (source: PRA):

Assets with highly predictable cashflows are capped at contributing 10% of the total MA benefit of the MA portfolio. Any insurer intent on including new asset types in their matching adjustment portfolio needs approval from the PRA (source: Clifford Chance).

Under the proposed Matching Adjustment Investment Accelerator (MAIA) framework, insurers that already hold MA permission can include new MA-eligible assets with features not covered by their existing MA permission in their MA portfolio. Therefore claiming the MA capital benefit immediately without prior PRA approval, provided they apply within 24 months to regularise those assets through a variation of their MA permission (source: PRA).

What are highly predictable cashflow assets?

The removal of the requirement for asset cashflows to be contractually binding in matching adjustment portfolios enables the inclusion of additional asset classes characterized by highly predictable cashflows.

Although these assets do not have fully fixed cashflows, they provide a high level of predictability within defined contractual parameters. The table below represents a selection of asset classes with potentially eligible highly predictable cashflows:

TABLE 1. A SELECTION OF POSSIBLE HIGHLY PREDICTABLE CASHFLOW ASSETS

Criteria	Dutch residential mortgages (whole loan)	Equity release mortgages (lower rated tranches in securitisations or whole loan)	Infrastructure/CRE debt (construction phase)	Consumer ABS
Spread above risk-free rate	80-150 bps	200-300 bps	150-250 bps	150-200 bps
Credit quality	Excellent – low credit risk	Good – longevity and NNEG risk	Good – construction risk	Variable – depends on credit quality (prime = low–medium risk)
Cash flow predictability	Excellent – amortising, regulated	Good – longevity modelling dependent	Good – subject to completion & ramp-up risk	Variable – credit dependent; amortising helps, but prepayment/ default risk remains higher
Duration matching	Good – supported by long fixed-rate periods	Excellent – 15-30 years (time to exit)	Excellent – 20-40 years	Medium – typically shorter maturities
Capital requirements	Low – counterparty risk module	Low to medium – impact from NNEG and rating	Medium – construction phase lowers rating	Medium – credit enhancement can reduce requirements
Market size /depth	Large – deep underlying market with stable origination.	Medium – higher long-term rates have meant origination has slowed down significantly	Small to medium – construction risk dampens favourability	Medium – substantial market size, but depends on underlying asset class

The different assets are categorized based on criteria pertinent to their suitability for inclusion in a matching adjustment (MA) portfolio. Equity release mortgages (ERM) offer a significant spread premium while maintaining a favorable risk profile and high capital efficiency. However, origination volumes have declined considerably (source: Equity Release Council) due to elevated long-term interest rates, which reduce the attractiveness of equity release products to older homeowners with locked-up home equity. Dutch mortgages represent a substantially larger market and offer diversification advantages for insurers aiming to mitigate their exposure to the UK housing market. Both asset classes are characterized by lower capital requirements, further enhancing capital efficiency.

Other assets, like construction phase commercial real estate (CRE) debt and consumer asset-backed securities (ABS) have more pronounced risk profiles and are to be sourced from smaller markets.

Benchmarking MA assets – Dutch residential mortgages vs. other MA asset classes

Dutch residential mortgages hold an attractive position relative to other asset classes with highly predictable cashflows eligible for the matching adjustment (MA) portfolio. When compared to prominent existing assets within matching adjustment portfolios, whole loan Dutch residential mortgages offer a compelling combination of high excess spread and strong risk characteristics. To quantify this, Dutch residential mortgages have been benchmarked against assets identified by the PRA as significant components of matching adjustment portfolios held by UK insurers.

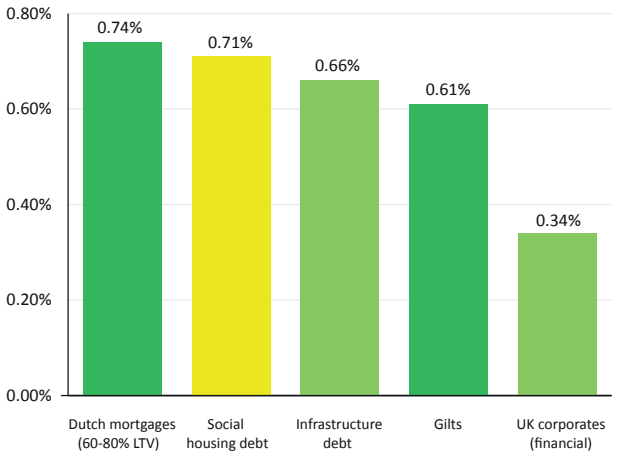
For this benchmark asset with maturities of approximately twenty years have been chosen. This corresponds to whole loan Dutch residential mortgages with a twenty-year fixed-rate period and loan-to-value ratios between 60% and 80%, twenty-year Gilts, AAA-rated corporate bonds (both financial and non-financial), securitised equity release mortgages, and lower-rated investment-grade operational phase infrastructure and social housing debt.

TABLE 2. COMPARATIVE MA BENEFIT FOR SELECTED ASSET CLASSES (20-YEAR HORIZON)

Instrument	Dutch mortgages (60-80% LTV)	20 year Gilts	UK financial corporates	UK non-financial corporates	Euro financial corporates	Euro non-financial corporates	ERM (securitised)	Infra debt (A+/A/A-)	Social housing debt (A+/A/A-)
Gross yield	4.26%	5.43%	5.37%	5.09%	3.32%	3.11%	5.30%	6.00%	6.05%
Risk-free rate	2.90%	4.82%	4.82%	4.82%	2.90%	2.90%	4.82%	4.82%	4.82%
Spread above RFR	1.36%	0.61%	0.55%	0.27%	0.42%	0.21%	0.48%	1.18%	1.23%
Fundamental spread	0.62%	0%	0.21%	0.09%	0.19%	0.08%	0.32%	0.52%	0.52%
MA benefit in %-points	0.74%	0.61%	0.34%	0.18%	0.23%	0.13%	0.16%	0.66%	0.71%

Methodology note: For Dutch residential mortgages, the fundamental spread is formed by internal and external data plus a 10 bp top-up. Fundamental spread for other asset classes is based on monthly PRA Solvency Technical Data releases. Risk-free rate (RFR) is the UK RFR for gilts, UK corporates, ERM, infrastructure debt and social housing debt. For the rest the Euro RFR is used. ERM gross yield is the average across previous securitisations; IG infrastructure/social housing debt gross yield reflects yields from comparable transactions. Foreign exchange risk is assumed to be hedged. Interest rate risk is assumed to be hedged. Numbers and calculations are indicative. Sources: Bloomberg, PRA, Achmea Mortgages.

GRAPH 1. TOP FIVE MA ASSET CLASSES (SORTED BY MA BENEFIT IN %-POINTS). BAR COLOURS INDICATE STANDALONE SCR RANGE (SPREAD RISK OR COUNTER-PARTY DEFAULT RISK).



Standalone SCR ranges

- 0 - 5%
- 5 - 10%
- 10 - 15%
- 15 - 20%

Because of the high spread compared to the risk-free rate, combined with a relatively low fundamental spread, Dutch residential mortgages provide the highest MA benefit in %-points, meaning that they deliver the largest uplift in the discount rate applied to liabilities and therefore the strongest improvement in own funds under Solvency II. This underlines the capital efficiency of including Dutch residential mortgages in a matching adjustment portfolio.

To make the cashflows of Dutch residential mortgages more highly predictable, some kind of tranching through internal securitisation could be used, making sure the tranches with more prepayment risk are disconnected from highly predictable cashflow tranches. Securitized Dutch residential mortgages have already been part of matching adjustment portfolios (source: KPMG). This would increase the capital charge, but as the PRA allows for (after approval) internal modelling to calculate the SCR this could be lowered significantly due to the low-risk nature of the assets. This same internal modelling could be used to lower the SCR on ERM securitisations, reducing the capital charge and therefore increasing efficiency.

Conclusion

The reforms to the Solvency UK matching adjustment have broadened the universe of MA-eligible assets, creating opportunities for insurers to enhance both yield and diversification within their MA portfolios. Our analysis shows that Dutch residential mortgages, in whole loan form, occupy a particularly attractive position: they combine low credit risk, strong duration matching, and substantial market depth with capital efficiency that outperforms many traditional MA assets. Dutch mortgages can deliver an MA benefit that is higher than traditional MA assets, such as gilts and corporate debt, while carrying a low SCR.

While securitisation of Dutch mortgages may further enhance predictability, it would come at the cost of higher capital charges unless internal modelling is applied. Nevertheless, the underlying stability of this asset class suggests such modelling could materially reduce the SCR, reinforcing its role as a high-quality addition to insurers' matching adjustment portfolios.

In the current environment of heightened regulatory flexibility and persistent demand for long-dated, predictable cashflows, Dutch residential mortgages stand out as a strategic complement to UK insurers' existing holdings. They not only offer a strong capital efficiency profile, but also bring meaningful diversification benefits, making them a compelling candidate for inclusion in Solvency UK MA portfolios.

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