BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

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Dear CEO

Solvency II: Equity release mortgages

Today we have published a consultation on proposals to update our Supervisory Statement SS3/17[1], aiming to provide greater clarity to firms on our expectations for how they should ensure that the matching adjustment claimed on restructured equity release mortgages (ERMs) is not overstated. I thought it might be useful to highlight some key points.

The starting point for this discussion is our strong support for the matching adjustment framework. Properly implemented, it appropriately reflects the risks to which annuity writers are exposed and delivers an important prudential benefit by encouraging matching of assets and liabilities. It also has financial stability benefits by allowing insurers to look through short-term volatility in credit spreads, avoiding any undesirable incentives to act pro-cyclically by selling risky assets as market prices fall.

Reflecting this position, the matching adjustment delivers a very significant capital benefit for UK annuity writers. The importance of this part of the prudential framework, and the size of the capital benefit, mean that we and the industry have a shared strategic interest in making sure that all use of the matching adjustment is well-grounded and appropriate.

Coming to ERMs, in basis point terms insurers are now taking the largest Solvency II matching adjustment benefit against the senior notes of restructured ERM portfolios (see chart below). The principal prudential concern addressed by SS3/17 is that compensation for underlying risks to which insurers' matching adjustment portfolios remain subject, particularly the risks associated with the provision of a no-negative-equity guarantee, should not translate into a matching adjustment benefit on the restructured notes. If it did, insurers would be understating their technical provisions and jeopardising their ability to meet their liabilities to policyholders.

The CP addresses three key issues:

1. First, insurers need to assess whether risks associated with the no-negative-equity guarantee have been properly taken into account in the amount of matching adjustment benefit claimed. They should not assess these risks as lower and inflate the matching adjustment claimed by assuming future house price growth in excess of the risk-free rate. Firms may in due course benefit from growth in house prices in excess of the risk-free rate, but they should not reflect this expectation in the form of an "upfront" matching adjustment. This is because ERM redemption payments are ultimately funded by the sale of property, and firms therefore remain exposed to the risk that house price growth above the risk-free rate does not materialise – this is a risk to which

[1] CP13/18 'Solvency II: Equity release mortgages': www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-equity-release-mortgages.

firms are exposed regardless of what view one takes of the most likely future path of house prices and of the fact that insurers are buy-to-hold investors.

2. Second, in economic terms the no-negative-equity guarantee effectively provides the borrower with a put option: they have the right to settle their debt by handing the property to the insurer if it ends up being worth less than the loan and accumulated interest. The value of this option depends on an assessment of the value today of obtaining possession of the property at some point in the future, which the PRA has characterised as a deferment price. The current version of SS3/17 reflects the PRA's view that a deferment price will be lower than the price at which two parties will agree today to transact immediately. This is because actual possession of a property has value, and so people will pay more today to obtain possession today than they will pay today to obtain possession in 10 or 20 years' time. The same rationale explains why properties are sold at a discount to current market value in home reversion plans. The extent to which the current price is higher than the deferment price does not depend on views of future house price growth, because both immediate and deferred possession give exposure to future house price growth. The only difference is the value attributed to possession during the deferment period. The deferment price, expressed annually as a 'deferment rate', can be estimated using reference points such as net rental yields. In our CP today we are consulting on a view that, while a range of judgements is possible, a deferment rate of less than 1% annually would be difficult to justify. This should be reflected in firms' assessment of the economic value of the no-negative-equity guarantee and thus in their matching adjustment calculations. The purpose of this proposal is to provide firms with greater clarity and transparency on the PRA's expectations in this context, as the current version of SS3/17, merely confirms our view that the deferment rate for a property should be positive (i.e. at least 0% annually).

3. Third, these proposals address risks inherent in ERMs. They are neither a consequence of the introduction of the Solvency II regulations nor of the restructuring of ERMs. They are therefore relevant not just to firms incorporating matching adjustment benefit in the calculation of their technical provisions but to any firm currently applying transitional measures on technical provisions to the calculation of its Solvency II technical provisions. The approach to the assessment of no-negative-equity guarantee and other risks arising from ERMs set out in the consultation is of equal relevance to firms with un-restructured ERMs in respect of which they are currently taking the benefit of an illiquidity premium in the transitional measures on technical provisions calculation of their technical provisions under the PRA's pre-Solvency II ICAS regime. For that reason, we are also consulting on the basis that all firms that have invested in ERMs (whether restructured or unrestructured) should properly reflect the no-negative-equity guarantee and other risks posed by ERMs in the calculation of their ICAS technical provisions for the purposes of transitional measures on technical provisions. This is consistent with the approach the PRA set out in SS6/16. We are, however, proposing to allow insurers that would be significantly affected to phase in the expectations in the updated SS3/17 over up to three years.

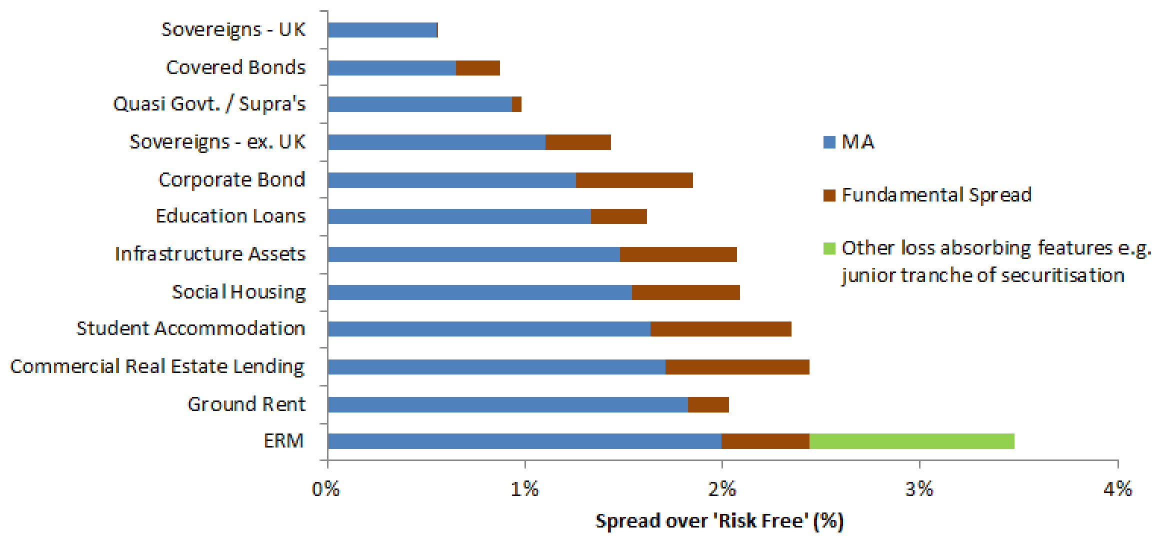
I hope you and your firms will engage positively in our consultation. Our strategic goal is to ensure that the matching adjustment framework remains robust in its application to all eligible asset classes and to avoid any risk that the credibility of this important element of the prudential framework is undermined. We continue to believe that restructured ERMs are an appropriate asset to back annuities as part of a diversified portfolio.

You may find it helpful to copy this letter to your board.

Yours faithfully

David Rule

<u>Chart of Average Matching Adjustment by Asset Class</u>



Source: Bank Calculations based on data submitted by insurers, 31.12.2016. Average Spread by Matching Adjustment Asset Class. Market Value and Duration Weighted results