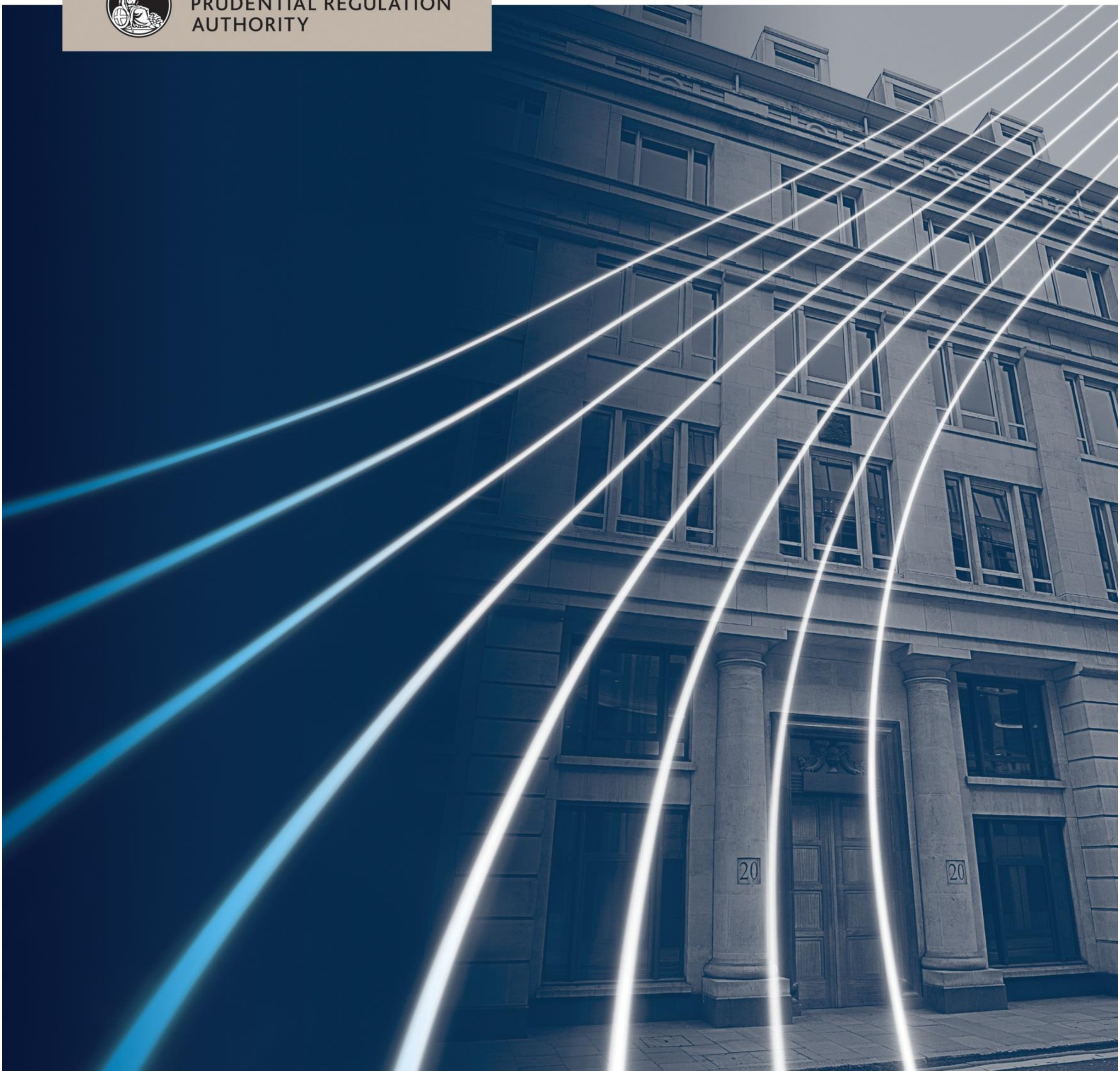
Policy Statement | PS19/19

Solvency II: Equity release mortgages – Part 2

September 2019

BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY



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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Overview

1.1 This Prudential Regulation Authority (PRA) Policy Statement (PS) provides feedback to responses to Consultation Paper (CP) 7/19 'Solvency II: Equity release mortgages – Part 2'.[1] It also contains the PRA's final Supervisory Statement (SS) 3/17 'Solvency II: Matching adjustment – illiquid unrated assets and equity release mortgages' (see Appendix).

1.2 This PS is relevant to insurance and reinsurance companies holding equity release mortgages (ERMs).

Background

1.3 CP7/19 contained proposals in five key areas:

(i) reviewing and updating the minimum deferment rate and volatility parameters in the Effective Value Test (EVT);

(ii) the treatment of assets other than ERM loans held by the Special Purpose Vehicle (SPV) used to restructure ERM loans;

(iii) the frequency with which the EVT would be assessed;

(iv) the treatment of ERM loans where the amount of principal and/or accrued interest at a given future date is uncertain; and

(v) principles for assessing ERM risks in internal model Solvency Capital Requirements (SCRs).

Summary of responses

1.4 The PRA received 12 responses to the CP. The responses were generally supportive in several areas but asked for some clarifications and opposed some of the proposals. In particular most respondents sought additional transparency about the PRA's approach to reviewing the EVT parameters.

1.5 The details of the responses and the PRA's feedback and final decisions are set out in Chapter 2.

Changes to draft policy

1.6 The PRA has made some changes to the draft SS after considering responses to the consultation and further analysis. The changes are as follows:

(i) Amended paragraph 3.13A to note that in some circumstances, it may be appropriate for firms to reach agreement with their supervisors on how to value certain assets other than ERMs for the purpose of the EVT.

(ii) Amended paragraph 3.20A(iv) to note that there is no expectation for firms to allow for the impact on existing lending from discretionary future lending that is not part of a pre-agreed facility.

1 April 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/solvency-ii-equity-release-mortgages-part-2.

(iii) Amended paragraph 3.21A to give more information on the inputs to the PRA's analysis of real interest rates, to clarify that the movement in the minimum deferment rate of at least 0.5 percentage points applies in general but not necessarily in all circumstances, and to state that the PRA will publish a rationale for the parameters as a matter of course.

(iv) Amended paragraph 3.30 to clarify the PRA's expectations on the scenarios that firms are expected to consider when using the EVT in stress as a validation technique.

1.7 The PRA has made some further changes to the draft SS on its own initiative. The changes are as follows:

(i) Amended paragraph 3.25 to clarify how the PRA expects the results of the EVT to be reported.

(ii) Minor typographical corrections and clarifications to internal cross-references.

1.8 Details of the changes are included in Chapter 2. The PRA considers that changes to the SS outlined in paragraph 1.6 and paragraph 1.7(ii) of this PS make the final policy clearer and do not result in any additional burden on firms compared to the original proposals. As a result the PRA has not updated the cost benefit analysis or assessment of the impact on mutuals from the CP in respect of the changes outlined in paragraph 1.6 and paragraph 1.7(ii).

1.9 The PRA has performed a cost benefit analysis in respect of the amendment to paragraph 3.25 of the draft SS relating to communication of EVT results, outlined in paragraph 1.7(i) of this PS. The PRA considers that this amendment will lead to benefits, both in the form of improved assessment of the EVT result on a consistent basis across firms, and in facilitating discussions about the EVT results between firms and their supervisors. The cost of communicating the EVT results in the form expected by paragraph 3.25 is expected to be low, because the information requested is aligned to the calculation of the EVT. The PRA considers that the impact of this amendment on mutuals is expected to be no different from the impact on other firms.

Implementation and next steps

1.10 The expectations set out in the updated SS3/17 will come into effect on Tuesday 31 December 2019, and will supersede the version of SS3/17 published in December 2018 that was due to come into effect on the same date.

1.11 The policy set out in this PS has been designed in the context of the current UK and EU regulatory framework. The PRA will keep the policy under review to assess whether any changes would be required due to changes in the UK regulatory framework, including those arising once any new arrangements with the European Union take effect.

1.12 In the event that the UK leaves the EU with no implementation period in place, the PRA has assessed that the policy would not need to be amended under the EU (Withdrawal) Act 2018 (EUWA). Please see PS5/19 'The Bank of England's amendments to financial services legislation under the European Union (Withdrawal) Act 2018'[2] for further details.

2 April 2019: https://www.bankofengland.co.uk/paper/2019/the-boes-amendments-to-financial-services-legislation-under-the-eu-withdrawal-act-2018.

1.13 The final SS attached to this PS should be read in conjunction with SS1/19 'Non-binding PRA materials: The PRA's approach after the UK's withdrawal from the EU'.[3]

2 Feedback to responses

2.1 The PRA has considered the responses received to the CP. This chapter sets out the PRA's feedback to those responses, and its final decisions. It has been structured broadly along the same lines as the proposals in Chapter 2 of the CP:

A. Reviewing and updating the minimum deferment rate.

B. Reviewing and updating the volatility parameter.

C. The treatment of assets other than ERMs in the EVT.

D. The frequency with which the EVT should be assessed.

E. The treatment of ERM loans with uncertain principal and/or interest.

F. The use of an 'EVT in stress' as a validation technique for internal models.

Two additional sections addressing comments made cover:

G. The consequences of failing to meet the EVT and approaches to mitigating this risk.

H. Further points, including more general issues around ERM valuation and the phasing-in period for firms.

A Reviewing and updating the minimum deferment rate

2.2 The PRA proposed to establish a framework for reviewing the minimum deferment rate and volatility parameters used in the EVT, in which the minimum deferment rate would be reviewed twice a year, in March and September. The minimum deferment rate parameter would not be expected to change in absolute terms by less than 0.5 percentage points, subject to remaining positive. The PRA would increase/reduce the minimum deferment rate if the review showed there had been a material increase/reduction in long-term real risk-free interest rates since the last update.

2.3 Respondents' comments were under the following themes:

(i) the link to long-term real interest rates;

(ii) transparency of the review process;

(iii) the frequency and timeliness of the review process;

(iv) the threshold for changing the minimum deferment rate; and

(v) publication of the updated parameters.

3 April 2019: www.bankofengland.co.uk/prudential-regulation/publication/2019/non-binding-pra-materials-the-pras-approach-after-the-uks-withdrawal-from-the-eu-ss.

A.1 The link to long term real interest rates

2.4 Several respondents welcomed the proposals and noted that they would reduce the sensitivity of the assessment in the EVT of the No-Negative Equity Guarantee (NNEG) to interest rates, although two respondents noted that imperfect correlation between nominal and real interest rates meant that some interest rate volatility would remain. One respondent felt that linking NNEG costs to implied inflation was appropriate since property is a real asset.

2.5 One respondent asked that the PRA explain why the proposed approach would be economically sound and appropriate. Another respondent raised several objections to the proposed methodology, arguing that option prices should be based on risk-neutral methods, and that they should not depend on inflation or property growth expectations, but rather the rental yield given up by the lender. Another respondent asked if metrics other than the real risk-free rate would be considered, including rental yields. Two respondents argued that the minimum deferment rate should be based on typical net rental yields, not interest rates, and should be significantly higher than its current prescribed value.

2.6 The PRA considers that the approach of linking changes in the minimum deferment rate to changes in real interest rates is economically sound and appropriate for the intended purpose of a diagnostic test, for the following reasons:

- Paragraph 2.59 of PS31/18 'Solvency II: Equity release mortgages'[4] noted that the Sportelli formula was one factor considered when setting the minimum deferment rate. The Sportelli formula has been used in land tribunals starting in 2005 to decide the premium payable by a leaseholder to extend the lease. From the perspective of the freeholder, extending a lease is an example of deferring possession and so the formula is one factor that is relevant to deferment rates. The structure of the Sportelli formula is linked to long-term real interest rates. CP13/18 rejected the use of the deferment rate of 4.75% for houses in the Sportelli judgement, on the basis that this rate had been calibrated to a stable view of long-term real interest rates rather than a market view. The calibration of the formula is distinct from its structure, and the PRA considers that the structure of the formula is relevant and useful for reviewing deferment rates.

- The structure of the Sportelli formula can be motivated from first principles by decomposing total property returns in two ways:

(i) as a deferment rate plus long-term capital growth, and

(ii) as the long-term nominal risk-free rate plus a risk premium.

Rearranging this expresses the deferment rate as the long-term nominal risk-free rate, plus a risk premium, less long-term capital growth. The Sportelli formula deducts long-term inflation from both sides to express the deferment rate as the long-term real risk-free rate, plus a risk premium, less real capital growth, and assumes the risk premium and real capital growth elements to be stable over the long term. Under this assumption of stability, changes in deferment rates are directly linked to changes in changes in long-term real risk-free rates. The PRA notes that the assumption of stability is not the same as assuming that one or both of long-term real capital growth and the risk premium are zero.

4 December 2018 (page 1 of 2): https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-equity-release-mortgages.

- The PRA's analysis was aimed at giving a minimum view rather than a best view. The difference between the minimum view and a best view can be regarded as taking effect through the calibration of the risk premium less long-term real capital growth, and as such has no impact on the link to real interest rates, subject to the resulting minimum deferment rate being strictly positive to meet Principle (iii) of SS3/17 paragraph 3.8.[5]

- The PRA considers it is reasonable to treat real capital growth and the risk premium as broadly stable. In respect of real capital growth, the PRA agrees that property is a real asset, and notes that many firms have adopted an approach to valuing ERMs in which real-world nominal property growth is calibrated as long-term inflation plus a stable assumption, prior to making adjustments to arrive at a fair value such as adding a spread to discount rates. The PRA considers it is appropriate to follow Sportelli in treating the long-term risk premium as broadly stable, subject to the next bullet point below.

- Notwithstanding their broad stability, the PRA notes that it is in principle possible for long-term capital growth and the risk premium to vary. In response to such variation, the minimum deferment rate would also need to change in a way that went beyond movements in long-term real interest rates. However, the PRA regards long-term real interest rates as the main driver of changes in the minimum deferment rate, for the reasons set out in the first two bullet points above.

- The PRA considered net rental yields in paragraph 2.59 of PS31/18 and agrees that net rental yields could be a reasonable starting point for determining deferment rates over short terms, as they are a measure of the income foregone by an ERM investor as compared to a direct owner of a property. However, a net rental yield is a short-term measure of deferment. NNEG risk on ERMs is generally immaterial over short terms, because the initial loan is generally small in relation to the property value. Over longer terms, NNEG risk tends to become more material as loan interest accrues, and as noted in paragraph 2.12 of CP13/18, there are term structure effects that lead to longer-term deferment rates departing from net rental yields.

2.7 Some respondents objected to the link to real interest rates on the basis that the approach was difficult to justify and would make risk management more difficult. One respondent noted the potential for step-changes in the EVT results to arise, even in response to small changes in external factors, while another recommended that the PRA use a consistent long-term or smoothed calibration of both the risk-free rate and deferment rates.

2.8 The proposal to link changes in the minimum deferment rate to changes in long-term real interest rates is intended to be appropriate in its own terms, and to reduce sensitivity of the EVT to the level of nominal risk-free rates. The rationale for this is discussed under paragraph 2.6 above. The most recently published value of the minimum deferment rate is intended to be appropriate for use in the EVT in economic conditions at the time of publication, and as those conditions change it is reasonable to expect views on the minimum deferment rate to change, noting that the deferment rate used in the EVT is a minimum view and the PRA considers it appropriate for this to be reviewed less frequently than a best view.

2.9 One respondent suggested that the proposed approach introduced inflation volatility into the balance sheet, which would unnecessarily incentivise inflation-hedging actions. Another

5 'Solvency II: Matching adjustment – illiquid unrated assets and equity release mortgages', September 2019: www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss.

respondent felt that the proposal to link the minimum deferment rate parameter to real interest rates was not justified and represented an inappropriate hybrid of real-world and risk-neutral approaches that would inhibit its ability to hedge the inflation risk that would be introduced, because in this respondent's view the MA benefit should be assessed on a risk-neutral basis and real-world methods were more relevant to projecting the balance sheet forward. This respondent further noted that insurers' own views of property growth were not of primary importance to assessing NNEG risk, and objected that the nominal interest rate used in option valuation should be based on the rate at which someone could borrow money against a property (less an allowance for credit risk), rather than the Solvency II risk-free rate.

2.10 The PRA considers that it would likely be inappropriate to hedge against a minimum view used in a regulatory diagnostic test, in part because a hedge ought to reflect the economics of the risk (as expressed, for example, in the principles set out in paragraph 3.8 of SS3/17) and hence reflect a best view of the deferment rate rather than a minimum view. This view is also informed in part by the considerations set out in paragraph 2.19 below. Furthermore, the assumptions used in a hedging approach (which as just noted would reflect a best view of the deferment rate) would also change from time to time and those changes would also need to be taken into account when hedging.

2.11 As previously noted in paragraph 2.55 of PS 31/18 'Solvency II: Equity release mortgages,[6] the PRA also reminds firms that the EVT is a diagnostic tool, not a valuation methodology. It considers that those responses that concern the use of risk-neutral or real-world approaches may be more relevant to valuation of ERMs.

2.12 For the reasons already set out in paragraph 2.53 of PS31/18, the PRA does not consider it appropriate to use the rate at which someone could borrow against a property, which would typically be higher than the Solvency II risk-free rate; nor would it be appropriate to use a long-term smoothed rate, which would not be consistent with the EVT's use as a test of matching adjustment (MA) benefit.

2.13 The PRA considers that it is in the nature of a minimum view that it should be expected to change less often than a best view, and therefore this may from time to time lead to step changes in the EVT results (as discussed in more detail in paragraph 2.25 below). The PRA notes that it is open to firms to adopt approaches that follow a best estimate deferment rate more closely, and as a result would be likely to mitigate the impact of step changes.

2.14 One respondent felt that the proposed approach would introduce inconsistency between the modelling of cash flows and the NNEG, as cash flows would be linked to inflation while the present value of those cash flows would be linked to nominal interest rates. This respondent also argued that it was inconsistent to set the volatility parameter on a long-term view and the minimum deferment rate on a short-term view.

2.15 The PRA considers there is no inconsistency for the purpose of the EVT between linking NNEG cash flows to implied inflation and the present value of these cash flows to nominal interest rates. Since the ERMs are being restructured with the aim of generating MA benefit, they are necessarily being used for cash-flow matching purposes, and so need to be discounted at rates derived from the basic risk-free rate, which is defined in nominal terms. For similar reasons the PRA considers it would be inappropriate to smooth the risk-free rate

6 December 2018 (page 1 of 2): www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-equity-release-mortgages.

used for discounting in the EVT, as this would also impede the use of restructured ERMs for cash flow matching.

A.2 Transparency of the review process

2.16 Several respondents requested that the PRA be more transparent, with one respondent expressly noting the PRA's obligation to have regards to transparency. Several respondents requested more transparency regarding the process used to review and update the minimum deferment rate parameter, noting that a lack of transparency would make it difficult for firms to manage their risks or perform scenario planning and had the potential to create confusion and inconsistency in the industry. One respondent noted that part of the effectiveness of MA tests relied on their having well-understood dynamics. Specific requests included asking the PRA to provide as much detail as possible on how it had calibrated the minimum deferment rate in current conditions, sufficient for firms to reproduce the results (including reference dates for market information), and publishing worked examples of the calculation of updated parameters. One respondent suggested that the PRA could provide an illustration of how the parameter would have moved under its proposed process since 2008, and one asked the PRA to reserve supervisory judgement for extreme conditions. One respondent expressed the view that the PRA should re-consult in the event of a material data source or methodology change that affects the PRA's determination of the minimum deferment rate. One respondent argued that the economic justification for the current value of 1% was unclear, and one respondent felt that the wording 'minimum of the published value of q' was unhelpful, and could be read to imply that firms should set their own view of the deferment rate.

2.17 Several respondents requested that the PRA codify the approach to setting the minimum deferment rate (one respondent drew a comparison with the Solvency II risk-free rate, for which the methodology is public). One respondent suggested that a lack of transparency could make it difficult for firms to comply with the Prudent Person Principle, if they did not understand their parameter risk. Some respondents asked the PRA to state whether changes in the minimum deferment rate would have a one-to-one relationship with changes in real interest rate movements. Two respondents suggested that a lack of clarity could create a 'regulatory overhang' which would affect the cost of capital. Last, one respondent noted that firms would face uncertainty when trying to plan for the end of the phasing-in period on Friday 31 December 2021, and increased transparency would help mitigate this.

2.18 The PRA recognises the requirement for it to have regards to the principle of exercising its functions as transparently as possible. The PRA considers that this requirement is met by the publication of a framework setting out the general approach it will take when reviewing the parameters, together with a rationale for the parameter values at each review (whether or not the review has resulted in a change in the numerical value of the parameters). Paragraph 3.21A of the final SS has been amended to give more information on the information that the PRA will have regard to in its analyses, prior to exercising judgement, and to state that a rationale will be published as a matter of course rather than when the PRA considers it to be necessary. If the framework for reviewing the parameters were to deviate materially from that set out in SS3/17, any new approach would necessarily be subject to further consultation, as noted in the last bullet point of paragraph 3.21A of SS3/17. The PRA considers that setting out an illustrative history of how the parameters could have moved in past conditions would be disproportionate, since the parameters are not set mechanically and the judgements that could reasonably have been applied at each past date would need to be considered individually. The justification for the value for the minimum deferment rate of 1% was set out in Chapter 2 of CP13/18 with further reasoning in PS31/18 Chapter 2 section B.

2.19 However, the PRA considers that publishing precise formulae and data sources relating to the parameter review process is neither required, nor would it be desirable, for the following reasons:

- The EVT parameters constitute a minimum view intended for use in a diagnostic test on the amount of MA benefit generated by restructured ERMs. The parameters do not collectively constitute a view intended for use in a valuation methodology that directly feeds into the Solvency II balance sheet,[7] and will be published by the PRA, with rationales, well in advance of the date at which they are to be used. As such, the PRA considers that a replicable methodology is not needed in the same way as is the case for the Solvency II risk-free rate, for example.

- To serve their intended purpose, the EVT parameters will not be set mechanistically but will involve an element of judgement. The PRA's judgement will have regard to a range of information. Specifying data sources and methodologies in advance would limit the PRA's ability to exercise judgement eg to adapt to changing circumstances.

- The PRA has not included a best view of the deferment rate in SS3/17, as this is not necessary for the diagnostic purpose of the EVT. However, the PRA notes that it is open to firms to develop their own best view of the deferment rate parameter. This could reasonably have all the properties desired by respondents for the PRA's minimum view, for example firms' own best views could be framed in a way that was predictable and could be changed with a smaller threshold value and at a higher frequency than the PRA parameterisation. The PRA considers that there is a very limited risk that firms would not meet the EVT (based on the PRA's minimum view) by using a credible best views of their own. However, the PRA would consider the evidence put forward by firms for their best views as one potential explanation for failing to meet the test, as envisaged by paragraph 3.22 of SS3/17. For the avoidance of doubt, the PRA is not setting an expectation on firms that they should adopt their own best views of the deferment rate, merely noting that it is open to firms to do so. The PRA is aware from discussions with respondents that other approaches would also be compatible with meeting the EVT on an on-going basis.

- The PRA interprets many of the respondent comments as seeking a high degree of predictability over the way in which the parameters may change, with the consequence that the amount of MA benefit that would be compatible with meeting the EVT can also be predicted, and notes structured to generate this amount of MA benefit. The PRA does not consider this to be an appropriate use of the EVT, which is expressly designed as a diagnostic test based on a minimum view of the deferment rate parameter.

- It is reasonable to expect that new or changed data sources and methodologies will emerge over time, for example the liquidity of some market instruments may increase. It is clearly not possible to assess these changes in advance. The PRA does not consider it necessary or appropriate to re-consult each time it has regard to new data or methods, unless this constitutes a change in the overall framework used to determine the minimum deferment rate.

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[7] PS31/18 paragraph 2.55 states 'The PRA also reminds firms that the EVT is not a valuation methodology and considers that several responses in this area are potentially more relevant to valuation of ERMs than they are to the MA issues that CP13/18 was intended to address.'

2.20 The PRA expects firms to conduct the EVT with a deferment rate at least equal to the published value. The option is available to firms to demonstrate compliance with the EVT using a deferment rate higher than the minimum if they choose to do so.

A.3 The frequency and timeliness of the review process

2.21 Several respondents requested that the PRA consider reviewing the EVT parameters more frequently than every six months, while one noted that real interest rates could move significantly between reviews without compensatory changes in the minimum deferment rate. One respondent wrote in support for the proposals to carry out ad-hoc reviews in times of market shifts. Some respondents suggested publishing 'non-live' parameters quarterly or monthly, and one felt that infrequent updates introduced an unwelcome inconsistency between deferment rates and interest rates. One respondent noted that the proposed three-month lag between publication of updated parameters and their use in the EVT would make it difficult for firms to manage risks, and suggested that the PRA should publish closer to year-end. One respondent asked for firms to have early sight of the value to be published in September 2019, in order to assist with planning for year-end 2019.

2.22 The PRA considers that the proposed six-monthly review process remains appropriate. This is because the deferment rate parameter is intended to constitute a minimum view for use in a diagnostic test, and as such it should not need to change frequently, or be published on a 'non-live' basis. It is open to firms to manage the risks associated with changing interest rates by developing their own best view of the deferment rate and updating it more frequently if they consider that worthwhile. The PRA reiterates that further reviews will be conducted outside the six-monthly review cycle if appropriate (for example, if there is evidence to suggest a sufficiently material shift in the level of long-term real risk-free interest rates since the most recent review).

2.23 The PRA recognises the need for parameters to be reviewed and updated near enough to the time of EVT assessment that they reflect up-to-date market conditions. However, this must be balanced against the need to provide firms with sufficient time to prepare for conducting the EVT. The PRA considers that a three month lead for publishing EVT parameters strikes an appropriate balance between these two goals.

A.4 The threshold for changing the minimum deferment rate

2.24 Many respondents considered that the proposed threshold for changes in the minimum deferment rate of 0.5 percentage points lacked justification and was too high, particularly in a low interest environment, and suggested significantly smaller thresholds to avoid excessive interest rate sensitivity. One respondent argued that the threshold could introduce 'cliff-edges' which could lead to the economic value sometimes being linked to inflation and sometimes to nominal interest rates. Some respondents also felt that having a floor on the deferment rate of 0% would increase interest rate sensitivity. Several respondents suggested that the PRA should clarify that the smallest increase in the minimum deferment rate would be 0.5 percentage points, but that the rate could in principle fall to a value between 0% and 0.5%. One respondent requested that the PRA remove or reduce the thresholds and permit firms to update the parameters themselves, using a published methodology.

2.25 The PRA considers that the proposed threshold of 0.5 percentage points is in most circumstances appropriate to a minimum view and avoids spurious precision, while noting that firms assessing the NNEG according to their own best view may reasonably use a deferment rate that moves with a different threshold. The PRA considers that the 0% floor on the deferment rate is necessary to avoid breaching the third principle stated in paragraph 3.8 of SS3/17.[8] The PRA notes the request for clarification about possible values of the minimum deferment rate, and paragraph 3.21A of SS3/17 has been amended to say that the threshold of 0.5 percentage points will apply in general, to acknowledge that there may be circumstances where a smaller threshold is appropriate. As discussed in paragraph 2.19 above, the PRA does not consider it appropriate to publish a methodology that firms could use to set their own deferment rate.

A.5 Publication of the updated parameters

2.26 One respondent asked that the PRA publish updated parameters in the same place as other regulatory parameters, with an alerting mechanism for when parameters are changed. Another respondent requested that the PRA publish the rationale for its review decision as a matter of course and not just when the parameter values change or when it is considered necessary.

2.27 The PRA will publish the results of the parameter review process on its website.[9] Changes to the parameters will be included in the updates that users of the PRA website can sign up to,[10] and will also be published in the PRA Regulatory Digest.[11] As noted in paragraph 2.18 above, the PRA intends to publish a rationale for its decisions as a matter of course.

B Reviewing and updating the volatility parameter

2.28 CP7/19 proposed that the volatility parameter would be reviewed once a year, by the end of September, having regard to new data on property price returns and relevant advances in techniques for estimating volatility for ERMs. To avoid spurious precision, the PRA would not expect to publish an updated value of the volatility parameter that would lead to its changing in absolute terms by under one percentage point.

2.29 Respondents' comments were under the following themes:

(i) the definition of volatility used in the EVT;

(ii) transparency of the review process;

(iii) the frequency and timeliness of the review process; and

(iv) the threshold for changing the volatility parameter.

B.1 The definition of volatility used in the EVT

2.30 Several respondents noted that the assumption of fixed interest rates used in the Black-Scholes formalism may be inappropriate and suggested that the stochastic nature of the risk-free rate and the deferment rate should be accounted for in the calibration of the volatility parameter, as well as the idiosyncratic behaviour of individual properties. One respondent asked the PRA to clarify what components of volatility had been incorporated into the calibration of the parameter, and suggested that the parameter should have a term structure. Some respondents argued that the interdependence of risk factors, such as prepayment rates with the level of equity remaining in the property, or property prices and interest rates, should

8 SS3/17 paragraph 3.8(iii) states, 'the present value of deferred possession of property should be less than the value of immediate possession'.
9 Available at: www.bankofengland.co.uk/prudential-regulation/key-initiatives/solvency-ii/effective-value-test-parameters.
10 Available at: www.bankofengland.co.uk/subscribe-to-emails.
11 Available at: www.bankofengland.co.uk/news/prudential-regulation?NewsTypes=65d34b0d42784c6bb1dd302c1ed63653&Taxonomies=b0e4487511a44c31b3c239c3d6470f42&InfiniteScrolling=False&Direction=Latest.

be reflected in an adjustment to the volatility parameter. Last, one respondent asked the PRA to clarify that the volatility parameter was based on a long-term view, and would not be expected to change in the short term.

2.31 As noted in paragraph 2.74 of PS31/18, the PRA has calibrated the volatility parameter with reference to historical index volatility, adjusted for autocorrelation over long periods and an allowance for additional volatility experienced by individual properties. There is no allowance for interest rate or deferment rate volatility, nor interaction with prepayment risk, and as a result, the PRA now considers the calibration to be modestly weaker than a best view taking these points into account. The PRA is content not to strengthen the calibration of the volatility parameter at this time because the EVT is designed to be a straightforward diagnostic test of MA benefit based on a minimum view of NNEG risk, so further precision in the volatility calibration is not warranted. However, the PRA considers that some of the points made by respondents could, with further research, constitute appropriate advances in techniques for estimating volatility, and may consider them in the future.

2.32 The PRA nonetheless considers that some of the arguments made regarding the volatility parameter may be valid and relevant for use by firms in the fair valuation of NNEG risk and encourages firms to consider these points in that context.

2.33 The PRA stated in paragraph 2.6 of CP7/19 that the volatility parameter is a long-term view.

B.2 Transparency of the review process

2.34 Some respondents requested that the PRA provide as much detail as possible on how it had calibrated the volatility parameter in current conditions, sufficient for firms to reproduce the results. One respondent asked that the PRA provide examples of scenarios in which it would exercise judgement prior to publication of an updated volatility value, and one respondent noted that the lack of a phasing-in period for the volatility parameter meant additional clarity would be especially helpful for firms' forward planning.

2.35 Similar considerations relevant to the issue of clarity over the process for reviewing the minimum deferment rate also apply to the process for reviewing the volatility parameter. The PRA considers that additional detail beyond that already provided on the calibration of the volatility parameter would limit the PRA's ability to exercise judgement over the appropriate value of this parameter, as discussed in paragraph 2.19 above.

B.3 The frequency and timeliness of the review process

2.36 Several respondents supported the proposal to review the volatility parameter annually, though one respondent commented that the proposed 12-month interval made it difficult for firms to manage their business.

2.37 The PRA considers the proposed review frequency to be appropriate, as the volatility parameter is based on a long-term view and is not expected to change frequently.

B.4 The threshold for changing the volatility parameter

2.38 One respondent requested that the PRA apply a lower threshold (for example 0.5 percentage points) for changing the volatility parameter, and another respondent felt that the proposed threshold was arbitrary and should be justified. Two other respondents indicated they were content with the proposals.

2.39 The PRA considers the proposed threshold of one percentage point to be appropriate to avoid spurious precision and to allow use of judgement as discussed in paragraph 2.19 above.

C The treatment of assets other than ERMs in the EVT

2.40 The PRA proposed that assets held in the same SPV as ERM loans should be taken into account for EVT purposes only to the extent that they served to support the securitisation, and that they should be treated consistently on both sides of the EVT (their balance sheet value should be added to the economic value of ERM cash-flows, while the effective value of the notes should also recognise the balance sheet value of other assets, apportioned between senior and junior notes). Basis risk, counterparty risk and costs should all be appropriately allowed for.

2.41 Respondents' comments broadly supported these proposals. Where objections were received they were under the following themes:

(i) recognition of other assets; and

(ii) valuation of other assets.

C.1 Recognition of other assets

2.42 One respondent commented that it was not clear why assets not supporting risk management of the restructured ERMs should be held in the SPV. Another respondent requested clarity around how such assets should be treated, as there was no easy way to remove them from the effective value side of the test.

2.43 The PRA agrees that it could be difficult for firms to justify the SPV holding other assets for purposes other than risk management, but considers it disproportionate to seek to prohibit this, preferring instead not to take such assets into account in the EVT. The PRA considers that if a firm is holding assets in its SPV that are neither ERMs nor held to support the risk management of ERMs, then it can either develop a system to exclude the value of these assets from effective value, or hold them outside the SPV.

C.2 Valuation of other assets

2.44 Many respondents supported the proposals regarding the treatment of other assets in the EVT. Nevertheless, several respondents expressed concern that there was the potential for inconsistency between the economic and effective value sides of the EVT if assets included in the securitisation for hedging purposes were not valued on the same basis as the NNEG. This could lead to the combination of the NNEG risk and the hedges being valued for the purposes of the EVT in an uneconomic way that could dis-incentivise firms from pursuing appropriate risk mitigation strategies. One respondent asked the PRA to consider assets not fitting the proposed approach on a case-by-case basis, and to include specific references to basis risk.

2.45 In the discussion below, the PRA wishes to be clear for the avoidance of doubt that firms are required to comply with the PRA Rulebook for the valuation of assets for balance sheet purposes, and that any departures from this are being discussed purely for the purpose of conducting the EVT.

2.46 Rule 2.1(1) of the Valuation Part of the PRA Rulebook stipulates that, for a Solvency II firm and unless otherwise provided, assets should be valued at the amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction. For the purpose of the EVT, for assets other than those used as partial hedges for NNEG risk, the PRA does not consider that it would be appropriate to depart from this value. In the particular case of assets used partially to hedge NNEG risk, the PRA does not consider that it would ordinarily be appropriate to deviate from a value calculated in accordance with the PRA Rulebook for the purpose of the EVT, for a number of reasons:

- The parameters used in the EVT basis assume a framework based on an option on an individual property. This includes significant contributions to the volatility parameter from idiosyncratic risk, which goes beyond that arising from index volatility. A partial hedge based on an index would fail to capture this source of volatility.

- Further, the deferment behaviour of a partial hedge may be different from a portfolio of individual properties, and so the appropriate deferment rate to use for a hedge may or may not be the same as the deferment rate to be used for the underlying ERMs, whether on a minimum view or a best view. The PRA considers this is another source of potential basis risk.

- The EVT is based on a minimum view of the deferment rate, for the purposes of a diagnostic test of MA benefit. As such, it is not intended to be used directly for the valuation of ERMs or assets exposed to similar risks.

2.47 Notwithstanding these general points, the PRA recognises that a market for partial ERM hedges could potentially develop and does not seek to prescribe a single treatment for all such assets for the purposes of valuing them in the EVT. In specific cases where the PRA or a firm considers it is appropriate to use a hypothetical valuation for the purposes of the EVT, which departs from the value determined in accordance with the Valuation part of the PRA Rulebook, the appropriate approach used by firms for partial hedging assets should be discussed and agreed with firms' supervisors. The PRA expects that this discussion will cover basis risk, including where relevant the treatment of volatility and deferment rates, and whether the same or different approaches should be used for economic and effective value. Paragraph 3.13A of SS3/17 has been amended to reflect this. However the PRA will expect the firm to justify the relationship between the hypothetical value of the partial hedge for the purposes of the EVT and the allowance for NNEG risk included in the calculation of economic value, before it will agree to consider such alternative valuation approaches for EVT purposes.

D The frequency with which the EVT should be assessed

2.48 The PRA proposed to evaluate the EVT in the following circumstances: a) when restructured ERM notes are established or amended; b) in support of the Supervisory Review Process; c) when recalculating transitional measures on technical provisions (TMTP); d) when a firm has reason to believe that the EVT may no longer be satisfied; and e) on request by the supervisor.

2.49 Several respondents wrote in support of the proposals. One respondent commented that the expectation to carry out the EVT at the end of the financial year could be an unnecessary burden at a busy time, while another respondent suggested that this expectation could be suspended in circumstances where a firm has recently recalculated the EVT following a parameter change in September. Conversely, one respondent suggested that the EVT should be assessed monthly, in line with recalculation of the Solvency II balance sheet. Last, one respondent asked for a proportionate approach to assessing the EVT for TMTP purposes if ERMs are not material to the firm's TMTP.

2.50 The PRA considers that year-end reporting is exactly when the EVT is most useful as a diagnostic test, and it notes that a firm could justify not performing a full recalculation if it could demonstrate that its EVT result is able to withstand recent changes in parameters and market conditions. The PRA further considers that unscheduled recalculations of TMTP are likely to be in response to a change in risk profile, which is an appropriate time to reassess the EVT. The PRA does not consider that setting a general expectation for monthly reassessment of the EVT would be proportionate, although it is open to firms to do in support of their own management processes. Accordingly the policy proposals about frequency are unchanged.

2.51 The PRA has also taken the opportunity to clarify how firms should communicate the results of the EVT (see paragraph 3.25 of the final SS).

E The treatment of ERM loans with uncertain principal and/or interest, including drawdown ERMs

2.52 The PRA proposed two key principles: a) that economic value should not recognise future uncertain principal amounts unless the amount and timing is known in advance; and b) that the impact of potential future lending on existing lending needs to be allowed for. CP7/19 suggested that methods for meeting these principles could include allowing for future drawdowns on a 'best estimate' basis, or using a prudent simplification (regarded as good practice), in which the property value in reduced such that the loan-to-value (LTV) is the same as it would be if all future draws were taken immediately.

2.53 Respondents' comments were under the following themes:

(i) terminology;

(ii) proposed principles;

(iii) methods for meeting the proposed principles; and

(iv) management of drawdown risk.

E.1 Terminology

2.54 Several respondents requested that the PRA clarify its terminology to distinguish between a drawdown ERM (where a customer is provided with a facility to draw upon further loans) and a further advance (an application subject to discretion on the lender's part, with no presumption of acceptance). Two respondents asked that the PRA clarify that the treatment of drawdown loans should be consistent with a funder's internal policy, such that it is not necessary to allow for additional loans that would not be made (for example, if house prices fell).

2.55 The PRA acknowledges that this is a helpful and relevant distinction and has amended paragraph 3.20A(iv) of SS3/17 to clarify that the treatment of uncertain future principal excludes further advances which are subject to new underwriting and not part of a pre-agreed facility, subject to firms demonstrating that in disregarding such further advances they have had appropriate regard to relevant legal and conduct requirements and expectations.

E.2 Proposed principles

2.56 Several respondents supported the principle that the NNEG should reflect the risk of further drawdowns, and that additional interest or return of principal on undrawn loans should not be included in the EVT. One respondent suggested that analogous approaches should be applied to other loan features which lead to uncertainty in loan principal or accrued interest. One respondent noted that the proposal to discuss complex cases with supervisors was positive.

2.57 One respondent felt that ignoring future draws would be prudent if it could be shown that the economic value increase from the additional principal and interest would outweigh the additional NNEG risk, and one argued that to include future draws in the NNEG without also including the future principal and interest would be contradictory and overly prudent.

2.58 The PRA considers that these objections do not address the particular content of the proposed policy. The issue that the PRA is seeking to address is that the security of the existing draws may be affected by future draws, rather than the NNEG risk of the future draws in their own right, and so the PRA does not consider that there is a contradiction or excessive prudence. Paragraph 3.20A(iv) of SS3/17 has been amended to emphasise that NNEG risk on future draws should only be included to the extent that it affects the security of existing notes. In respect of the application to loan features other than drawdowns, the PRA notes that paragraph 3.20A of SS3/17 was drafted to apply generically.

E.3 Methods for meeting the proposed principles

2.59 Some respondents supported the suggested method of scaling down the property value to reflect the risk associated with future draws. One respondent supported the 'best view' approach, suggesting that uncertainty in this area could be incorporated into the allowance for 'other risks'. Some respondents asked for examples to be included of how a firm that could demonstrate credible draw rate experience should apply this over time, including the case where experience suggests that some of the facility will remain undrawn, or how firms should allow for future draws being taken at different customer rates from original rates. One respondent objected to the proposed methods, taking the view that policies with high LTVs would be removed from any pool of securitised mortgages after a stress event, thus removing the risk of future draws endangering the senior note.

2.60 Some respondents felt the suggested methods for meeting the principles were inappropriate or unrepresentative of how future draws affect the LTV, and suggested that the PRA be open to alternative methods, such as adding future draws or fixing the LTV. One respondent suggested allocating property values appropriately among draws in the calculation of the NNEG, while another recommended that in stressed value calculations, it would be sensible to allow for higher drawdown rates in higher inflation scenarios. One respondent objected to the proposals on the basis that a partially drawn policy could have the same NNEG as a fully drawn policy and look relatively riskier despite actually having less risk. Last, one respondent commented that draws taken a long time since inception should give rise to less NNEG risk than draws taken near inception.

2.61 The PRA does not seek to prescribe a set of acceptable methods for meeting the proposed principles and cannot provide examples that anticipate all potential methods. The PRA considers that it is for firms to develop and apply approaches appropriate to the risk profile of their portfolio, including the appropriate allocation of property value (discussing with their supervisor where necessary). The PRA considers that the method proposed (of scaling down the property value) would lead to partially drawn loans having the same relative risk as fully drawn loans, which would be appropriate as a way to reflect the risk of future draws affecting the security of existing loans. CP7/19 proposed an amendment to paragraph 3.23 of SS3/17 to allow for uncertainties in the best view of future draws and this has been retained in the revised SS. As noted in paragraph 2.58 of SS7/18 'Solvency II: Matching adjustment',[12] the PRA expects that any deterioration in the quality of underlying assets should be reflected in the regular updating of the credit rating of the issued notes, rather than by removing assets from the structure. While the PRA is open to a range of methods, the PRA considers some alternative methods, such as adding future draws, would incorporate the principal on those draws into the EVT. This would be contrary to the principle in paragraph 3.20A(i) of SS3/17.

2.62 The PRA agrees that firms should consider whether drawdown rates would increase in a higher inflation scenario. The PRA considers that the risk profile of earlier and later draws will

12 July 2018: www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-2-matching-adjustment-ss.

depend on several conditions, for example property performance, and it is not possible to make general statements about the relationship.

E.4 Management of drawdown risk

2.63 Some respondents suggested that the policy should recognise the ability of firms to manage the risks associated with drawdown facilities (such as the ability to withdraw the facility at their own discretion, or to manage the risk via the pricing of further draws). One respondent noted that firms could manage contagion risk using other means (such as injecting new assets or monitoring the credit rating of notes). One respondent asked for clarity over the level of justification that would be required to support management actions to withdraw the drawdown facility.

2.64 The PRA considers that some of the proposed methods for managing drawdown risk do not mitigate the central concern that this policy is designed to address, which is the risk that additional draws affect the NNEG risk of the existing draws. The PRA does consider that firms could demonstrate the ability to manage this risk if the capacity to withdraw funding meets expectations around legal and franchise risk set out in paragraph 3.20A of SS3/17. The PRA also considers that there is a distinction between assessing risk and mitigating it. The EVT is designed to assess the retained risks of the ERMs, here specifically the risk to existing lending arising from future lending. The PRA considers that injecting assets and monitoring credit ratings may be helpful mitigating actions in some circumstances, but they do not of themselves affect the assessment of the ERM risk in the EVT.

F The use of an 'EVT in stress' as a validation technique for internal models

2.65 The PRA proposed that performing an 'EVT in stress' would be an appropriate internal model validation technique for providing assurance that the amount of MA benefit is not overstated in a modelled stress scenario.

2.66 Respondents' comments were under the following themes:

(i) the use of the EVT in stress as a validation technique;

(ii) scenarios in which the EVT in stress could be tested;

(iii) parametrisation of the EVT in stress; and

(iv) miscellaneous points.

F.1 The use of the EVT in stress as a validation technique

2.67 Several respondents supported the use of the EVT in stress as an internal model validation tool, and agreed that it would not be appropriate to use it as the only validation tool. One respondent suggested that the PRA should allow firms to incorporate the EVT in stress into their primary methodologies.

2.68 Some respondents asked for clarification on the potential implications of failing to meet validation requirements. One respondent objected to the use of the EVT in stress within internal models, on the basis that the EVT does not form part of the calculation of Best Estimate Liabilities (BEL), and hence there should be no need to consider it for the purpose of determining or validating the SCR. This respondent also suggested that any failure of the EVT in stress should be addressed through changes in the SCR methodology rather than in base Technical Provisions.

2.69 The PRA considers that the EVT, being based on a minimum view, is not suitable for use as a primary methodology for calculating capital requirements. This does not prevent the EVT being useful as a validation tool – other validation tools (such as benchmarking) do not form part of the BEL calculation but are nonetheless valuable. Since the EVT in stress is a validation technique for the SCR, the PRA agrees that a failure to meet the EVT in stress may be better approached in the first instance by reviewing the SCR methodology rather than the methodology for base Technical Provisions.

2.70 Some firms suggested that the PRA clarify how the allowance for 'other risks' in the EVT would be treated in stress, and suggested that there is potential for double-counting (for example, with regard to prepayment risk).

2.71 Principle (iv) of SS3/17 discussed in paragraph 3.18 of the SS states that 'when considering the fair value of the ERMs, a rational investor would require compensation above and beyond the average outcome based on their best estimate assumptions, to reflect the risk of loss in adverse scenarios'. The PRA considers that this principle applies in stressed conditions as well as in base. Market participants would continue to require compensation above and beyond the average outcome, and in fact, would be likely to demand additional compensation for the greater uncertainty arising in stressed conditions. Thus the PRA considers that stressing the allowance for 'other risks' would not constitute double counting of the stressed assumptions.

2.72 Nevertheless, proportionality and materiality considerations still apply. As part of their internal model applications (or major model change applications), firms may be able to demonstrate that, in the scenarios in which they are considering the EVT in stress, the impact of stressing the allowance for other risks would not be material, or may be able to justify taking pragmatic approaches on materiality grounds.

F.2 Scenarios in which the EVT in stress could be tested

2.73 Several respondents suggested that for firms with Monte Carlo simulation internal models, the EVT should not be embedded in each stochastic scenario, but should be assessed in the most important scenarios (at the appropriate level of granularity). One firm felt that it would be overly prudent to apply the EVT separately in every component of the internal model, and another suggested that it would be useful to consider a range of upside and downside scenarios.

2.74 The PRA expects that firms should apply the EVT in a sufficiently wide range of scenarios to give reasonable assurance that the MA benefit in stress is not overstated. For internal models based on Monte Carlo simulation, the SCR is a function of the ranking of scenarios as well as the balance sheet values (including the value of the MA benefit) arising in each scenario, and the PRA therefore expects firms to consider the impact of the EVT in stress on the ranking of scenarios. Firms whose internal model is based on Monte Carlo simulations could in principle limit the application of the EVT in stress to a key subset of the scenarios generated, provided they can demonstrate that the results of the test do not indicate that any material re-ranking of simulated scenarios would be required. The PRA considers that it would be good practice to apply the EVT in upside and downside scenarios.

F.3 Parametrisation of the EVT in stress

2.75 Many respondents argued that the calibration of appropriate stresses and correlations for the purposes of the EVT in stress would require more clarity on how the EVT parameters are set in base, and one asked the PRA to clarify that stressing deferment rates was an emerging science. One respondent suggested that codification of movements in base could lead to greater consistency across firms in stress calculations. Several respondents asked for guidance on how deferment rates and property prices should be linked. One respondent said it was not clear how rental yields and deferment rates were correlated to property prices in practice. Another respondent asked for some allowance for the difficulty of obtaining reliable property values in a stress scenario.

2.76 Some respondents asked the PRA to clarify that firms applying the EVT in stress could use their own internal view of real interest rate stresses to infer a stress to the minimum deferment rate, and one asked for firms to be allowed to stress the minimum deferment rate without the 0.5 percentage point threshold. One respondent suggested that a deferment rate stress would likely be derived as a combination of interest rate and inflation stresses, which would re-introduce interest rate exposure. One respondent suggested that the 0% floor on deferment rates could be breached in a stress scenario if property prices are temporarily dislocated. One respondent argued that the EVT had a hybrid real-world/risk-neutral nature which could lead to uneconomic behaviour under stress and could lead to pro-cyclical behaviour from firms. Last, one respondent asked the PRA to clarify that the base calibration of the volatility parameter included an adjustment for the idiosyncratic behaviour of individual properties (relative to an index), and would not need to be introduced in its entirety in stress.

2.77 The PRA expects firms to engage with the principles in paragraph 3.8 of SS3/17 when calibrating an EVT in stress, and notes that model change applications will be reviewed with regard to the Solvency II principle of proportionality. The calibration of an EVT in stress should be based on the firm's own view, rather than necessarily attempting to model the PRA's view, and as such the PRA considers that it would in principle be acceptable for firms to use their own view of real interest rates and to vary the deferment rate continuously (without a threshold for change) if they choose. The PRA expects the deferment rates to remain strictly positive in stress. Similarly, the PRA considers that firms should form their own views about the linkage between deferment rates and property prices in stress, having regard to prospective and historical scenarios for property market downturns.

2.78 For the avoidance of doubt, the PRA notes the volatility parameter is calibrated to include an allowance for idiosyncratic risk as covered in paragraph 2.16 of CP13/18, but firms applying the EVT in stress may choose to consider how this allowance might change.

F.4 Miscellaneous points

2.79 Some firms asked the PRA to confirm that any buffer held in base would not be expected to be maintained in stress. One respondent asked the PRA to confirm that the EVT in stress will not be considered to be subject to requirements around model and parameter error under Article 229(g) of the Delegated Regulation[13].

2.80 The PRA considers that as the EVT is based on a minimum view, firms are not required to hold any specific buffer above that view in base or in stress, and that if firms are using a buffer for risk management purposes in base, it would be disproportionate to expect this buffer to be maintained under stress. The PRA considers that Article 229(g) of the Delegated Regulations would not be applicable to the EVT in stress used as a validation tool, rather than a primary internal model methodology.

2.81 One respondent argued that where the EVT in stress validation led to a significant increase in a firm's SCR, this excess should be subject to TMTP relief, through a TMTP recalculation documented in advance as a future management action.

13 Commission Delegated Regulation (EU) 2015/35.

2.82 The PRA does not consider the issue of TMTP recalculations (or other future management actions that depend on PRA approval being obtained) in an internal model to be limited to the EVT in stress; in general, the appropriateness or otherwise of such modelling will depend on individual firms' circumstances, and will be dealt with bilaterally as part of internal model (change) applications. All future management actions included in an approved internal model, including any recalculation of TMTP in stress, must meet the requirements of Article 236 of the Delegated Regulation, in particular that the future management action is realistic, not contrary to legal provisions and consistent with other future management actions. Firms must also take into account the time needed to implement the action in practice.

G The consequences of failing to meet the EVT and approaches to mitigating this risk

2.83 Proposals on this topic were not included in CP7/19, but several respondents made comments in this area, under the following themes:

(i) preventing failures to meet the EVT; and

(ii) appropriate actions in response to a failure to meet the EVT.

G.1 Preventing failures to meet the EVT

2.84 Several respondents requested that the PRA confirm that there would be no specific regulatory expectation for headroom or a buffer to be held above the EVT. While one respondent acknowledged that a buffer was one way of preventing repeated breaches, some respondents made arguments against holding a buffer, including that it would prevent firms from recognising positive experience variation in property performance, that it would represent excessive prudence if the EVT were already calibrated with prudent views of the parameters, and that resilience buffers should be recognised in rating stresses rather than the EVT. One respondent expressed concern that a resilience buffer over the EVT could become a biting test that drives the EVT result, and took the view that a deferment rate buffer was only needed because the parameter was insufficiently sensitive to risk factor movements. This respondent also commented that, as interest rates varied, a fixed buffer over the EVT would not provide a consistent level of headroom expressed in terms of the probability of breaching the EVT. One respondent suggested that if firms did not hold headroom in a 1-in-200 stress, any prudence in Own Funds would be released in the SCR, leading to volatile excess Own Funds.

2.85 One respondent noted that firms may be expected to adjust their MA if stakeholders expect a buffer to be maintained over time. Another respondent request that the EVT be considered in aggregate across multiple securitisation structures, rather than individually.

2.86 The PRA expects that firms will not experience regular breaches of the EVT, and while it does not prescribe particular approaches to managing this risk, it notes that headroom is one way of achieving this result. The PRA does not agree with those respondents who expressed concern about excessive prudence; as the EVT is expressly designed as a minimum view, the PRA considers that by definition it is not prudent.

2.87 The express purpose of the EVT is to ensure that MA benefit is not overstated; it does not set any expectations for stakeholder management, nor does it expect firms to hold a buffer providing headroom, with or without any constant level of probability. Further, the PRA does not consider it appropriate to include any notion of fungibility between securitisations in the EVT, which would be incompatible with MA rules, and so expects the EVT to be applied to each securitisation individually. The PRA considers that it is open to firms to hold some headroom in stress to mitigate volatility of excess own funds, if they so wish.

G.2 Appropriate actions in response to a failure to meet the EVT.

2.88 Several respondents asked for clarity regarding the PRA's expectations in the event of failing to meet the EVT, and requested that a range of flexible actions could be taken (for example, holding a temporary additional provision). Some respondents also requested that the PRA respond sympathetically to breaches of the EVT that are not material or are temporary in nature, and that firms should be allowed to take long-term views of the reasonableness of a securitisation structure.

2.89 As established in paragraph 2.90 of PS31/18, the PRA does not consider it appropriate to hold temporary additional provisions to remedy an underlying failure to meet Solvency II requirements for the valuation of liabilities. Paragraph 2.90 of PS31/18 also notes that the failure to meet the EVT does not give rise to automatic regulatory consequences. The PRA does not consider it appropriate to prescribe specific responses, and the appropriate actions will need to be discussed with the firm's supervisors in accordance with paragraph 3.22 of SS3/17.

H Further points, including more general issues around ERM valuation and the phasing-in period for firms.

2.90 Respondents to CP7/19 made additional points, under the following themes:

(i) ERM valuation;

(ii) the competitiveness of the ERM market; and

(iii) the phasing-in period.

H.1 ERM valuation

2.91 One respondent asked the PRA to clarify that the EVT is only intended as a boundary test for MA benefit on complex securitisation structures and not a valuation method. This respondent further expressed concern that not every firm would be comfortable owning an internal view of the deferment rate parameter, which could lead to inconsistency across the industry.

2.92 Another respondent requested that the PRA assert that good practice for valuation of ERMs should be based on market consistency, and that the PRA should impose market consistency requirements on firms' own assumptions around the deferment rate. This respondent also requested that the PRA make clear that good practice valuation should not be swayed by profitability incentives.

2.93 The PRA is clear that the EVT is intended as a diagnostic test of MA benefit, rather than a best estimate valuation technique. Nevertheless, the PRA has previously[14] encouraged firms and their auditors to consider methods for ERM valuation that meet the principles set out in paragraph 3.8 of SS3/17, as these principles were first consulted on in 2016 and since then have received no credible challenges. The PRA does not consider uniformity of best views on appropriate deferment rates necessarily to be desirable.

H.2 The competitiveness of the ERM market

2.94 One respondent commented that it was key to the ongoing sustainability of the ERM market that the regulatory treatment balanced managing the risks in a sound and prudent manner with the ability to deliver products that offered value to customers. One respondent

[14] See David Rule's (formerly Executive Director for Insurance Supervision) 'Dear CEO' letter published 3 April 2019 at www.bankofengland.co.uk/prudential-regulation/letter/2019/solvency-ii-equity-release-mortgages-part-2-apr-19.

reiterated concerns with the EVT in concept, arguing that it was not required by Solvency II, that it used a risk-neutral calibration of the NNEG which was not reflective of firms' true risk exposures and would put UK firms at a competitive disadvantage to other ERM providers (which would lead to a drain of business overseas).

2.95 The PRA considers the EVT to be a proportionate means of supporting its statutory objectives. The PRA considers that there is no incompatibility between the EVT and Solvency II: the EVT is not an addition or overlay to Solvency II requirements but a diagnostic test that the PRA expects firms to carry out as a means of monitoring compliance with Solvency II requirements relating to the calculation of the Fundamental Spread (FS) and thus the MA in the case where MA liabilities are matched with restructured ERMs. The PRA notes that property risks are retained in full by insurers holding ERMs, as discussed at greater length in paragraph 2.20 of PS31/18, and so the PRA remains of the view that the risk-neutral calibration of the EVT is appropriate.

2.96 The PRA considers that its policy is an appropriate part of the implementation of Solvency II so that the risks associated with ERMs are properly reflected in insurers' balance sheets. Any transfer of risk to non-UK providers would not therefore reflect excessive UK regulatory requirements. To the extent that ERM risks are transferred overseas, the PRA will discuss the risks with the relevant regulators. The PRA supports common international standards for internationally active insurers and reinsurers.

H.3 The phasing-in period

2.97 Paragraph 3.21 of SS3/17 established that firms could use a phasing-in period, whereby a minimum deferment rate of 0% could be used before 31/12/2021, and 1% thereafter. Several respondents requested that the PRA clarify whether the use of this phasing-in period would require an application and whether it would be granted to a firm that already met the EVT using a deferment rate of 1%. One respondent asked if a firm that could pass the EVT with a deferment rate of 1% would be expected to stress that parameter in any EVT in stress validation prior to Friday 31 December 2021.

2.98 The PRA reiterates that firms will not be required to apply for approval to use the phasing-in period, and considers that the text of SS3/17 is clear on this point. However firms that have already elected to meet the EVT using a positive deferment rate (eg 1% in PS31/18) will not be expected to depart from the published calibration. Firms wishing to make an internal model change regarding the treatment of securitised ERMs will be expected to discuss their approach with their supervisor in the usual manner.

Appendix

SS3/17 'Solvency II: Matching adjustment – illiquid unrated assets and equity release mortgages' available at: https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss