Risk Transfer Market Update:

PRA consultation and impact on the bulk annuity market

The Prudential Regulation Authority (PRA) issued a consultation this week that should be of interest to pension schemes considering buy-in or buy-out. The consultation has the potential to increase buy-in and buy-out pricing for some insurers, and if implemented as proposed, could also have a significant impact on insurer solvency levels.

The consultation relates to insurers' use of equity release mortgages as an asset class to back buy-in and buy-out business. The PRA has expressed concerns that some insurers should be holding additional capital when using these assets.

The consultation closes on 30 September 2018 and the proposals are timetabled for implementation on 31 December 2018. We expect that many insurers will take a prudent approach and factor in the potential impact of the proposals immediately when pricing new business.

What does this mean?

- **Possible buy-in/buy-out price increases** for insurers who have been using equity release assets to support pricing on new business.
- **Possible quotation or transaction delays** while insurers digest the new proposals and quantify their impact.
- **Potentially significant impact on solvency levels for insurers**, where a material proportion of their entire portfolio is invested in equity release, unless mitigating actions are taken to dampen the impact of such proposals should they be implemented as set out.

How should pension schemes respond?

- Schemes who are considering or actively seeking buy-in or buy-out should ensure that these new proposals are understood and, where necessary, update information already presented in order to support any decisions taken to date or current plans, for example shortlisting of insurers or transaction timeline.
- Schemes who plan on entering into a buy-in or buy-out prior to 31 December 2018 should seek to understand the potential impact of these proposals on the solvency level of their chosen insurer and the mitigation actions of the insurer to deal with the proposals.
- Schemes who have buy-ins in place should monitor the situation to understand any potential longer term solvency impact on their insurer.

What is equity release and why do insurers invest in it?

An equity release mortgage is a way of homeowners borrowing against the value of their home. Equity release mortgages (ERM) come in many varieties. When viewed as an asset class from the perspective of an insurer, a typical equity release mortgage involves a single capital outlay at the point of lending money to an individual, with no regular interest payments due, and the full capital sum repayable with accrued interest at the point of the borrower's death or move into long term care. The loan is secured against the individual's home, and as it is typically repaid by selling the home, the repayment amount is capped at the property value. This is known as a no negative equity guarantee.

Due to the long term of these loans, ERM can form a helpful component of an insurer's asset portfolio used to back annuity liabilities, and to date the yield on ERM has compared very favourably with other long term alternatives.

What are the risks that the PRA is concerned about?

The PRA's main concern is around the allowance insurers make for the no negative equity guarantee. This guarantee will bite (and the insurer will lose money) if the compounding of the loan with interest coupled with stagnant property prices means that the loan becomes greater than the property value.

Will the proposals materially impact buy-in and buy-out pricing?

While these are only proposals, insurers will be concerned that they will be adopted on 31 December 2018, and so may well act prudently and allow for them in their current pricing. Different insurers use different proportions of ERM to support new business pricing and some insurers' assumptions when using these assets are less prudent than the PRA has proposed. We therefore do expect that for some insurers their pricing is likely to rise. For others, ERM is either a smaller proportion of the portfolio supporting their pricing or they are already being sufficiently prudent in respect of the credit taken for ERM. Since the proposals would impact some insurers more than others, any schemes who are actively considering a buy-in or buy-out and have already shortlisted insurers should review their shortlisting decisions to ensure that they remain appropriate.

Will it materially impact the solvency levels of insurers?

The PRA performs a very close oversight role of insurers, and as such will have a high level of insight into the assumptions insurers are currently applying to ERM. The PRA itself acknowledges in the consultation paper that the impact "may be significant for some firms". In such cases the PRA would consider a phased in approach, but unlikely to be more than over a 3 year period.

Whether or not it materially impacts the solvency level of an insurer is not necessarily connected to the impact on new business pricing, as it depends on the level of ERM that the insurer has in their entire portfolio, not just what they are using to back new business. As they currently stand, the PRA's proposals have the potential to have a material impact on a minority of insurers.

While the proposals are not yet final, we recommend that schemes who are considering a buy-in or buy-out prior to 31 December 2018 seek to understand their potential impact on the solvency level of their chosen insurer, in order to ensure that the Scheme remains comfortable with the financial security offered by the insurer before entering into a transaction. This may mean that some schemes choose to delay some buy-in or buy-out processes until there is further clarity around the degree of this impact. We expect insurers will look to provide further details to allay any concerns that may arise during the course of the consultation period.

My Scheme has previously secured a buy-in. Should I be concerned?

This consultation shows some of the benefits of a pro-active regulatory environment, which should give schemes comfort about the insurance regime. The protections of the regime remain, and if the proposals are enacted and do have a material impact on the solvency levels of any insurers, we expect the regulator to work closely with them to facilitate recapitalisation or in extremis a transfer of business to insurers who are less exposed to ERM. We certainly recommend that schemes closely monitor developments in this area and the impact on their particular insurer.

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