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Solvency II newsflash

PRA issues CP on real estate loans and internal ratings

On 27 September 2019, the Prudential Regulation Authority ("PRA") published CP23/19, setting out its proposed expectations for insurers investing in certain types of property-backed debt – referred to as income producing real estate ("IPRE") loans – as well as elaborating on its expectations for the use of internal credit assessments for assets held in matching adjustment ("MA") portfolios. While much of the consultation paper ("CP") is aimed at internal model ("IM") firms, certain points are addressed to Standard Formula firms. The CP will also be of interest to asset managers who either manage, or have ambitions to manage, illiquid assets for insurance clients.

In this newsflash, after introducing the category of IPRE, we focus on:

- The importance of risk identification
- Internal ratings
- Internal models and the fundamental spread in stress
- Next steps

What are income producing real estate loans?

IPRE loans are defined by the PRA as 'a method of providing funding to real estate where the prospects for repayment and recovery on the loan primarily depend on the cash flows generated by the asset'. A common category of IPRE lending in UK insurers' investment portfolios is commercial mortgage loans ("CMLs"); typically structured as a loan to a special purpose vehicle ("SPV") that owns one or more commercial properties, with the property acting as security for the loan.

However, the broad definition of IPRE indicates that the regulator intends for its expectations to be applied to a wider range of real estate-backed assets, which could include lending against social housing, student accommodation, ground rents or private rental sector assets. Indeed, the PRA 'encourages firms to consider whether the proposed expectations are applicable to other relevant assets within their portfolios'. Looking beyond real estate, firms will likely identify infrastructure loans as one such 'other relevant asset'.

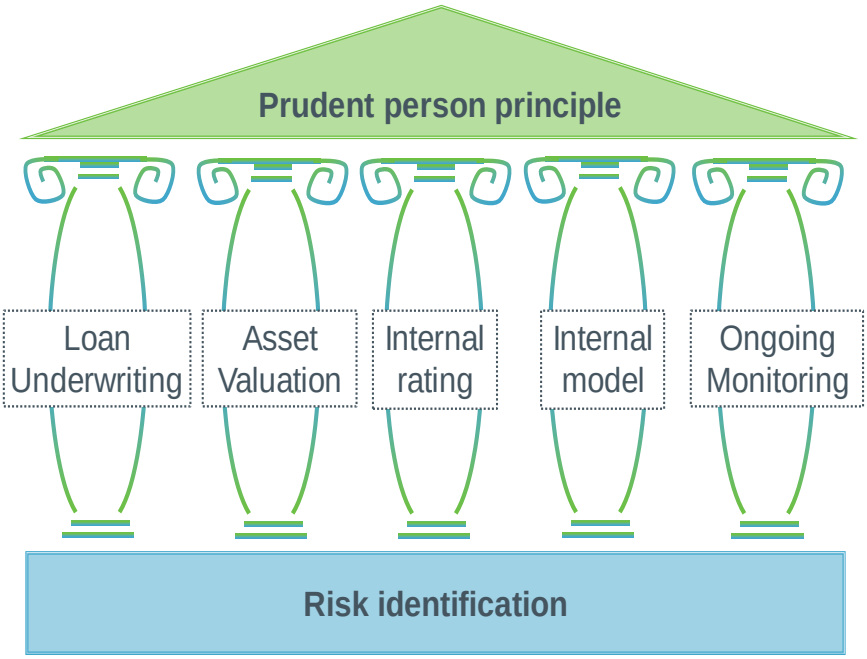
Firms should consider the wider applicability of the requirements of CP23/19 to other assets in their portfolios.

Risk identification is key

The central message of the CP is that the PRA considers **thorough risk identification to be of paramount importance for insurers investing in illiquid assets**. The PRA provides six reasons why this is particularly the case for investment in IPRE loans when compared to corporate bonds:

1. Loans are heterogenous in nature and, therefore, it is important to assess both systemic and idiosyncratic risks;
2. It is impossible to perform a quantitative risk assessment based on market data due to the lack of a deep and liquid market;
3. Investment in loans may increase concentration risk and exposure to certain systemic risks – here the PRA suggests that IPRE loans may bring greater exposure to political- and climate-related risks;
4. The lack of public ratings places greater reliance on insurers' internal rating and ongoing monitoring processes;
5. There are risks to performance arising from the insurer's own management capabilities and that of third parties;
6. Lack of liquidity means that it is hard to sell assets in distress or when circumstances compel the firm to do so.

For an insurer regulated under Solvency II, risk identification serves as the foundation for meeting the Prudent Person Principle requirement to 'only invest in assets and instruments the risks of which it can properly identify, measure, monitor, manage, control and report, and appropriately take into account in the assessment of its overall solvency needs.' As illustrated to the right, activities supported by risk identification include loan underwriting, asset valuation, assigning internal ratings, internal model calibration and ongoing monitoring. Not all these steps will necessarily be carried out by the insurer – for example, valuations may be provided by asset managers – but all are referenced in the CP and are linked through a reliance on risk identification.



Firms should assess how best to integrate the activities required for effective risk, capital and performance management of IPRE loans.

IPRE risks

The PRA proposes that a firm's risk identification exercise should cover 'all sources of risks that the firm could be exposed to in relation to their IPRE loans'. The PRA states that, at a minimum, the exercise should encompass the following:

Broad category	Factors
External market factors	Supply vs demand, interest rates, economic growth
Cash-flow predictability	Tenant quality, lease terms, voids, re-lettings
Collateral	Location, design, condition, property and valuation risks, ability to realise the collateral (work-out), securit package
Loan characteristics	Leverage, serviceability, pre-payment risk, refinancing risk, covenants, structural protections
Risks arising from third parties	Sponsor strength, servicing and managing agents (for the loan, SPV and/or underlying properties)
Other	Concentration, basis, liquidity, legal, political and regulatory risks

The CP makes it clear that the PRA does not intend this to be taken as an exhaustive list and nor is it expected to be a one-off exercise. To meet the requirements, firms will need to conduct the exercise at the point of loan origination and keep it updated as exposures and circumstances develop and change.

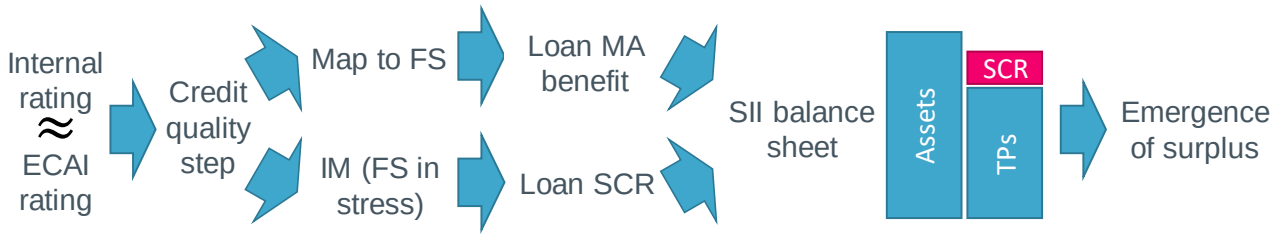
1. **Firms should assess whether they have the required skills to perform the risk identification exercise; and**
2. **Firms will need to develop systems and processes to gather and parse the required data in a timely, accurate and repeatable manner.**

Internal ratings

IPRE loans and many other forms of illiquid private debt are not typically rated by external credit assessment institutions ("ECAIs") and, therefore, internal ratings placed on these assets can be highly significant for a firm's regulatory capital position – particularly when these assets are held in MA portfolios. Generally, internal ratings are linked to:

- The fundamental spread ("FS") used to haircut a loan's cash flows when calculating the MA and, therefore, the value of technical provisions ("TPs") in the Solvency II balance sheet;
- The solvency capital requirement ("SCR") applying to the loan (see internal models section below).

Together, the level of MA benefit achieved, and the amount of SCR held, have a significant impact on the capital efficiency of these assets. This in turn has an impact on a firm's ability to provide new business competitively or to achieve desired levels of cash generation from its back book.



jThe PRA has already set out expectations around the use of internal credit assessments for assigning fundamental spreads to assets held in MA portfolios in Supervisory Statement SS3/17. The CP further develops these expectations in respect of all internally rated MA assets (as opposed to solely for IPRE loans).

The PRA re-emphasises the importance of consistency with ratings provided by ECAIs – that an internal rating, when mapped to the Solvency II credit quality step scale (0 = AAA, 1 = AA, etc.), should be plausibly aligned to the rating that could have arisen from a rating provided by an ECAI. There is a certain irony here in that the Solvency II Delegated Regulation encourages development of internal ratings 'in order to reduce overreliance on external ratings.'

The new material on internal ratings in the CP focuses on how insurers should document and demonstrate that their approaches are robust. Ensuring that the internal rating reflects the output of a thorough risk identification exercise is central to this, but the PRA also highlights several other factors, as illustrated in the graphic to the right.

Many firms will feel that they are not best placed to carry out the internal rating process, preferring to outsource this activity to their asset manager. Where this is the case, the PRA expects firms 'to also demonstrate the effectiveness of the systems and processes the outsourcer has in place, including validation, to ensure that outsourced internal credit assessments for assets satisfy the expectations'.

Some insurers may conclude that it is preferable to develop their own internal rating process rather than attempt to validate that of a third party to the standards required by the regulator.

Firms should review their internal ratings approaches against the requirements of CP23/19, taking into account not only their current portfolios, but also their plans for future investment in new assets.

Internal models

In Supervisory Statement SS8/18, the PRA set out a five-step process for determining the MA within the calculation of the SCR. The PRA's proposed expectations for internal models in CP23/19 are aligned to this process. The five steps are set out below, along with our comments on CP23/19. While the CP focuses on assets held in MA portfolios, the first step – stressing the asset value – is relevant wherever IPRE loans are held on the balance sheet.

Step	Our comments and references to CP23/19
1. Re-value the MA portfolio assets under a one-year stress	The PRA 'does not have a preference on the approach taken by firms to model the risks on IPRE loans, subject to the chosen approach meeting the relevant tests and standards. For example, firms may choose to model a proxy for the IPRE loan exposures, or to model the underlying IPRE loan risk drivers directly.' The CP references one potential "direct" approach – deriving 'an implied transition matrix by stressing inputs into the internal credit rating model'[1]. The PRA makes it clear that, however a firm chooses to model IPRE loans, the approach should reflect the output of the risk identification exercise. The PRA notes 'that firms may have more limited data for IPRE loans than for other types of asset that are traded more frequently' and therefore **expert judgements ("EJs") may play a greater role** in the internal model calibration than for other assets. Consistent with its views on what constitutes a robust internal rating approach, the PRA emphasises the importance of EJs being credible, subject to appropriate governance, and 'based on the expertise of persons with the appropriate skills and experience'. The PRA suggests that firms should re-value the assets in stress consistent with how they are valued in the base balance sheet, but potentially with additional adjustments for valuation uncertainty and modelled errors. Asset valuation is often outsourced (e.g. to asset managers), so firms may need support in this area.
2. Calculate updated fundamental spread values, reflecting the stressed modelled economic environment	Again, the PRA expresses agnosticism around how exactly the fundamental spread ("FS") is stressed, but highlights the importance of linking the stressed FS to the risk identification exercise. The CP, like SS3/17 before it, refers to the language used in Article 77c of the Solvency II Omnibus II Directive that 'the MA must not include the fundamental spread reflecting the risks retained by the insurance or reinsurance undertaking'. The PRA suggests that one appropriate validation tool for the stressed FS calculation should be a 'mechanistic reapplication of the methodology used to assign the FS for the purposes of calculating the technical provisions' in the stressed environment – sometimes referred to as the "EIOPA-in-a-box" approach. In the PRA's view, such an approach is likely to underestimate the "true" increase in the level of retained risk and, therefore, such an approach should set a floor for the level of stressed fundamental spread.
3-5. Verify if MA qualifying conditions are still met; if necessary, determine cost of re-establishing MA compliance; re-calculate the MA	These three steps concern whether the portfolio continues to comply with the MA requirements post-stress. The CP adds some specific considerations for IPRE loans: - The MA portfolio could be rebalanced by transferring in IPRE loans held elsewhere on the balance sheet. However, the PRA would expect a clear demonstration of these assets' MA eligibility. It is unlikely to be acceptable for firms to assume that loans can be sourced externally. - The PRA would not usually expect firms to rely on being able to sell IPRE loans to fund the purchase of new assets to re-balance the portfolio. If this action is assumed, the PRA requires strong evidence of its viability.

[1] In this case, firms must assess the "shape" of the resulting transition matrix and 'consider the binary effect of credit transitions on individual IPRE loans and the impact of name level concentration risks.'

Implications for Standard Formula firms

Despite a number of areas of the CP being addressed to internal model firms, the PRA expects Standard Formula firms investing in IPRE loans to also conduct a risk identification exercise. This exercise should feed into the firm's assessment of Standard Formula appropriateness. If the conclusion is that the Standard Formula does not reflect the firm's risk profile, the PRA suggests that the firm 'may need to consider whether it should use a partial internal model to calculate the SCR.'

Standard Formula firms with exposure to IPRE loans, or illiquid assets with similar features, should review the requirements for a risk identification exercise and the potential implications for Standard Formula appropriateness.

Next steps

Following the consultation period, which closes on 27 December 2019, the PRA proposes to implement its proposals by 31 March 2020 through an update to Supervisory Statement SS3/17.

There are certain "no regret" actions that firms can take immediately:

1. Assess the relevance of the CP to assets on your balance sheet today – not just IPRE loans – and to your plans for future investments in alternative assets;
2. Conduct a gap analysis of your current treatment of IPRE loans and other relevant assets against the proposed requirements; and
3. Based on the results of the gap analysis, identify priority areas for development.

Hymans Robertson has a wealth of Solvency II, Illiquid Asset, Internal Model and Matching Adjustment experience. Our consultants would be delighted to support you to evaluate the impact of CP23/19 on your business.

If you would like to discuss with one of our specialists, please get in touch.

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