HYMANS ROBERTSON

Solvency II newsflash

PRA consultation on equity release mortgages – Part 2

On 3 April 2019, the Prudential Regulation Authority ('PRA') published the second part of its consultation on Equity Release Mortgages ('ERMs'), CP7/19. As highlighted in the policy statement it issued as part of the first consultation, PS31/18, the PRA identified the following areas where it is consulting further:

- When and how the PRA publishes updated values for the deferment rate and the volatility parameter that form part of the Effective Value Test (the 'EVT');
- The treatment of other assets in the same Special Purpose Vehicle ('SPV') as the ERMs;
- The frequency that firms are required to assess the EVT; and
- Principles for how the PRA would assess the approaches firms could use to model the risks associated with ERMs in their internal models, including the application of EVT and varying the deferment rate assumption under stress.

In addition to the areas above, the PRA is also consulting on the approach for ERMs with an uncertain principal amount and accrued interest at exit, e.g. loans with further advances or the option for borrowers to pay back some (or all) of the interest.

The consultation closes on 3 July 2019.

Details of the outcome of the PRA's first consultation paper on equity release mortgages following publication of PS 31/18 can be found in our previous ERM newsflash.

PRA's proposals at a glance

Area	What does CP7/19 say?
Reviewing and updating the deferment rate and volatility parameter	The PRA proposes that the deferment rate is reviewed twice a year, in March and September, and that the volatility parameter is reviewed annually, by September each year (updates for each will only be published if they change by an absolute amount more than 0.5% and 1% respectively). In addition, the PRA proposes that it can perform ad-hoc updates to the parameters. The PRA has clarified that although the deferment rate will be published by September 2019, firms who opt to make use of the phase-in period are not expected to use the published rate. The volatility parameter published in September 2019 must be used from 31 December 2019 onwards (i.e. no phasing-in period).
Treatment of assets other than ERMs in the SPV	The PRA has clarified that it only expects assets other than ERMs in the same SPV to be considered if they are held for supporting the restructuring of the ERMs. For the EVT, the balance sheet values of these assets will need to be added to the economic value of the ERM loans. This amount should be equally recognised within the effective value and apportioned between the notes post-restructuring. The PRA also expects firms to consider the basis risk and counterparty risks arising from non-ERM assets and to incorporate any costs associated with the non-ERM assets – for example commitment fees on any liquidity arrangements.

Area	What does CP7/19 say?
Allowing for uncertain loan principal and accrued interest	Given the wide range of potential customer options included in ERM loans, the PRA says that the economic value of ERMs at the EVT assessment date should not consider future principal amounts or accrued interest, where these are uncertain (for example, where a borrower has an agreed future drawdown facility remaining). However, when assessing the no-negative Equity Guarantee ('NNEG') within the EVT, the PRA expects firms to reflect their best estimate view of borrower behaviour in future assumed advances. Firms are then required to reflect the risks of borrower behaviour being out of line with their best estimate view within the allowance for "other risks" in the calculation of the economic value of an ERM in the EVT. Firms are required to discuss their approaches to NNEG risks with the PRA where there are potentially multiple advances that are not fixed in timing or amount.
Frequency of EVT assessments	The PRA has clarified the circumstances where it expects the EVT assessment to be conducted. The PRA expects firms to communicate the results of their EVT assessments promptly, and as soon as possible if the EVT assessment indicates that an inappropriately large matching adjustment benefit may be derived from the ERMs.
Principles for assessing Internal Model SCR	The PRA proposes an 'EVT in stress' which compares the stressed economic value of the ERMs with the stressed effective value of the restructured ERMs, taking into account the change in ratings and spreads. The PRA expects firms to develop their own approach to stressing the deferment rate and volatility parameter, which should be consistent with the confidence level of a 99.5% over one-year period.

Allowing for uncertain loan principal and accrued interest

The Equity Release Council's (the 'ERC's') Spring 2019 Market Report states that 64% of all new plans taken by customers throughout H2 2019 provided a future drawdown facility. Furthermore, the ERC reports a "sustained increase" in product options on ERMs, noting that such options have "more than doubled year-on-year" to January 2019. Much of this innovation is targeted at providing flexibility to borrowers, including allowing borrowers to service their debt (the ERC notes that one in five product options now offer this feature).

The PRA proposes an "overarching principle" – that the "*economic value at a particular assessment date should not recognise future principal amounts…, or the interest accruing thereon, unless both the timing and amounts of the future principal are known and certain in advance*".

However, the PRA states that firms' assessments of existing NNEG risk should include an allowance for additional risk arising on future additional lending or accrued interest on a best estimate basis. The PRA acknowledges that this is a potentially complex area with many different potential approaches, so asks firms to discuss their approaches with their supervisors.

The consultation paper also highlights an example of a complication introduced by the securitisation process where multiple drawdowns secured against a single property may result in two senior notes (as well as two junior notes) being exposed to the same property. In this case, the notes linked to the second advance may have subordinated rights on interest in the underlying property when compared to the junior and senior notes of the initial advance. This demonstrates how the securitisation process may complicate the calculation of allowance for NNEG risk on multiple advances secured against the same property.

The 'EVT in stress'

The PRA has stated that it expects firms to use validation techniques that ensure the MA benefit in stress is not overstated, and that it considers an 'EVT in stress' an appropriate validation test for this purpose. The PRA expects such a test to complement existing validation tests and standards, rather than replace them.

The EVT in stress would compare the stressed economic value to the stressed effective value of ERMs. In order to conduct the comparison, firms would stress all inputs to the EVT in a way that is consistent with a 99.5% confidence level.

As well as stressing the inputs to the EVT, the PRA also proposes that firms consider additional areas, including:

- The basis risk arising on property indices (i.e. that individual properties will not track the diversified property indices);
- The joint behaviour of variables, especially nominal interest rates and the deferment rate (noting here the impact on implied inflation); and
- The impact of any management actions that firms may take.

The PRA has proposed that firms must apply an 'EVT in stress' from no later than the end of the phasing-in period (which is 31 December 2021).

An annuity is a serious business: Part 2

On 10 April 2019, David Rule spoke at the Westminster & City 17th Conference on Bulk Annuities, following on from his speech at the same conference in 2018. In a wide-ranging talk he made it clear that the PRA "supports sensible diversification of portfolios backing annuities into assets such as … equity release".

Rule did stress that ERMs are exposed to the risk of *individual* property prices, noting that "a portfolio of options is a very different thing to an option on a diversified index". Two important factors here are variations in regional house price inflation measures and potential dilapidation (where homeowners become unable, or are unwilling, to maintain the property).

A further factor highlighted by Rule was climate change – and in particular the risk to properties from a rise in sea levels, with this risk being unevenly distributed across the United Kingdom. These comments follow on neatly from the PRA's consultation on financial risks arising from climate change published in October 2018 (CP 23/18).

So where next?

Given that firms have previously highlighted the additional sensitivity to risk-free rates that is introduced by using a risk-neutral approach, the industry will welcome the regular review of the deferment rate proposed by the PRA.

If the consultation is approved in its current form, there will be additional work for insurers to (i) understand the impact of the proposals for uncertain future drawdown and interest accrual; and (ii) develop an approach for the 'EVT in stress' (between now and the end of the phasing-in period).

Firms have until 3 July 2019 to respond to the consultation paper. The PRA expects the proposals in this consultation paper to become effective from 31 December 2019.

Hymans Robertson has a wealth of Solvency II and equity release experience. Our consultants would be delighted to support you to evaluate the PRA's implemented changes.

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

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