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The results from equity release consultation: what does it mean for trustees?

On 10 December 2018 the Prudential Regulatory Authority PRA published the results of its consultation on the reserving requirements in relation to equity release mortgages. This had the potential to increase pricing for buy-ins and buy-outs for those insurers who invest in this asset class and to impact negatively on their solvency position. The results of the consultation are less onerous for insurers than originally considered, in particular in respect of solvency impact.

This update follows on from our July 2018 update[1] on the original consultation. A more technical overview of the outcome of consultation is also available[2], primarily aimed at insurers.

What is the outcome of the PRA's review?

The PRA has made a number of changes to reserving requirements that, for many insurers, will increase the amount of capital that they need to set aside when investing in equity release mortgages to back annuity liabilities.

However, the increase in capital requirements is smaller than envisaged in the original proposals, and the PRA has confirmed that the changes will be phased in gradually over the next three years.

What does this mean for bulk annuities?

Insurers generally made allowance in the second half of 2018 for the PRA's views as set out in the consultation paper. This notably increased bulk annuity pricing for some but not all insurers. The outcome of the consultation is somewhat less onerous than expected, so we expect this to result in a slight pricing improvement for some insurers.

The biggest change compared to the consultation is however in respect of solvency impact. Whereas previously we expected this to have a significant solvency impact on some insurers, the impact will now be far more modest.

Equity release: a quick recap

Equity release mortgages, also known as lifetime mortgages, are typically repaid with interest only at the point of death or on moving to long term care, with no prior repayments. These products have a "no negative equity guarantee" which ensures that the amount repaid does not exceed the value of the property it is secured against. While this guarantee protects the borrower, it can act to limit the expected returns for the lender. Due to the long term of these mortgages, they often form part of an insurer's asset portfolio used to back annuity liabilities, and to date the yield on these loans has compared very favourably with other long term investments.

The PRA has been considering whether the allowance insurers have been making for the potential reduction in returns from the no negative equity guarantees are sufficient or should be strengthened.

[1] https://www.hymans.co.uk/news-and-insights/research-and-publications/publication/pra-consultation-and-impact-on-the-bulk-annuity-market/

[2] https://www.hymans.co.uk/news-and-insights/research-and-publications/publication/pra-publishes-supervisory-statement-on-equity-release-mortgages/

What does this mean for buy-in pricing for trustees looking to enter into a buy-in?

As predicted in our July update we did see increases in pricing from some insurers as a result of the initial consultation. In the consultation the PRA noted a minimum level of prudence in respect of the two key assumptions for valuing the no negative equity guarantees along with a stated best estimate, and most insurers are likely to have been using this best estimate for pricing new annuity business during the consultation period. Following the consultation, the PRA adopted the best estimate for one of the key assumptions but the minimum level for the other. As insurers converge around these assumptions, this should mean slight price improvements for those who had been using the previous best estimates.

In practice it may be challenging to separate this impact from pricing changes for other assets held as part of an insurer's overall portfolio and the impact on pricing due to the record transaction volumes seen in 2018, which has put pressure on the availability of higher yielding assets that insurers can find to back new business.

What does this mean for insurer balance sheets and solvency position?

Insurers who hold equity release mortgages as part of their portfolio will have been considering the impact of a range of positions that the PRA could have adopted. This would have included considering whether any changes would be needed to re-optimise their investment portfolio, such as uses of reinsurance or reducing their investment allocation to equity release mortgage assets. As the outcome of the consultation does not require significant increases in capital, we do not expect it to result in significant changes to insurer business models.

One particular concession by the PRA compared to the consultation is to limit the immediate impact on business written before the current "Solvency II" regime came into force on 1 January 2016. This significantly reduced the impact of the changes, such that we expect the decrease in solvency coverage ratios[3] to be less than 5% for all insurers, with a negligible impact for those without material equity release holdings.

The PRA has stated that it will continue to consider some of the underlying assumptions so we expect insurers to be mindful of this ongoing activity.

[3] Broadly, this is the ratio of free capital held by insurers compared to minimum amount of solvency capital required by the PRA.

How should trustees looking to enter into a buy-in or buy-out view the outcome of the PRA's consultation?

Trustees should take a high degree of comfort that the PRA is actively monitoring the bulk annuity market and seeking to ensure that the insurance regime continues to offer a very high degree of security for policyholders.

For those looking to enter into a buy-in in the near future, we expect trustees to welcome the certainty from the conclusion of the review, as well as the slight price improvement it should bring from some insurers.

How should trustees with an existing buy-in view the outcome of the PRA's consultation?

Increasing the amount of capital required to be held by an insurer generally means that insurers are more resilient to a larger risk event and so is generally viewed positively by policyholders. However, material or unexpected changes in capital requirements have the potential to negatively impact an insurer's business plans and could lead to unanticipated changes or restructuring that were not expected by the trustees when entering into a contract with a preferred insurer.

As the consultation is generally viewed as leading to a tolerable increase in capital requirements for those insurers who invest in equity release mortgages, we believe that trustees should generally have a favourable view of both the process and outcome of this consultation.

As always, we strongly recommend that trustees carefully consider the strength of an insurer's balance sheet and of the regulatory regime for bulk annuity insurers before entering into a buy-in or buy-out contract. As always, please speak to your usual Hymans Robertson contact if you would like to find out more.

If you would like to discuss this further, please contact:

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