Institute and Faculty of Actuaries

CP48/16: Matching adjustment – illiquid unrated assets and equity release mortgages

IFoA response to Prudential Regulation Authority

14 March 2017

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Institute and Faculty of Actuaries

CP48/16
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

14 March 2017

Dear Sir,

IFoA response to Consultation Paper CP48/16: Matching adjustment – illiquid unrated assets and equity release mortgages

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the PRA's consultation on the Matching Adjustment (MA) - illiquid unrated assets and Equity Release Mortgages (ERM).

2. A number of IFoA working parties (including parties considering the MA and ERM) and our Life Insurance Board have been involved in the drafting of this response. Members of these working parties and Board are actively engaged with the investment of illiquid unrated assets and ERM assets by life insurers.

3. Our detailed response to the consultation is set out in the Annex; however the most important issues are noted below.

4. The MA has a material impact on many insurers and was negotiated to reduce inappropriate disincentives in the Solvency II (SII) Directive. As the PRA recognises in the consultation paper, insurers are increasingly using illiquid assets in MA portfolios, including ERM assets. These illiquid assets are important both to the interests of current/ prospective policyholders, and to the wider public interest in their impact on the national economy.

5. The guidance provided in the consultation paper provides some helpful insights into the PRA's thinking on such private credit investment. However, we are concerned that the PRA's proposals could decrease the attractiveness of illiquid assets and could give rise to a number of potential unintended consequences:

    - less investment by insurers in socially beneficial investment (such as infrastructure projects and lifetime mortgages);
    - less attractive annuity rates for those providing for their retirement;
    - increased systemic risk caused by firms investing in a smaller pool of similar, externally-rated assets.

6. There are two overarching areas where additional clarity is needed from the PRA in order to ensure that the principles of the Supervisory Statement (SS) are implemented correctly:

    a. the scope of the SS should be clarified. At present, the draft refers variously to illiquid assets, restructured assets, and assets inside/outside of the MA portfolio, with some

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commentary being applicable widely and some not – yet the scope is limited in paragraph 1.1;

   b. consistency should be maintained with the principles of proportionality and materiality under the SII regime. In certain areas, the expectations could reasonably be interpreted as going beyond proportionate oversight of material risks.

7. The draft SS requires a greater justification of internal ratings than applies to external ratings, regardless of whether the internal rating is consistent with ECAI rating. This could also have unintended consequences, including increasing the reliance on external ratings.

8. We appreciate the need for independent assurance reviews of the internal credit assessment process, but careful consideration needs to be given to the level of additional processes and/or assurance required by the SS in relation to the mapping of Fundamental Spreads (FS). These will add more cost and complexity to an area that is already considerably burdensome for firms managing MA portfolios and this can act against the public interest.

9. The PRA's quantitative approach appears to be unduly focussed on the size of the MA. We believe that the PRA should instead be considering the size of the FS. For a cashflow matched MA portfolio, it is the default risk that matters, not the size of the liquidity premium which goes onto both sides of the balance sheet.

10. We welcome the PRA's proposal that adjustments to internal credit assessments can be upwards as well as downwards. This is an important point as many firms already allow for considerable prudence within their internal ratings.

11. The draft SS focuses on the value of the No Negative Equity Guarantee (NNEG) to the detriment of other material risks of ERM. In the context of a hold to maturity illiquid asset, it is cashflows net of NNEG costs rather than valuation that are the relevant factor in the resilience of the restructured ERM.

12. We note that the PRA does not specifically deal with capital considerations within the consultation paper but notes that it is an area to be revisited later this year. We would welcome the opportunity to discuss our views on the capital treatment of illiquid assets with the PRA. In particular, we recommend that a pragmatic approach is used to help determine the behaviour of the asset and FS under stress. In addition, consideration should be given to the fact that private assets are often bilateral loans, meaning insurers can have a significant degree of control of the process in a credit event.

13. As mentioned above, more detailed consideration to support this response is given in the Annex, and we would be happy to clarify/elaborate on any of our responses within the Annex.

Should you wish to discuss any of the points raised in further detail please contact Steven Graham, Technical Policy Manager (steven.graham@actuaries.org.uk / 0207 632 2146) in the first instance.

Yours sincerely

Colin Wilson
President, Institute and Faculty of Actuaries

Annex – Detailed Response to PRA Consultation Paper CP48/16

Scope

1. The scope of the draft Supervisory Statement (SS) should be clarified. The introduction to the SS says that it is 'addressed to firms with restructured illiquid assets in an MA portfolio'. However, a number of the considerations could be expected to apply whether the assets are restructured or not:

    - the PRA should clarify whether the draft SS applies only to restructured assets in an MA portfolio, or whether some of the requirements apply more broadly;
    - valuation of bilateral loans is a material risk for non-MA portfolios, where valuing a private asset with a spread that is too low would increase reported solvency.

2. The SS scope in relation to ERM is specific to restructured ERM notes and the mapping of FS. However, the valuation principles prescribed also reference unrestructured ERMs and could create differences in fair values of ERMs across different market participants e.g. banks, building societies and pension funds.

3. It would also be helpful to define the key terms used in the SS. Terms such as 'economic value', 'fair value', 'value' or 'best estimate' seem to be used interchangeably (or in fact otherwise) – we would welcome clarity in this regard. In particular, 'illiquid' is a subjective term. The use of 'private' may be more objective.

Risk Assessment

4. The emphasis of the PRA's proposals on risk identification and assessment is welcome. We would welcome some further considerations around proportionality, in relation to insurers contemplating investing in private assets or entering the ERM market, to avoid adding more cost and complexity to an area that is already considerably burdensome for firms managing MA portfolios.

5. The draft SS explains that firms are required to provide additional assurance of the FS mapping for internally-rated assets, where those ratings are produced by a method consistent with that used by an ECAI. However, if firms adopt a process that is equivalent to an ECAI for rating internal credit assessments (for assets with similar expected recoveries on default), we believe it follows that this mapping should still hold for MA calculation purposes without significant additional assurance.

6. The draft SS differentiates between internally-rated and externally-rated assets not on the basis of consistency of rating, but on the complexity or risk exposures of the particular asset. The fact that an asset is internally or externally-rated does not by inference determine the complexity of the relevant asset. Therefore, the need for additional assurance regarding FS mapping being made conditional first on whether the asset is internally-rated introduces a regulatory bias to externally-rated assets.

7. Care is needed to ensure that the additional requirements set out in the draft SS do not create an uneven playing field between externally-rated and internally-rated assets. This could deter firms from investing in illiquid, unrated assets which would increase the level of risk

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concentration within MA portfolios, increase systemic risk within the UK annuity industry and damage the public interest through its impact on the wider economy.

8. Paragraph 1.3 of the draft SS would suggest that the approach is less onerous for externally-rated assets because there is a prescriptive mapping provided by EIOPA. We note that EIOPA highlights the potential for over-reliance on external ratings included within its current SII consultation due to close in March 2017. We would ask the PRA to consult with EIOPA prior to finalising the draft SS to avoid potential inconsistencies in the regulatory treatment of internally- and externally-rated assets between national regulators.

9. The wording of Paragraph 1.4 in the draft SS appears to discount any proportionality in its implementation as it must be applied to assets that have the greatest complexity or risk exposure. To avoid inefficient use of firms' resources, the statement should clarify that the level of scrutiny should be proportionate to the materiality of exposures, and therefore great complexity of itself is not sufficient if the risks are still not material.

10. We would expect that many insurers will already be carrying out and evidencing many of the actions in paragraph 2.7 of the draft SS as best practice (when investing in illiquid credit assets), having appropriate regard to both proportionality and materiality. However paragraph 2.7 does not seem to reflect this.

11. Paragraph 2.7 of the draft SS states that the internal credit assessment and FS mapping should be performed by individuals who are free from conflicts of interest. We support the intention of this requirement:

    - we believe the public interest is best served by individuals with appropriate skills to carry out the internal credit rating and FS mapping assessment. Appropriate individuals could include asset managers with relevant skills and resources to perform the internal rating. The firm's risk management framework should ensure that these assessments are subject to appropriate independent oversight and challenge. The performance of such oversight should include individuals free from conflict of interests supported by other members with relevant expertise. However, the wording used in the draft SS could be interpreted as prohibiting this model;
    - on a practical level, we note that there is limited expertise in the market and sourcing/employing further individuals for the sole purpose of performing rating assessments and FS mapping is likely to be challenging for firms. This might lead to damaging consequences, when less onerous requirements may achieve the necessary prudential control.

12. Senior managers (specifically named as the Chief Actuary function, the Chief Risk function and the Head of Internal Audit function) need to satisfy themselves (where material) that an appropriate FS is applied to the asset. This seems like quite a step-up in their responsibilities, particularly for the Head of Internal Audit, who might expect to be required only to satisfy themselves that effective processes are in place to derive the internal rating and FS, rather than be satisfied that the FS itself is appropriate. All such senior managers may from time to time have to rely on other professionals with greater expertise, and their responsibility is to satisfy themselves on that expertise and then on the reasonableness of the answer.

Thresholds

13. We welcome the PRA's top-down approach to oversight of private assets. We would encourage the PRA to share more details on the process that will be used to set the threshold levels for different private credit investments.

14. The PRA's quantitative approach appears to be unduly focussed on the size of the MA. We believe that the PRA should instead be considering the size of the FS: nothing in the Directive supports a cap on the MA per se. For a cashflow-matched MA portfolio, it is the default and downgrade risk that matters, not the size of the liquidity premium which goes onto both sides of the balance sheet. For example, a firm could (in theory) claim that a lower illiquidity premium applies to their asset. This reduces the MA and hence increases liabilities. However, it would also increase the asset value, so it may be neutral on the balance sheet. We would therefore recommend that PRA focuses more on inappropriately low FS rather than high MA.

15. The PRA mentions that it will be calibrating thresholds for intervention based on the 'MA benefit derived from the asset'. Since the MA is derived on a whole portfolio (acknowledged in footnote 2 on page 5 of the consultation paper), firms may not necessarily have a concept of the 'MA benefit derived from the asset', and may not have processes to produce it. In any case, for the reasons above we believe this is inappropriate and could be contrary to the principles in the Directive.

16. To the extent that the thresholds are used to benchmark the MA benefits that different firms are getting from illiquid assets, care needs to be taken. Illiquid, internally-rated assets can vary significantly in risk profile and structure, and generally speaking, no two assets are the same.

Risk Quantification

17. We welcome the proposal from the PRA that, when it seeks detailed assurance on mapping to FS CQS, it will only do so in a proportionate way, focusing on those assets that are complex or have a high MA benefit. However, careful consideration needs to be given to the level of additional processes and/or assurance required, to avoid adding more cost and complexity to an area that is already considerably burdensome for firms managing MA portfolios.

18. A consistent approach, subject to the overriding principle of proportionality, is needed in terms of how 'risks retained by the firm' should be treated when determining MA, whether private, unrated or otherwise. However, there should not be undue reliance on ECAI. In particular, the use of ECAI methodology may not be appropriate, from a Prudent Person Principle standpoint, where the ECAI has limited or no access to quantitative and/or qualitative data and thereby leads to an uninformed assessment. Such qualification would be consistent with the SII consultation currently being performed by EIOPA into initiatives to reduce the reliance on ECAI, including in particular the key measure of insurers using internal rating assessments.

19. In paragraph 2.3 of the draft SS the PRA highlights the need for internal credit assessment (and the FS mapping process) to have broad consistency with ratings that ECAI would produce. We note that:

a. ECAIs use a range of approaches, and it is not clear how consistency would be measured. For example, some ECAIs use an expected loss methodology while others use a probability of default methodology;
b. consideration will be required to ensure comparisons between the internal ratings and output ratings from different ECAI agencies are made on a like-for-like basis. This is particularly relevant for private credit assets as they often exhibit features (e.g. secured against real assets, government support) that result in higher expected recoveries in the event of default. A different (higher) rating might therefore be anticipated for a private asset under an expected loss methodology compared to probability of default methodology;
c. where public ECAI ratings are available for similar assets, this will support firms in ensuring that the rating adopted by the firm is appropriate to the risks in the private asset.

20. We would encourage the PRA to provide additional commentary in some areas, to encourage insurers investing in private asset classes. Areas for additional commentary include:

- guidance on what internal credit assessment techniques are acceptable to the PRA in cases where ECAI ratings do not exist for an asset class;
- the published methodologies of ECAIs may not be appropriate, without modification, to provide a credit rating on a particular asset class - for example, ERMs or residential ground rent financings. The need to satisfy the requirement for broad comparability (with ECAI ratings) may therefore create a challenge for firms.

21. Paragraph 2.1 of the draft SS reminds firms that internal credit assessment and FS mapping are two distinct processes. We can see the rationale for why many firms may adopt a two-stage process, but we note that some firms may not feel this is appropriate and choose to go directly to the FS. We believe that firms should determine which approach is appropriate and that guidance in this area should be focused on outcomes rather than process.

22. Many firms already allow for additional sources of credit risk as part of their internal credit assessments. This is often achieved via explicit downwards notching of the assigned rating (although this could also be addressed in capital treatment rather than the best estimate calculation). In cases such as this, an upwards adjustment may be appropriate for FS mapping purposes.

23. Paragraph 2.4 of the draft SS highlights the need to incorporate factors, qualitative and quantitative, in the FS mapping process to the extent these are not already incorporated in the credit assessment methodology. Credit assessments will regularly consider these areas. Apart from recovery rate, which is discussed above, it is not clear what, if any, additional factors will need to be incorporated into the FS mapping process (that are not already captured in the internal credit assessment process). Further clarity on the PRA's expectations in this area would be helpful, though we note the limited scope of the FS as determined by Article 77c(2).

24. We would suggest that firms should document qualitative and quantitative risk factors and the relative weighting given to each factor e.g. quantitative factors such as property risk, mortality risk, and qualitative factors such as legal risks. In addition, the firm should keep this inventory of risks and weighting under review as part of its credit rating framework. The firm should also compare these risk factors with available ECAI to provide an independent check that no material risk factors have been omitted.

25. FS mapping can be subjective and hard to fit to an internal calibration of risk given the large differences in quantum between CQS and inherent prudence already included (e.g. due to the

long term average spread floor). It is therefore difficult to produce sound justification for mapping to individual CQS in all circumstances.

26. A particular area of subjectivity is the mapping to financial or non-financial FS, which can have an impact almost as large as CQS.

27. FS are used in the calculation of the Best Estimate Liabilities (BEL). As such, they should reflect a best estimate view of the risk. Allowance for any additional risks or uncertainties should be accounted for within the capital firms hold, rather than introducing prudence into the base position.

Valuation

28. In terms of fair valuation, the draft SS is concerned primarily with assessing a fair value (or assigning a 'fair' spread) for the No Negative Equity Guarantee (NNEG). The SS suggests that the value put on the NNEG directly impacts the amount of MA benefit, therefore the firm requires a fair value being put on the loan as a whole and also on appropriate attribution of value (or spread) between the no-guarantee loan and the attached NNEG option. The consequence of this approach is that the spread attributable to NNEG would be reflected in the FS only.

29. If this interpretation is correct, we believe that it would be clearer for the PRA to state that the spread associated with NNEG is ultimately a credit risk premium, and not a liquidity premium. Consequently, MA cannot be claimed for this part of the spread, and the FS must be at least as large as the NNEG spread attributable to the notes assigned to the MA fund. This seems to be a reasonable overall approach and consistent with the compensation for risk in other assets. We would note that firms do need to ensure that there is not a double-count of risk premium between the NNEG, when restructuring equity release mortgages, and the FS.

30. However, it must be noted that not all NNEG risk is passed to the MA asset generally speaking - often some of it is absorbed by other parts of the structure, and to this extent it may not be trivial to assess.

31. The draft SS focuses on the value of the NNEG to the detriment of other material risks of ERM. In the context of a hold to maturity illiquid asset, it is cashflows net of NNEG costs rather than valuation that are the relevant factor in the resilience of the restructured ERM. The SS requires greater justification of the validity of internal ratings versus external ratings, regardless of whether the internal rating is consistent with ECAI rating. This could have the following unintended consequences:

    - encourage UK insurers to seek external ratings and thereby increase the reliance on external ratings and thereby the systematic risk to ECAI ratings. The recent financial crisis serves as a reminder of the risks to the system of ECAI. The current EIOPA SII consultation focuses on this subject and is seeking means to reduce the European insurance industry reliance on ECAI. Internal ratings can be argued to be more robust that ECAI ratings as the firm has access to non-public information on a timely basis through due diligence, product knowledge and interactions with market participants who are themselves unrated. This enables the firm to provide more information on the risk exposure to management and regulators;

- dissuade small and medium sized UK life insurers from investing in illiquid assets due to either the cost of an external rating or the added uncertainty. Costs involved are not economically viable for small invested amounts in segregated MA eligible investment mandates;
- reduce the competitiveness of UK insurers to invest in illiquid assets such as UK infrastructure projects due to greater regulatory uncertainty versus those for European and Global insurers;
- increase costs to policyholders through the higher risk premium firms would have to bear in terms of uncertainty over regulatory treatment, in particular retrospective views on MA benefits.

32. Paragraph 2.13 of the draft SS mentions that the cashflows flowing to junior notes could (for example) be kept in reserve in the early years. We agree in principle that this approach provides good risk management. We would suggest that the SS should state that firms should document the process by which they make payments to junior note holders, including how they take into account the impact on the credit rating of the senior notes.

33. Paragraph 3.7 of the draft SS makes reference to the 'asset'. For clarity it would be helpful to refer explicitly to restructured ERM senior notes consistent with the wording in paragraph 3.1.

34. The draft SS seems to require firms to develop stochastic models in order to participate in the ERM asset class, given the wording in paragraph 3.9. This requirement could create a material systemic risk by favouring one calculation approach over another. There are well documented pros and cons to using stochastic models; ultimately any model, no matter its complexity and granularity, is only as good as the assumptions it is given. Therefore, the choice of method in itself should not invalidate the results.

35. A requirement for stochastic modelling could act as a barrier to new entrants to the ERM market. This could have the potential knock-on danger of stifling professional challenge to methodologies, and creating Group Think amongst practitioners that the approach set out in the SS is the most appropriate.

36. We consider it more important to justify any areas of simplification/approach to proportionality in the calculation. This could be in relation to a closed form solution, a stochastic model or in the derivation of the assumptions; one-off checks of more simplified approaches against stochastic models could be used to address this, for example.

37. The drafting of paragraph 3.12 of the SS should be tightened to avoid confusion. It states that all the NNEG should be reflected in the value of securitised assets (the senior notes) or in the FS assigned to those assets. This omits the junior notes of the SPV structure which are designed to take the first loss of any exposure to NNEG. It is correct to state that the NNEG should be reflected in the fair value of junior notes and the fair value of the MA eligible senior notes, or the FS assigned to these senior notes. The wording in paragraph 3.17 of the draft SS should also be amended in line with this.

38. We agree with the concept of Principle (II) (draft SS paragraph 3.8) but cannot see how market participants could validate this principle since, to our knowledge, there are no ERM products that exist without NNEG. We therefore understand this to mean firms would comply with this Principle by valuing the cash flows with and without the NNEG, to demonstrate the ERM with NNEG has a lower value, but this seems a pointless exercise.

39. The drafting of paragraph 3.14 of the SS could also be clarified. We understand the relationship in Principle (II)/ (III) to be an independent check of the value the firm places on ERM cash flows. For each ERM, the present value of deferred possession is calculated

independently and then compared to the present value of the ERM. This does not affect the firm's valuation of ERM cash flows but adds an additional independent check on the final value placed on ERM.

40. The consultation paper does not provide any guidance on how firms may wish to assess valuation uncertainty in respect of private credit assets.

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