Institute
and Faculty
of Actuaries

CP7/19 Solvency II: Equity release mortgages – Part 2

IFoA response to the Prudential Regulation Authority

3 July 2019

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The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers.

We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

Actuarial science is founded on mathematical and statistical techniques used in insurance, pension fund management and investment. Actuaries provide commercial, financial and prudential advice on the management of assets and liabilities, particularly over the long term, and this long term view is reflected in our approach to analysing policy developments. A rigorous examination system, programme of continuous professional development and a professional code of conduct supports high standards and reflects the significant role of the profession in society.

Institute and Faculty of Actuaries

CP 7/19
Prudential Regulation Authority
20 Moorgate
London
EC2R 6DA

3 July 2019

Dear Sir/ Madam,

IFoA response to Consultation Paper CP7/19: Equity release mortgages – Part 2

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the PRA's consultation paper (CP) on Equity Release Mortgages (ERM). In particular, we welcome the PRA's continued focus on the appropriate prudential management of ERM: this product continues to grow in its importance in UK retirement planning.

2. A number of parties within the IFoA have been involved in the development of our response to CP7/19; these are our:

    - ERM working party;
    - Life Standards and Consultations sub-Committee; and
    - Life Insurance Board.

    Members of the working party, Committee and Board are actively engaged with the investment of ERM assets by life insurers.

3. The IFoA's comments within this response are taken from two distinct but complementary perspectives:

    - the likely impact on a practising actuary's ability to carry out his/her work for their life insurance client, either as the regulated role of Chief Actuary, or as an actuarial practitioner in a non-regulated role; and
    - the public interest as served by a stable and robust life insurance and investment sector. It is not the IFoA's role to argue in the interests of life insurers in general. However, where practices would lead to uncertainty of regulation or pro-cyclical actions, this is unlikely to be in the public interest given likely industry instability and potentially negative impacts on consumer outcomes.

4. We believe it is key to the ongoing sustainability of ERM that the associated regulatory treatment balances (a) managing the corresponding risks in a sound and prudent manner; with (b) the ability to deliver products that offer customers value whilst meeting their needs.

5. As you may be aware, members of our ERM working party and Life Insurance Board met with the PRA on 28 May to discuss both CP7/19 and potential next steps for the ERM working party/ IFoA more generally. Our response reflects this useful discussion from our perspective.

London 7th Floor · Holborn Gate · 326-330 High Holborn · London · WC1V 7PP · **Tel:** +44 (0) 20 7632 2100 · **Fax:** +44 (0) 20 7632 2111
Edinburgh Level 2 · Exchange Crescent · 7 Conference Square · Edinburgh · EH3 8RA · **Tel:** +44 (0) 131 240 1300 · **Fax:** +44 (0) 131 240 1313
Oxford 1st Floor · Park Central · 40/41 Park End Street · Oxford · OX1 1JD · **Tel:** +44 (0) 1865 268 200 · **Fax:** +44 (0) 1865 268 211
Beijing 6/F · Tower 2 · Prosper Centre · 5 Guanghua Road · Chaoyang District · Beijing China 100020 · **Tel:** +86 (10) 8573 1000 · **Fax:** +86 (10) 8573 1100
Hong Kong 2202 Tower Two · Lippo Centre · 89 Queensway · Hong Kong · **Tel:** +11 (0) 852 2147 9418 · **Fax:** +11 (0) 852 2147 2497
www.actuaries.org.uk

Summary

6. The IFoA recommends that a number of clarifications are added to the Supervisory Statement that follows PRA CP7/19, as follows:

    - transparency - the PRA should set out how the deferment rate and volatility parameters are expected to be updated in normal circumstances, to improve transparency. This will enable firms to manage more effectively the impacts of the Effective Value Test (EVT) between publication dates, and consider the impact on their capital plans of the EVT within their scenario planning;
    - proportionality - the PRA should clarify that the financial impact within the EVT on the No Negative Equity Guarantee (NNEG) as a result of future releases of funds from an outstanding drawdown facility can be calculated on a best estimate basis; and
    - parsimony - more guidance should be provided on how the EVT will change under more severe stresses so that firms can model this appropriately within capital models.

Reviewing and updating the deferment rate and volatility parameters

7. The IFoA welcomes the introduction of a framework to review and update volatility and deferment rate parameters. In particular, it is helpful that the PRA recognises the movement in the deferment rate is linked to real rates of interest, rather than nominal rates.

8. However, in our view, the methodology used to calibrate these parameters could benefit from greater transparency. The EVT may act as a constraint on a firm's capital position, and so firms would be expected to monitor and manage this position carefully against their own internal view. A lack of transparency could be a potential cause for concern for firms since:

    - the limited information provided by the PRA on the calibration of these parameters leaves firms open to the risk of significant and/ or unexpected changes in parameters and firms may not be in a position to predict these;
    - this includes parameter changes that may be driven by changes in the underlying data used to perform the calibration, the calibration methodology, or any incremental PRA 'supervisory judgement' overlay applied.

9. We recognise the need for the PRA to retain the ability to exercise 'supervisory judgement' in times of extreme/ exceptional market conditions. Notwithstanding this, we suggest that the PRA considers determining a middle ground between (i) application of a published mechanistic methodology and (ii) the ability to apply flexibility in times of stress. Such a middle ground could help avoid undue uncertainty for firms whilst not being overly restrictive to the PRA.

10. The proposed minimum movement in the deferment rate is 0.5%. This minimum movement (or lack of movement if the minimum thresholds are not met) may be material to a firm's capital position. We therefore consider a lower movement in the deferment rate of, say 0.25%, to be more appropriate for this purpose.

11. We understand (from our discussion with the PRA on 28 May) that the 0.5% initial deferment rate does not act as a floor to the deferment rate, although the smallest movement is +0.5%; we also note that the PRA has stated that the deferment rate should always be greater than zero. We think it would be helpful to confirm this explicitly within the final Supervisory Statement.

12. The PRA also sets out that the volatility parameter is based upon a long term view. We understand this to mean that the volatility parameter is unlikely to change in the short term. Again, it would be helpful if the PRA could make this clear in the Supervisory Statement.

Treatment of assets other than ERMs held by the SPV

13. The proposals include the ability to allow for the balance sheet value of other assets placed into the securitisation to be recognised on both sides of the EVT calculation, along with any associated residual risks that such assets may bring.

14. We note that there may be instances of potential basis risk on certain risk-mitigating instruments e.g. if a hedge does not last until run-off or if a hedge is based on an index. The balance sheet valuation of an asset may be inconsistent with the way the risk the asset is hedging is measured within the EVT calculation if a different basis of recognition is used. For example, NNEG risk is measured within the economic value using the prescribed PRA basis; however, any hedge that is held on the balance sheet to mitigate this risk (for which we are aware that a market is developing) may not be valued in the same manner. This inconsistency in valuation may lead to counter-intuitive EVT outcomes. We would expect the items such as this to be measured in a consistent way to the wider EVT calculation, rather than the way that they are measured on the balance sheet. We would also expect the PRA to consider other specific positions which do not fit the approach proposed within CP7/19 on a case-by-case basis. We suggest including explicit reference to potential basis risk and the potential issue where a different basis of recognition is used and case-by-case assessment as a backstop within the final Supervisory Statement.

Uncertain loan principal or accrued interest

15. The CP includes proposals around the allowances for future loan principal/ accrued interest within the EVT calculation for products with unused drawdown facilities. In relation to these proposals, we understand that firms shall (a) make no allowance for any future income from non-guaranteed future lending but (b) should consider the impact on the NNEG on any amount issued to date, from their best estimate expectations of future lending.

16. The CP wording on the measurement of (b) above could benefit from further clarity. We understand that a potentially proportionate approach to considering the risk of future lending on the NNEG, and the potential impairment on existing notes issued within Matching Adjustment (MA)-compliant securitisations, would be to revise the property value that is used within the NNEG calculation. This revision would reflect the amount of best estimate future lending. We note though that:

    - the majority of the additional drawdown capacity we have observed within the market does not commit to providing this capacity at guaranteed rates. Market participants can choose to price based on the marginal cost of the NNEG for each individual drawdown and manage the associated risk in this manner;
- firms may manage and monitor the specific contagion risk of incremental lending within the notes issued by their MA-compliant Special Purpose Vehicles (SPVs) using other means. For example, they may inject new assets (or a portion of the new lending that is proportionate to the change in the NNEG risk on the existing issued notes) into the SPV to manage such emerging risk. Whilst firms may inject new assets where available it is noted that incremental lending will result in a cash outflow. Firms may also monitor the security/ credit rating of the notes that have been issued by the SPV to check that the change in lending has not impaired the issued notes materially. Any approach to the

consideration of future lending should therefore be aligned with the way in which the firm manages and monitors the ensuing risk;
- some contracts contain specific clauses that permit providers to refuse lending on these unused facilities. These contracts, subject to them being tested for legal and practical enforceability, should be given the weight that they are due, as long as firms employ consistent treatment throughout their capital calculations.

Frequency of EVT assessment

17. The IFoA supports the proposals in relation to the frequency of EVT re-assessment.

Principles for assessing internal model SCRs

18. The PRA recommends that the EVT under stress is also used as a validation test for firms' internal models. The structure and form of the internal models within individual firms will be very different. We suggest it would be useful for the PRA to set the expectation that where used as a validation test:

    - the EVT is not embedded into each simulated stochastic scenario of the internal model and passed at each level, but instead
    - is assessed within the most important scenarios and levels of granularity within the internal model.

    For example, this could consider entity and portfolio level residential property and volatility stress scenarios and a sample range of scenarios that may provide a view on the appropriateness of the MA/ support that the EVT is likely to be met at a variety of points across the distribution of own funds. Furthermore, we believe it would be useful to consider a range of upside and downside scenarios from a use test perspective.

19. As noted earlier in this response, it would be helpful if more guidance could be provided on how the EVT will change under stress so that firms can model this appropriately. Given the current lack of clarity over how the base parameters are set, it could therefore be challenging to determine equivalent parameters under stress. It would also be useful to have some clarification on the potential implications of the EVT under stress failing to meet validation requirements.

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

John Taylor

President, Institute and Faculty of Actuaries