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F8: Alternative Investments and the Matching Adjustment – A Case Study on Lifetime Mortgages

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07 November 2016

Agenda

- The market
- Recent challenges
- The case study



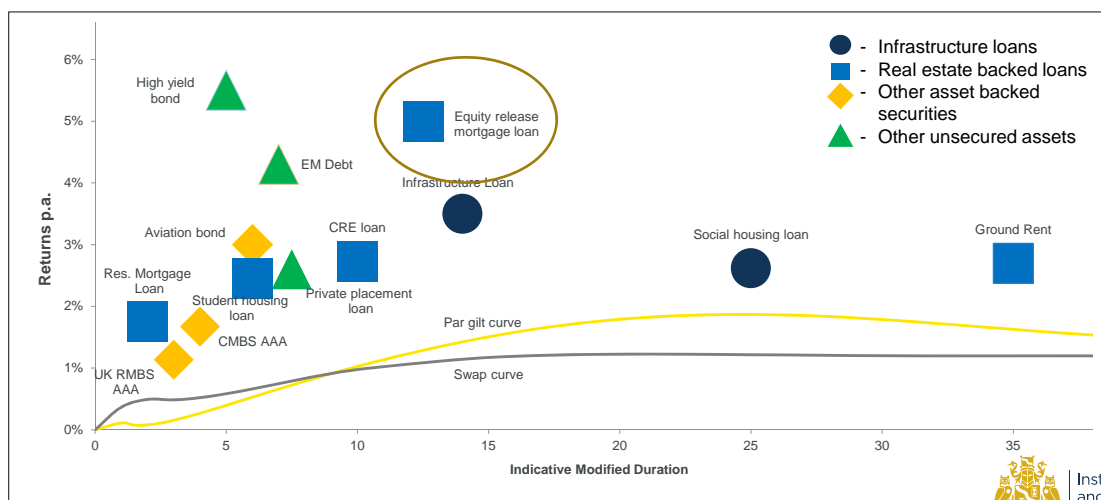
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The market

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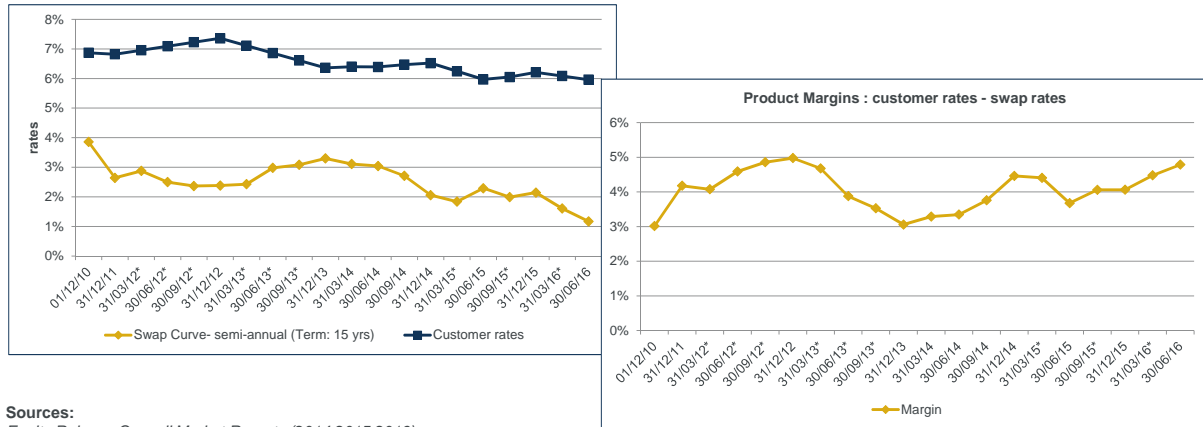
Insurers seek to explore other opportunities



Source: As at June 2016, EY analysis based on Institute of Actuaries Non-Traditional Assets Working Party

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Lifetime mortgage(LTM) product rates



Sources:

Equity Release Council Market Reports (2014,2015,2016)

*The customer rates for these specific dates have been interpolated given the data available from the ERC's Market Reports.



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Lifetime mortgage (LTM) market specifics

- New entrants into bulk annuity markets
- Focus from other non-insurers
- An increasing range of product offerings
- Back-book transactions versus origination
- Regulatory sentiment – FCA / PRA view



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Recent challenges

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Uncertainty.....or opportunity

Economic	<ul style="list-style-type: none"> • Brexit implications for housing markets • Ever reducing (and negative interest rates) 	Manage economic risks effectively (underwriting, data collection, LTVs)
Regulatory	<ul style="list-style-type: none"> • Solvency II implications • Changes to retirement planning and consideration of funding • PRA discussion paper 	Mitigate regulatory uncertainty and maintain resilience
Operational	<ul style="list-style-type: none"> • Valuation methodology • Data requirements 	Use operational model in most effective way Independent review



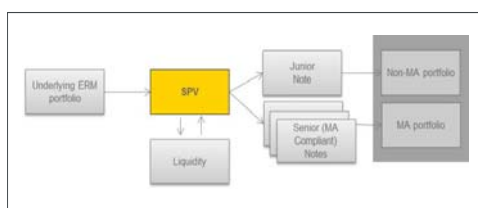
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Some of the focus areas within the DP....

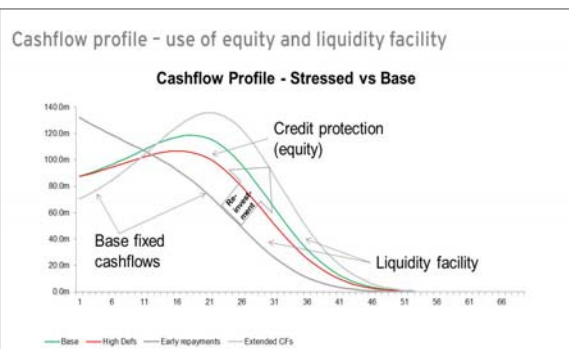


The Solvency II MA challenge



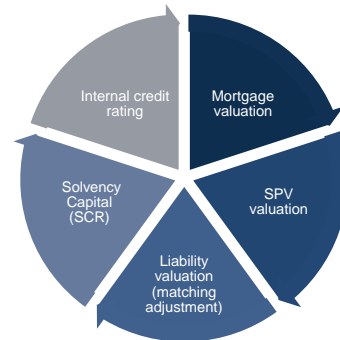
MA requirements *

Bond-like cash flows	✓
Same currency as the liabilities	✓
Fixed cash flows	✓
Sufficient compensation upon option exercise.	✓



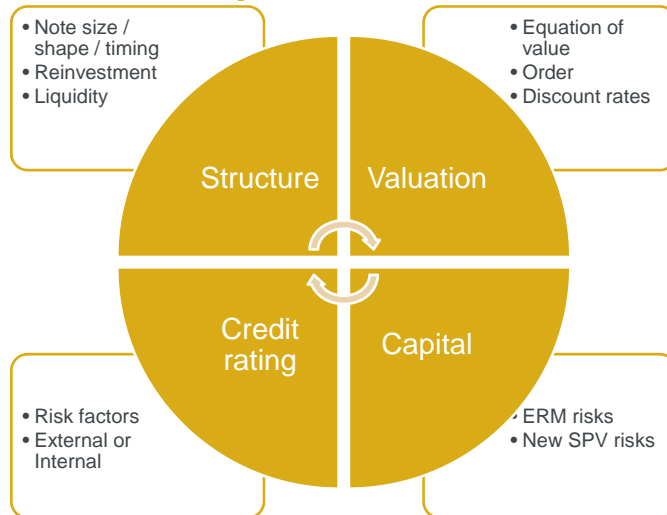
Where are we now with MA approvals

- 4 firms with approved LTM structures in the market at YE 2015
- A number of further firms with applications for LTM structures in with the PRA
- This has been accompanied with:
 - For firms with internal models, extension to internal model approvals
 - For firms under SF, a move to a Partial Internal Model of some form
- Securitisation also being considered as an option for other asset classes?

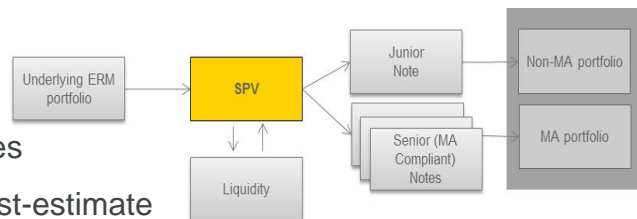


The case study – lifetime mortgages

Key transaction steps



Structure



- Securitisation with two or more notes
- Shape of senior note defined by best-estimate profile of mortgage cashflows
- Excess cashflows reinvested – only paid to Junior note once senior note is fully funded
- Structure includes a liquidity facility (sized to tolerate extension stresses)
- Investment through the same legal entity in the Insurance company (follows PRA letter in February 2015)

Valuation

- Pre-securitisation
 - Discounted cashflow (deterministic), allowing for early repayment, ill health, mortality
 - Risk-neutral Black-Scholes approach to reflect the NNEG in the value
 - Discount rate derived from market rates
- Post-securitisation
 - Equation of value and valuation order?
 - Reinvested assets / Senior fees / leakage of value
 - Discount rates set by expert judgement and “solved”
 - Reinvested assets change the balance of risk and the discount rate



Credit and capital

- Proxy method or look through to underlying loans?
- Stress the risk factors for the underlying loans (e.g. mortality)
- Stress the risk factors introduced by the SPV (e.g. reinvestment)
- MA requirements
 - Bond-like cashflows
 - Fixed cashflows
 - Same currency as liabilities
 - No optionality in senior note
- Internal rating approach used, but validated by credit opinion from ECAI
 - Combined univariate stresses, no diversification
 - Heavy prepayment and low reinvestment rates



Specific challenges of LTM - business

- New type of asset through securitisation bringing specific challenges
 - Model ownership and governance
 - Transaction execution
 - Operational readiness – who performs tasks post transaction
 - Further advances & Treating customers fairly

Questions

Comments

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