SLAUGHTER AND MAY

PS31/18 – Equity Release Mortgages

December 2018

Headline points

On 10 December the PRA published PS31/18, its policy statement to its July consultation on Solvency II and equity release mortgages (**ERMs**). No doubt to the relief of insurers holding ERMs as part of their matching adjustment portfolio, the PRA has backed down on part of its original proposals, although the core policy remains unchanged. The headline points are:

- the PRA is sticking with its proposals for the "Effective Value Test" (**EVT**) for ERM repackagings, including the valuation of no-negative equity guarantees (**NNEG**). This approach in effect does not allow projected house price increases above a risk-free rate to be taken into account when valuing the NNEG

- the PRA is keen to stress that the EVT is a diagnostic tool only, to be used to establish whether existing Solvency II requirements are being satisfied in insurer's MA calculations. The feedback to responses from insurers suggests that not everyone in the sector agrees with the PRA's interpretation of those requirements

- the PRA is withdrawing its proposal to require firms to use the same approach for valuing ERM assets in their ICAS calculations for the purposes of calculating the transitional measure on technical provisions (**TMTP**). This is a significant change from the draft updated supervisory statement as it allows insurers to phase in the impact of the PRA's proposals for pre-Solvency II business over the remaining lifetime of the TMTP (13 years)

- as announced in October, the effective date for the updated policy will be 31 December 2019.

Comments

The PRA's change of heart on the TMTP calculation eases the impact of its proposals considerably. Shares in Just Group, the insurer most exposed to the impact of the proposals, rose by 20% following the publication of the policy statement.

By contrast, the PRA has made no material changes to the core proposals to apply an Effective Value Test where ERM assets are used for matching adjustment purposes, despite what appears to have been a significant amount of push back from industry.

The PRA's feedback to responses received still do not reconcile fully the PRA's policy with the detailed Solvency II requirements. In particular, the policy is not obviously consistent with the mechanistic process for determining the fundamental spread as prescribed by the Delegated Regulation. There is also no clear justification in the Solvency II rules for requiring possible future property value increases to be taken into account on a risk neutral basis.

As noted above, it is clear from the text of the policy statement that there had been a high level of industry engagement with the proposals. Some of the points raised by stakeholders and the PRA's responses of particular interest as discussed briefly below.

ICAS calculations

The PRA has withdrawn its proposal that firms should apply the same set of principles to calculating ERM asset valuations in their ICAS calculations as they are being required to in 2019 under the updated supervisory statement. This proposal arguably undermined the intention for the transitional measure to smooth the technical provisions calculation from the Solvency I calculation to the Solvency II calculation, and was therefore potentially contrary to the wording of the Solvency II Directive.

The PRA maintains that the starting point for the valuation of insurance liabilities under both the ICAS regime and Solvency II is the discounting of cash flows by a rate that is genuinely risk-free. The implication is that firms should have been using a similar approach to that contained in the PRA proposals even pre Solvency II. The PRA does acknowledge, however, that there was not equivalent guidance under INSPRU 7 and that "principles for measuring the extent of expected and unexpected risks arising on ERMs were not consistently applied and understood".

The result of the change of heart is that insurers will be able to take a TMTP benefit which will effectively reflect the difference between their ICAS and Solvency II valuations of ERM assets (on a tapered basis). There is a small caveat, however. The PRA comments that where there is a material dependency by a firm on the TMTP to cover its SCR the PRA will closely monitor the robustness of the firm's phasing-in plan to ensure it can meet its solvency requirements at the end of the transitional period. It reminds firms that if a plan is not realistic the PRA can revoke an approval to apply the TMTP.

Impact on annuity and ERM markets

The PRA is unsympathetic to arguments put forward by respondents to the consultation that the proposals could have a negative impact on the ERM market, the annuity market, and/or the returns on insurers' capital. It also rejects the suggestion that they create a risk of unfair competition from non-UK providers. This view is based on the premise that the proposals simply reflect the Solvency II requirements and therefore "any transfer of risk to non-UK providers would not therefore reflect excessive UK regulatory requirements". As touched on above, there are differing views on the extent to which the PRA proposals go beyond the strict requirements of Solvency II. In practice it seems likely that there will be an impact on the ERM market, whether or not this can be ascribed to excessive regulatory requirements.

Retrospective rule changes

Responses to the consultation included comments on the potentially retrospective effect of requiring the "new" methodology to be used for the ICAS calculation input into the TMTP. Although the PRA proposals in this area have been withdrawn, the PRA's response to these suggestions is robust. It rejects the suggestion that the regulatory treatment of insurance assets and liabilities should not change over their lifetime and goes on to comment that *"if necessary in pursuit of its statutory objectives and consistent with applicable laws, the PRA will change the regulatory treatment of both new and existing business"*.

Links

https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-equity-release-mortgages

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