BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Executive Director
Insurance Supervision
Prudential Regulation Authority

20 February 2015

Solvency II: equity release mortgages

I would like to update you on our latest thinking with regards to the treatment of equity release mortgage assets (ERMs) in calculating the matching adjustment under Solvency II.

The matching adjustment is an adjustment to the risk-free interest rate term structure used to calculate the best estimate of the value of a portfolio of eligible insurance obligations. Its use is subject to prior supervisory approval where certain eligibility criteria are met. These eligibility criteria are set out in Article 77(b) of the Solvency II Directive[1]. Article 77(b)1(h) requires that the "cash flows of the assigned portfolio of assets are fixed and cannot be changed by the issuers of the assets or any third parties". This is important when considering the eligibility of equity release mortgage assets' ('ERMs') for the matching adjustment portfolio.

In my previous letter dated 15 October 2014, I set out feedback to firms on matching adjustment trial submissions and gave PRA advice that in their current form, ERMs would be unlikely to qualify for inclusion in a matching adjustment portfolio.

Some firms are seeking to re-structure their ERM portfolios in order for them to be eligible for inclusion within a matching adjustment portfolio of assets: a number of such proposals have been included in submissions in the matching adjustment pre-application process. Firms have raised a number of questions about the types of re-structuring that might be acceptable.

The purpose of this letter is to clarify the PRA's expectations in respect of ERM re-structuring. It will not recommend any particular form of re-structure or comment on specific proposals put forward by firms. The PRA have, however, considered the general issues arising out of common elements of firms' proposals, and frequently asked questions, in order to provide clarification ahead of firms submitting their formal applications for approval from April 2015.

Executive Director

[1] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast) (Text with EEA relevance). http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1412873282412&uri=CELEX:02009L0138-20140523

Solvency II: Equity release mortgages

Use of internal special purpose entities

Re-structuring of equity release mortgages (“ERMs”) through a subsidiary company set up for this purpose, wholly owned within the insurance group is likely to be acceptable, provided that proposals comply with the relevant legal and regulatory requirements.

It is important, however, that the re-structure is appropriately recognised within the group’s risk management framework, including the changes in the risk profile for all the funds and legal entities affected by the asset transformation.

Classification of the form of re-structure

The classification of the form of re-structure will depend on the specific nature and risk characteristics of firms’ proposals.

A number of proposals involve the pooling and transformation of cash flows from a defined set of underlying exposures into a series of ‘tranches’ of separate cash flows. These separate cash flows are distinguished by an increasing scale of risk posed to the investor (from senior to junior tranche). The PRA considers that such a structure is, in substance, a securitisation. Following this approach, the calculation of the model based capital requirements should consider the substance, rather than rely solely on the technical classification of the structure by product or securitisation type. The PRA’s expectations in respect of capital requirements are set out in more detail below

Rating and Valuation of Notes

As noted in the consultation paper on Solvency II Approvals (CP 23/14), as part of deriving the matching adjustment, it is anticipated that firms may seek to use internal rating systems to assign a rating category. Firms will need to be able to demonstrate the appropriateness of any internal rating model used.

The PRA will need to be satisfied, inter alia, that the following areas have been appropriately considered for the purposes of both risk management of the re-structure and the ratings process:

- the ability of the issuer to support fixed payments on the senior notes given its dependency on variable cash flows from ERMs and the potential leverage of the senior notes within the subsidiary entity (issuer);
- the quality of data used and reasonableness of key assumptions made in projecting expected cash flow receivables from the ERMs;
- the extent to which the expected ERM cash flow receivables (both amount and timing) have been stress-tested and the appropriateness of these scenarios;
- the strength of security of the mortgage assets – including underwriting standards, LTVs, diversity of property exposure, terms and conditions of the mortgages (eg

prepayment terms), and the ability of the issuer to substitute underlying mortgage assets;

- the extent to which reliance is being placed on additional liquidity facilities to maintain the ability of the issuer to support the fixity of cash flows and the liquidity of the structure, including the availability of these facilities over the expected lifetime of the special purpose entity, and under stressed conditions; and

- the extent to which reliance is being placed on the re-investment of surplus cash flows to maintain payments on the notes and the proposed (re)investment strategy for these.

The PRA note that stresses in respect of longevity, property value and early repayment developed in the context of VaR over one year at 99.5% confidence level are unlikely on their own to be sufficient to support a rating assessment over the duration of the notes, given the long term nature of the notes.

The requirements of [supervisory statement 9/14: valuation risk for insurers] continue to apply when valuing the notes. In addition, firms should recognise the risk of valuation uncertainty within their own risk and solvency assessment (ORSA) and, where appropriate, allow for this risk in determining their capital requirements.

Capital requirements

As set out above, the classification of the form of re-structure will also depend on the specific nature of firms' proposals and the risk characteristics of the structures. The PRA considers the pooling and transformation of cash flows from a defined set of underlying exposures into a series of 'tranches' of separate cash flows with different risk exposures to be, in substance, securitisation.

For firms proposing to use the standard formula to calculate the solvency capital requirement (SCR), the PRA would expect that the notes issued by the special purpose entity would be treated as a Type 2 securitisation as they are likely not to meet certain Type 1 criteria.[2]

The PRA anticipates that given the bespoke nature of the investment, firms otherwise using the standard formula may seek to develop a partial internal model (PIM) for this risk exposure(s). It is probable that this would be a situation in which use of a PIM would be appropriate should firms satisfy the relevant requirements for model use.

For firms applying for approval to use a internal model, the asset transformation as a result of the re-structure will need to be reflected in the model. A comprehensive consideration of the risks of asset transformation as well as the underlying ERMs and any diversification restrictions between the matching adjustment portfolio and the rest of the entity/group is required. Models will also need to make allowance for default, spread and concentration risks arising from investment in the notes issued by the entity.

For the junior tranches, firms will need to hold capital appropriate for the specific nature of the investment, noting the long tail and expected volatility of the risk exposure.

[2] Article 177(2) of the Solvency II Directive

Group Own Funds Consolidation

Solvency II Regulation[3] requires that in the calculation of consolidated group own-funds, intra-group transactions should be netted out.

The PRA considers that a structure where all the tranches are held by the same entity which contains the matching adjustment portfolio (albeit with any junior tranches and / or equity held outside the portfolio in order to comply with matching adjustment portfolio requirements), could be classified as an ‘intra-entity’ transaction (between the matching adjustment portfolio and the rest of the entity), rather than ‘intra-group’. As such, any matching adjustment benefit secured at a solo level would not then be eliminated on consolidation.

The PRA does not consider it appropriate for firms to replicate this form of re-structure in order to invest in assets which would not be considered suitable given the nature of the liabilities which are being matched. Firms should not assume that the PRA will necessarily approve replication of the use of such a structure and the ‘intra-entity’ treatment, if this were applied to cash flows from pools of other assets.

Future mortgage lending

If firms intend using the structure to include new mortgage lending in future (including incremental drawdown on existing policies), the application will need to set out the process for doing so. This should include an assessment of the volume of additional lending which will need to be accumulated before further tranches of notes of sufficient quality can be issued.

Firms will need to identify the sources of funding for any additional lending for the interim period ahead of the issuance of further tranches of notes, and how this complies with the relevant liquidity management policies.

Any assumption that the matching adjustment portfolio will make an advance commitment to purchase additional tranches of senior notes must be demonstrated to be compliant with the ALM and liquidity policies of the matching adjustment portfolio, including potential scenarios of closure or material restriction in volumes of new annuity business, and / or increase in additional drawdowns on existing equity release policies. Firms should consider whether a commitment fee should be made for such a facility.

Governance

If the re-structuring of the ERMs results in a permanent transformation of the assets, this will need to be reflected in firms’ risk management frameworks. It is important that firms have in place, and are able to demonstrate, the necessary governance and expertise to manage the additional risks arising from the re-structure, including the exposures within each of the special purpose entity, the matching adjustment portfolio and the holder of the junior tranches and /or equity.

[3] Article 335(3) of the Delegated Act

Solvency 1 transition

For firms seeking to re-structure equity release mortgage exposures, there is a potential challenge managing this within existing Solvency 1 concentration limit restrictions. In this case, it would be possible to submit re-structuring proposals for approval within a matching adjustment eligibility decision from April 2015, provided the structures are fully developed and in place and then transfer the ERM assets and hence issue notes at the point of Solvency II implementation.