BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

David Rule
Executive Director, Insurance Supervision

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Dear CEO

Solvency II: Equity release mortgages

I wrote to you in July[1] to explain our proposals in Consultation Paper 13/18 on equity release mortgages. The PRA is grateful for the many responses we received to the consultation. We have considered the feedback to the consultation carefully and are today publishing our updated Supervisory Statement.[2]

While we have made some changes based on consultation responses, the core of our proposals is unchanged. We will use our Effective Value Test as a diagnostic tool to ensure compliance with Solvency II requirements relating to the calculation of the matching adjustment benefit where liabilities are matched by restructured equity release mortgages, recognising in particular the risks arising from the no negative equity guarantee feature. The Effective Value Test will be calibrated with a house price volatility assumption of 13% and a minimum deferment rate of 0% from 31 December 2019, rising to 1% from 31 December 2021.

Our rationale for this approach remains as I set out in my July letter: 'insurers need to assess whether risks associated with the no negative equity guarantee have been properly taken into account in the amount of matching adjustment benefit claimed. They should not assess these risks as lower and inflate the matching adjustment claimed by assuming future house price growth in excess of the risk-free rate. Firms may in due course benefit from growth in house prices in excess of the risk-free rate, but they should not reflect this expectation in the form of an 'upfront' matching adjustment. This is because equity release mortgage redemption payments are ultimately funded by the sale of property, and firms therefore remain exposed to the risk that house price growth above the risk-free rate does not materialise – this is a risk to which firms are exposed regardless of what view one takes of the most likely future path of house prices and of the fact that insurers are buy-to-hold investors.'

However, in response to the feedback received, the PRA has decided to make a number of changes to the proposals. These are listed in Chapter 1 of the Policy Statement also published today[3] and I would like to highlight two key points.

First, we are not taking forward the proposal to apply an equivalent of the Effective Value Test as a single approach to determining the illiquidity premium in the pre-Solvency II Individual Capital Adequacy Standards regime for the purposes of the transitional measure on technical provisions. Insurers should assess the risks arising from equity release mortgages in their Own Risk and Solvency Assessments and consider the appropriateness of including them in the disclosures they make in their Solvency and Financial Condition Reports. The Policy Statement also reminds firms that they need to have a sustainable phasing-in plan where there is a material dependency on the transitional measure to meet

[1] https://www.bankofengland.co.uk/prudential-regulation/letter/2018/solvency-ii-equity-release-mortgages.
[2] SS3/17 'Solvency II: Matching adjustment – illiquid unrated assets and equity release mortgages': https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss.
[3] PS31/18 'Solvency II: Equity release mortgages': https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-equity-release-mortgages.

solvency capital requirements, and of the need to have sufficient assets under stressed conditions to continue to match liability cash flows in matching adjustment portfolios.

Second, we have reflected on the feedback that the new approach may make insurers' balance sheets more sensitive to interest rates. Our current thinking is that the minimum deferment rate should be updated periodically in line with movements in real interest rates, although it would always remain a positive rate. We believe a minimum deferment rate of 1% is appropriate currently. The PRA intends to follow up with a consultation in Q1 2019 on the ongoing assessment of the Effective Value Test, and how best to address excessive interest rate sensitivity that may arise over time, with the intention of completing the Supervisory Statement well ahead of the end 2019 implementation date. We also intend to include in that consultation principles for how we think the Effective Value Test may be applied in stress by insurers using internal models to calculate their Solvency Capital Requirement.

Our strategic goal remains to ensure that the matching adjustment framework remains robust in its application to all eligible assets and to avoid any risk that the credibility of this important element of the prudential framework is undermined. We continue to believe that restructured equity release mortgages are a suitable asset to back annuities as part of an appropriately diversified portfolio.

Yours sincerely

David Rule