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Sid Malik
Head of Division, Life Insurance and Pension Risk

1 February 2021

Dear Chief Actuary,

Feedback on the application of the Effective Value Test

In Supervisory Statement (SS) 3/17 'Solvency II: illiquid unrated assets',[1] the Prudential Regulation Authority (PRA) set out a diagnostic test, the Effective Value Test (EVT), to assess the appropriateness of the matching adjustment (MA) benefit life insurers derive from restructured equity release mortgages (ERMs). The PRA has reviewed the submissions from life insurance firms reporting the results of the EVT at year-end 2019, and the models and data provided in response to a data request of Thursday 27 February 2020, and it has identified the items of feedback contained in this letter as a result. In order to promote the clarity and consistency of submissions, the PRA asks firms to please consider the following key points when conducting the EVT, which should be shared with the relevant people at your firm:

Structure of economic value

1. The decomposition of economic value is set out in paragraph 3.13 of SS3/17 as follows:

    a) the value of expected ERM cash flows prior to deductions (ie as a risk-free loan on expected decrements);

    b) expenses;

    c) no negative equity guarantee (NNEG); and

    d) any other adjustments (ie to allow for pre-payment risk).

2. The PRA has observed a number of different approaches to this deconstruction. The PRA reminds firms that the first component should be based on all expected decrements (exits due to death, entry into long-term care and early repayment, including any applicable early repayment charges), while allowances for deviation from best estimate should be included in the 'other risks' component.

Use of appropriate assumptions

3. As set out in paragraph 3.20 of SS3/17, the economic value of a portfolio of loans should be based on a projection of cash flows that uses best estimate assumptions for mortality, morbidity and prepayment. Where prudent assumptions are used for fair valuation under

[1] April 2020: https://www.bankofengland.co.uk/prudential-regulation/publication/2017/solvency-2-matching-adjustment-illiquid-unrated-assets-and-equity-release-mortgages-ss.

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IFRS rules, these should not be used for the economic value. The PRA prefers firms not to use prudent assumptions in one part of the EVT calculation to offset imprudence or uncertainty elsewhere.

4. In keeping with the point directly above and paragraph 3.4 of SS3/17, the modelled cost of NNEG should be based on actual contractual triggers, in order to properly reflect the underlying NNEG risk. For example, the NNEG would normally be triggered on the sale of collateral upon death or entry into long-term care of the customer. In some occasions, the NNEG may be triggered on voluntary early redemption of the loan, but the model should not assume NNEG costs to be incurred where this is not the case.

5. As established in paragraph 3.23 of SS3/17, the PRA expects firms to demonstrate that they have made a realistic and credible allowance for other risks when assessing the economic value of ERM cash flows. The PRA has observed a number of different approaches and considers that observed best practice is to include an allowance for uncertainty (in cash flow amounts or timing) in the 'other risks' component. Where firms have not made any allowance for this uncertainty, they should justify this assumption.

6. SS3/17 specifies that the formula for calculating the cost of NNEG should include a 'current reasonable estimate at the balance sheet date of the value of the property providing collateral against the ERM'. Where this current estimate is based on scaling up a previous valuation in line with movements in a relevant property price index, the PRA considers that the observed best practice is to allow for underperformance of the property, relative to the index. The PRA also considers that the observed best practice is to allow for sales costs when setting this estimate. When submitting the results of the EVT, firms should confirm what allowance is made in respect of these features, or provide a justification for why they have not been included.

7. SS3/17 stipulates, where there is the risk of future lending on the same property at the discretion of the borrower, that risk should be reflected in the NNEG calculation. This is expected to be calculated on a best estimate basis, which should be discussed with the supervisor. The PRA considers any attempt to calibrate best estimate assumptions regarding drawdown rates should be carefully justified, using good quality data. Where this is not possible, firms should assume the full drawdown facility is used, as recommended in Policy Statement (PS) 19/19 'Solvency II: Equity release mortgages – Part 2'.[2]

8. The PRA reminds firms that the interest rates used in discounting cash flows for economic value should be the unadjusted Solvency II risk-free rate term structure

Presentation and submission of results

9. The PRA prefers that when setting out the components of economic value, firms should separate expenses relating to the underlying loans from expenses relating to the Special Purpose Vehicle structure.

2 September 2019: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2019/ps1919.pdf.

10. In circumstances where the EVT is passed with little headroom, the PRA may wish to understand what circumstances could lead to the test being failed. With this in mind, the PRA considers that it may be useful in future submissions to report sensitivities for some key market/economic parameters.

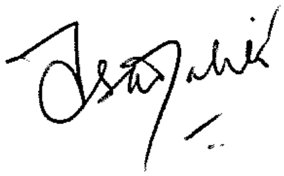
11. The PRA reminds firms that EVT results should be reported promptly. It is appropriate to submit year-end results alongside Q4 Quantitative Reporting Templates on Thursday 4 February 2021 and corresponding dates in following years.

12. The PRA reminds firms that the expectations for the content of any EVT report are set out in paragraph 3.25 of SS3/17. Firms are free to report results in a manner convenient for them, but the PRA provides a template that firms are welcome to use if they choose to do so.[3]

These recommendations around best practice should be incorporated into your EVT models at your nearest convenience, and at the latest by Friday 31 December 2021, when the full expectations of SS3/17 will come into effect.

Yours sincerely,

Sid Malik
Head of Division, Life Insurance and Pension Risk



3 Available at: https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/regulatory-reporting/insurance/evt-results-template.xlsx.