Briefing

Insurer valuation of equity release mortgages

Note for pension scheme trustees

Will recently proposed regulatory changes in respect of equity release mortgages affect the solvency of bulk annuity insurers?

This note is relevant to trustees of pension schemes who hold a buy-in insurance contract and trustees of schemes contemplating a bulk annuity transaction in the current market.

A long-running dispute between the insurance industry and the Prudential Regulation Authority (PRA) is nearing its conclusion. The outcome could significantly impact the solvency of some annuity companies.

Virtually all of the insurance companies in the bulk annuity market invest in Equity Release Mortgages (ERMs). These currently are assumed to produce attractive risk-adjusted long-term returns that insurers allow for in their pricing of annuities. However, the PRA is challenging the way many insurers allow for the risks inherent in these assets for solvency purposes and has proposed minimum assumptions that need to be used.

Whilst not all insurers will be materially impacted, these alternative assumptions could force those insurers with significant holdings of ERMs to raise additional capital, or if this is not possible, close to new business or put themselves up for sale.

If trustees of a scheme with a buy-in contract have reason to be concerned over insurer solvency, there are potentially far-reaching implications for the scheme. They should consider any specific contractual clauses that might be triggered and the need to reconsider funding discussions and the ongoing governance of the scheme, including considering possible conversion of the contract from buy-in to buy-out.

It also seems inevitable that some insurers will have to reduce the assumed benefit being taken in respect of ERM assets and will pass this on in their pricing to some extent, leading to downward pressure on the recent favourable pricing conditions.

Background

ERMs are loans offered to homeowners, usually near or in retirement, to enable them to access the equity in their homes without having to sell or move out. Typically, interest is rolled-up on the loan, which is repaid on death or a move into a care home. The market has grown significantly over recent years, with over £3bn of funds being borrowed against homes in 2017. A key feature of these products is the No Negative Equity Guarantee (NNEG), whereby lenders guarantee that the amount repayable is no more than the price achieved on sale of the house following death or move to a care home of the borrower.

Insurance companies have been key funders of ERMs (either directly or via third party providers), using the proceeds of annuity sales to lend to homeowners and then using the loan repayments to match their long-dated annuity liabilities. Virtually all of the insurance companies in the bulk annuity market invest in ERMs. These currently are assumed to produce attractive risk-adjusted long-term returns that insurers allow for in their pricing of annuities.

CHART OF AVERAGE MATCHING ADJUSTMENT BY ASSET CLASS

Source: Bank of England Calculations based on data submitted by insurers, 31.12.2016. Average Spread by Matching Adjustment Asset Class. Market Value and Duration Weighted results.

Whilst there are differing amounts of ERMs on the books of insurers depending on when they first started investing in them, nearly all annuity firms assume a significant proportion, which can be 25% or more, of new business premiums is invested in ERMs when pricing. This has been a major contributing factor in the improved pricing conditions for bulk annuities seen in recent times.

Solvency II regulations for insurers require that assets are valued at market value and that any guarantees are valued on a market-consistent basis. There is no observable secondary market for ERMs and so the values placed on them are subjective. The insurers, the regulator and other market commentators have very different views on what those values should be.

As well as impacting the asset side of the balance sheet, there are also knock-on effects on the value of the liabilities (through the calculation of the Matching Adjustment, effectively the illiquidity premium allowed to be added to the discount rate for liabilities) and the SCR capital required.

The differing views on the value of the loans

The value of the ERMs on the asset side of the insurer balance sheet is calculated as L' = L-NNEG where

- L = The expected loan repayment amount
- NNEG = The value of the NNEG

The value of the NNEG depends, amongst other assumptions, on a view of future house prices to determine the upper limit on the loan repayment amounts. Most insurers have assumed positive long-term house price growth as has been observed historically. Insurers argue that this "real-world" basis is consistent with the treatment of corporate bonds, where historic allowances for defaults are assumed.

The PRA issued a supervisory statement SS3/17 in July 2017. This was primarily concerned that the amount of Matching Adjustment benefit was not overstated due to the securitisation of the ERMs (which insurers had been forced to do to meet Matching Adjustment eligibility criteria). However, it also contained the following directions on valuing the ERMs:

- any guarantees must be valued consistently with asset (ie on fair value principles)
- L' < Current property value

The latter point makes considerable mathematical sense: because an equity release customer always has the ability to repay the loan in full by giving up their home in the future. Therefore, the value the insurer places on the loan must be less than the current value of the home, as part of a house price reflects the benefit of ownership in the interim period (which can be estimated using rental yields).

Insurers took this on board and, for example, Just Group plc restated their Solvency Coverage Ratio in their 2017 Solvency and Financial Condition Report to allow for this for business written since Solvency II came into force in 2016.

The PRA was still not happy though with the industry response to the supervisory statement and issued a consultation paper; CP13/18 in July 2018.

This proposed amendments to SS3/17 making it clear that the valuation principles apply not just to the value of the insurers' liabilities (via the Matching Adjustment) since 2016 but that the assumptions should also be applied to the liabilities of business written before Solvency II came into force.

> CP13/18 also proposed minimum acceptable assumptions to be used for the gap between rental yields and discount rates in valuing ERMs but allowed a phasing in of the assumptions over three years. The consultation ends in September 2018 with the expectation that the revised SS3/17 comes into force before the end of 2018.

Separately, Professor Kevin Dowd issued a paper in August 2018 through the Adam Smith Institute, entitled "Asleep at the Wheel: The PRA and the Equity Release sector". In it, he argues that using the real-world approach to valuing the NNEG is flawed because:

- the NNEG is a put option
- therefore the NNEG should be valued using option pricing mathematics on a risk-free basis, ie using the futures price for owning property, not the future price (this is consistent with the PRA view)

He also makes some damning statements about the industry and the PRA, for not regulating the valuation of these assets strongly enough.

The impact on insurers' solvency coverage ratios

A change in the valuation of the NNEGs in line with the consultation paper will have a triple impact on most insurers' balance sheets:

- The market values of the ERM assets will be marked down as the value is essentially the value of the loan repayment less the value of the NNEG, which has previously been underestimated.
- The value of liabilities will increase because the total amount of illiquidity premium allowed in the discount rate (via the Matching Adjustment) is reduced due to the lower value of the ERM assets in the portfolio. Any insurer who is phasing in Solvency II liability regulations over a transitionary period in respect of historical business (following the introduction of Solvency II in 2016) will also suffer an immediate impact on their pre-2016 liabilities.
- The amount of capital required will increase to reflect the higher value of these guarantees in stressed conditions.

The Dowd paper suggests that a market-consistent value of the loans could easily **be 50% lower** than currently being held, with the values falling to close to zero in stressed conditions.

Many firms disclose the impact of not benefiting from the Matching Adjustment and the liabilities transition measures and generally the impact on solvency coverage ratios is large (albeit that they wouldn't lose all of these benefits in this case). The impact on the capital is difficult to quantify as it is non-linear. However, it is clear this potentially is a significant issue for a number of providers who have material holdings of ERMs.

The information required to calculate the impact on coverage ratios is not available publically.

However, the PRA are requesting impact assessments as part of CP13/18

Barnett Waddingham are conducting interviews with each of the insurers to understand the potential impact on these numbers and the assumptions behind them.

What should trustees be doing now?

Schemes holding a buy-in contract remain exposed to the credit risk, and so financial strength, of their insurer. Like any pension scheme investment, trustees should consider their policy for monitoring and measuring the credit risk associated with the investment. We would expect any policy to be activated when the trustees become aware of developments which have the potential to materially affect the financial position of their insurer.

If trustees have reason to be concerned over insurer solvency, there are potentially far-reaching implications for the scheme. They should consider any specific contractual clauses that might be triggered and the need to reconsider funding discussions and the ongoing governance of the scheme, possible conversion of the contract from buy-in to buy-out may also be a consideration.

Historically, trustees have been able to take considerable comfort over insurer creditworthiness from the regulatory regime, the level of PRA supervision and the requirement to hold audited capital buffers. Whilst we still think the UK regulatory regime for insurers is strong, there is clearly a temporary issue here whereby the solvency coverage ratios of some insurers are likely to worsen from the most recently published levels. Whilst different firms will be impacted to different extents, in some cases, the reductions could be material and may lead to insurers needing to raise additional capital, or if this is ultimately not possible, close to new business.

Barnett Waddingham's Insurance Consulting practitioners are able to undertake a financial strength review of individual insurance companies and can assess the potential impact on solvency coverage.

Where an individual firm may not be able to carry on writing new annuity business, there has been proven appetite from other providers to step in and purchase the closed books, for example Paternoster, Lucida, Aegon and Prudential have all been bought out in recent years (totalling over £20bn). We could envisage a similar process happening again, and would subsequently expect this to leave policyholders unaffected (and possibly even in an improved situation depending on the nature of the buyer).

In the case of an insurer failure and no buyer, individual annuitants would be covered by the Financial Services Compensation Scheme (FSCS) and so should in principle not lose their benefits. However, we suspect members of recently transferred policies will not be impressed by having to go through the FSCS. Whilst those schemes with buy-ins are also potentially covered by the FSCS, this has not been tested and the mechanism for recovering money may be difficult or time-consuming, even if the FSCS is capable of paying the full value of the benefits.

Finally, the biggest impact may be on the future pricing of annuity markets.

> If annuity writers are unable to assume as much benefit for ERMs in pricing, then annuity rates are likely to rise.

Whilst proportions of ERMs held are quite small for many providers, the proportions assumed to be backing new business can be 25% or more and so this could have a meaningful impact on pricing for some insurers – depending on the levels assumed and the degree of existing prudency in their assumptions. If insurers choose to absorb this loss, this could reduce margins which could then see some providers leave the market, possibly reducing competition and capacity. So the unusually good pricing conditions seen during 2018 may deteriorate.

For more information, please contact your Barnett Waddingham consultant, who will be happy to help you. Alternatively, get in touch with one of our insurance specialists:

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