# Association of British Insurers

## ABI response
## CP48/16 Solvency II: Matching adjustment – illiquid unrated assets and equity release mortgages

**The UK Insurance Industry**

The UK insurance and long-term savings industry is the fourth largest in the world. It plays an essential part in the UK's economic strength, managing investments of over £1.6 trillion (equivalent to 25% of the UK's total net worth) and paying nearly £12 billion in taxes to the Government. It employs around 305,000 individuals, of which around a third are employed directly by providers with the remainder in auxiliary services such as broking.

**The ABI**

The ABI is the leading trade association for insurers and providers of long-term savings and the largest financial services trade association in the UK. Founded in 1985, we represent around 250 brands from London Market wholesale general insurance to long-term savings providers and a wide range of specialist providers.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and advocating on behalf of insurers
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance
- Promote the benefits of insurance to government, regulators, policy makers and the public

We welcome the opportunity to comment on the PRA's consultation *CP48/16 Solvency II: Matching adjustment – illiquid unrated assets and equity release mortgages.*

## Key messages

- Investment in real assets can have wider economic benefits, such as investment in infrastructure projects which can provide significant social benefits and support the competitiveness of the UK economy. However, we note that some aspects of the PRA proposals could result in noticeable burdens on firms, especially when considered on a cumulative basis, and that this could discourage insurers to invest in real assets. We would therefore urge the PRA to take a proportionate approach.
- By nature, illiquid assets are likely to have larger spreads than other assets, such as corporate and government bonds, as they are not easily tradable and have a longer maturity period. Having larger spreads than other assets is not necessarily an appropriate indicator, nor should it be the sole one, to be used to evidence the potential risk that the Matching Adjustment benefit is being "overstated".

**The appropriateness of the Fundamental Spread (FS) is the key factor in measuring risks retained by firms rather than total spreads**

- We believe the PRA's focus should be on the appropriateness of the FS rather than the level of the MA which, if considered in isolation, can be a misleading indicator. For assets held in an MA portfolio, the appropriateness of the FS is the key factor which measures the risks retained by firms rather than the total spread.

**In assessing the consistency between internal and external ratings, a number of factors need to be considered, including the data and methodology used**

- Ratings provided by ECAIs for assets other than government bonds may not always allow a direct "apples-to-apples" comparison with internal ratings which may have been based on data different from corporate bonds data.
- Any assessment of consistency of an internal rating with a rating produced by an ECAI should take into account the methodology adopted by the ECAI as rating methodologies used by ECAIs differ.
- An "apples-to-apples" comparison may prove to be difficult in the case of ERMs, a niche product line requiring a level of expertise and understanding of the associated risks to write such products, as well as to issue ratings. ERMs are illiquid assets typically spanning over a 25 year period and valued using demographic assumptions, which other assets that ECAIs rate would not be subject to.

**Comparing re-structured ERMs' level of MA benefit to that of a comparable reference instrument is inadequate**

- We note that the PRA proposes to monitor the level of MA benefit claimed for illiquid assets by comparing it to the benefit from a comparable reference instrument. For assets such as re-structured ERMs, we are concerned that this would be inadequate as ERMs do not have a comparable instrument which could be referenced. We would encourage the PRA to clarify what a "comparable reference instrument" would be, and provide a justification for why it is appropriate given variations observed in firms' portfolios and risks.

## Detailed comments

| Section | Reference | Comments |
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| General comments | | **There are sound economic reasons why illiquid assets have larger spreads, and this does not necessarily mean the MA benefit is "overstated"**<br>• By nature, illiquid assets are likely to have larger spreads than other assets, such as corporate and government bonds, as they are not easily tradable and have a longer maturity period. Having larger spreads than other assets is not necessarily an appropriate indicator, nor should it be the sole one, to be used to evidence the potential risk that the Matching Adjustment benefit is being "overstated". |
| Overview | 1.1 | • We believe that the scope of the consultation would benefit from further clarity. We understand the scope applies to illiquid assets held in MA portfolios and the consequences for Own Funds. However, we note the approach to the valuation of illiquid assets held outside an MA portfolio can also influence Own Funds. For example, the valuation of loans held outside an MA portfolio using spreads which are too low may result in an overstatement of Own Funds.<br>• In addition, Paragraph 1.1 of Appendix 1 states that the draft supervisory statement is "addressed to life insurance and reinsurance companies holding or intending to hold restructured illiquid assets (including equity release mortgages (ERMs)) in an MA portfolio". However, paragraph 2.1 to 2.8 of Appendix 1 can be interpreted as applying to all internally rated assets as opposed to only restructured ones. We understand the PRA is referring to the latter, and so encourage the PRA to confirm this point in the final supervisory statement. |
| | 1.3 | • We agree with the PRA that investment in real assets can have wider economic benefits, such as investment in infrastructure projects which can provide significant social benefits and support the competitiveness of the UK economy.<br>• However, we note that some aspects of the PRA proposals, when considered on a cumulative basis, could result in noticeable burdens on firms – notably the external assurance on the internal ratings process, the assurance on the process of mapping ratings to FS, the possibility of an independent review under Section 166 of the FSMA 2000, and the expectation for the Head of Internal Audit function to opine on the appropriateness of the FS.<br>• We therefore urge the PRA to take a proportionate approach to ensure insurers are not unnecessarily discouraged to invest in real assets. |

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| 2. Proposals | 2.4 | **In assessing the consistency between internal and external ratings, a number of factors will need to be considered, including the data and methodology used**<br>• We note the PRA's view that internal credit assessments should be broadly consistent with the issue ratings that ECAI would produce. In assessing consistency between internal and external credit ratings, we believe that this assessment should not be overly prescriptive and take into account a number of factors.<br>• We understand that the fundamental spreads (FS) published by EIOPA apply to corporate bonds and government bonds, and that assets other than government bonds are calculated in the same way as for corporate bonds, using corporate bonds data. As such, ratings provided by ECAIs for assets other than government bonds may not always allow a direct "apples-to-apples" comparison with internal ratings which would have been based on data different from corporate bonds data.<br>• An "apples-to-apples" comparison may prove to be difficult in the case of ERMs. ERMs are an increasingly important and growing, but still niche product line, requiring a level of expertise and understanding of the associated risks to write such products, as well as to issue ratings. We note that ERMs are illiquid assets typically spanning over a 25 year period and valued using demographic assumptions, which other assets that ECAIs rate would not be subject to. For this reason, firms writing ERMs have generally tended to rely on internal credit assessment rather than external ones.<br>• In addition, we note that ratings methodologies used by ECAIs differ. Whilst some ECAIs adopt an approach based on probability of default, other ECAIs adopt an approach based on expected losses. Any assessment of consistency of an internal rating with a rating produced by an ECAI should take into account the methodology adopted by the ECAI. |
| | 2.5 | • We understand the PRA intends to conduct in-depth reviews and establish thresholds for intervention. Given the number of variations found in ERMs across firms, comparing firms' ERMs could be a difficult exercise.<br>• When intervening, it will be important for the PRA to consider other factors beyond the thresholds to assess whether there has been MA benefit misstatement.<br>  ○ For instance, when looking at firms where the MA would represent a large impact on the balance sheet, the PRA should consider the assumptions used in the calculation of the NNEG which could be high. This would reflect the level of prudence that firms assumed in their balance sheet.<br>  ○ We would also encourage the PRA to take into account the risk management practices that firms have in place when the ERM's are added onto the balance sheet. This would allow the PRA to assess the relative riskiness of different ERMs.<br>• More generally, we would find helpful to have further information from the PRA on the benchmarks which will be used to enable firms to understand key differences in assumptions across industry and how firms might seek to address these differences: |

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| | | ○ Data sources and methodology the PRA will use to establish these assumption benchmarks (e.g. how to derive benchmarks for property volatility). This would enable firms to assess which benchmarks (their own, or the PRA's) would be the most appropriate for their businesses.<br>○ Overall benchmark ranges at a higher level (e.g. benchmarks for the NNEG as a percentage of loan-to-value (LTV)). This would allow firms to assess whether the overall NNEG was reasonable even if it was above or under the assumptions.<br>• Such information would help firms to ensure a more consistent level of understanding between the PRA and industry, which would further improve firms' own risk management practices for these products. |
| Appendix<br>1. Introduction | 1.5 | • According to Article 47 of the Solvency II Directive, we note the Internal Audit function is responsible for independent assurance on the adequacy and effectiveness of the firms accounting and reporting procedures. However, we believe that expecting the Head of the Internal Audit function to opine on the appropriateness of the FS goes beyond what is required under the Directive. This could make the process unnecessarily burdensome as well as place UK firms at a competitive disadvantage. |
| 2. Use of internal credit assessments for assigning fundamental spread | General comments | ***The appropriateness of the FS is the key factor in measuring risks retained by firms rather than total spreads***<br>• We believe the focus of the consultation should be on the appropriateness of the FS rather than the level of the MA which, if considered in isolation, can be a misleading indicator. For assets held in an MA portfolio, the appropriateness of the FS is the key factor which measures the risks retained by firms rather than the total spread.<br>• For example, for a given FS, a firm could increase the value of the assets on its balance sheet by using a lower total spread. However, this would also result in a higher value of liabilities through the use of a lower MA, which would broadly offset the increase in value of assets. We would therefore recommend that the PRA focuses on the appropriateness of the FS given the risks retained by firms rather than consideration of the level of the MA in isolation.<br>***Firms may not always use internal ratings as an intermediate step***<br>• We note that whilst some firms may use an internal rating as a factor for translating the risks they retain from investment in an illiquid asset into an FS, this may not be the only way.<br>• For some illiquid asset classes, firms may find it more appropriate to go directly to the FS, without using an internal rating as an intermediate step. For example, some firms use risks characteristics, which are in some cases more granular than internal ratings, in the mapping process. This is particularly relevant for asset classes for which no rating is published by an ECAI. |
| | 2.5 | • We note that the PRA proposes to monitor the level of MA benefit claimed for illiquid assets by comparing it to the benefit from a comparable reference instrument. For assets such as re-structured ERMs, we are concerned that this would be inadequate as ERMs do not have a comparable instrument which could be referenced. |

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| | | ○ Given the "niche" nature of ERMs, we are concerned that features of individual portfolios can lead to pricing differentials. Firms will have different portfolio and risks (e.g. differences in underwriting standards, variation in Loan to Value criteria, and interest paying or non interest paying characteristics of the underlying loans), and hence, the nature of the underlying ERMs and the structures will be different. As such, we believe that each portfolio of assets needs to be considered on a first principle and risk-based approach and that it would not be appropriate to compare notes issued by one firm with those issued by another.<br>• We would encourage the PRA to clarify what a "comparable reference instrument" would be, and provide a justification for why it is appropriate given variations observed in firms' portfolios and risks. |
| | 2.11 | • We note that the PRA included the strength of the security in the list of quantitative features which a firm should consider when assigning an internal credit rating.<br>• This could result in more regular reviews of properties underlying the restructured ERM's which could be costly, and possibly act as a deterrent to new market players. |
| 3. Assessing the risks from embedded guarantees in equity release mortgages | 3.9 | • Paragraph 3.9 of the draft supervisory statement sets out the definition of the best estimate cost of the NNEG. As currently drafted, the wording can be interpreted as the PRA expecting a more detailed analysis of the risks above the current calculation of the NNEG. This would require a different methodology to the current way firms are calculating the best estimate cost of the NNEG, and could be onerous and unnecessary.<br>• The current methodology is clear and works effectively, which we would favour keeping. Using the alternative of a stochastic model would require new model builds and result in additional resources for firms, which is an important factor for the PRA to consider if it has plans to change the current methodology. As a more proportionate approach, we would favour a closed-form solution rather than an alternative stochastic model, were this results in similar answers but with reduced complexity. |
| | 3.13 | **Restriction of the economic value of ERM cash flows should be applied to the fair value of ERMs**<br>• We believe that the term "economic value of ERM" is unclear and would benefit from further clarification. In particular, it is unclear how the restriction of the economic value of ERM cash flows is intended to apply. We believe that the restriction should be applied to the fair value of ERMs (e.g. excluding the MA benefit).<br>• We do not consider that it would be appropriate to restrict the Effective Value to the market value of future possession of the property, in the same way as it is not appropriate to restrict the Effective Value of a portfolio of corporate bonds to the market value of those bonds. A typical investor would place a greater discount on the illiquidity and payment deferral of property future possession than an insurance investor using it to cover long term illiquid liabilities. |