Matching adjustment for equity release assets
This paper has been prepared for European enhanced annuity writers that invest in equity release assets. It provides some potential solutions for dealing with the fact these assets may be ineligible for a matching adjustment under Solvency II.

Introduction

Many enhanced annuity writers’ business models are based in part on using equity release assets to back annuity liabilities. In the current low-interest-rate environment, yields on equity release mortgages are used to bolster annuity rates, leading to better value for consumers. For companies, investing in these assets can lead to capital efficiencies under the current Solvency I regime.

The table below provides a summary of recent customer interest rates for lifetime equity release mortgages for enhanced annuity writers. These rates are notably higher than recent yields on corporate bonds. As of 31 August 2013, yields on corporate bonds ranged from 3.8% (AAA) to 4.9% (BBB) (source: Reuters).

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<thead>
<tr>
<th>Company</th>
<th>Rate</th>
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<tbody>
<tr>
<td>Aviva Equity Release</td>
<td>7.10%</td>
<td>LV=</td>
<td>5.79%-6.19%</td>
</tr>
<tr>
<td>Hodge Lifetime</td>
<td>5.59%-5.74%</td>
<td>Partnership Assurance</td>
<td>7.45%</td>
</tr>
<tr>
<td>Just Retirement</td>
<td>6.20%</td>
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Source: Moneyfacts magazine August 2013, Issue 298, p119-120.

While investing in equity release as an asset liability management (ALM) strategy has proven to be very successful for many enhanced annuity writers, under a Solvency II regime, this model is coming into question. As it stands, the rules indicate that equity release assets will be ineligible for a “matching adjustment.” For companies investing in equity release, all other things being equal and in the absence of transitions, they can expect to have to hold higher best estimate liabilities and capital requirements relative to competitors that are able to utilize a matching adjustment.

Evolution of the matching adjustment

Early versions of Solvency II regulations were built from banking rules and did not recognize the concept of an illiquidity premium for long term insurance liabilities. Following the financial crisis, the importance of the illiquidity premium became very apparent prompting discussions regarding its inclusion. Even since the concept was first introduced, controversy has surrounded its scope and quantum, and as a result restrictions have been applied.

On 13 November 2013, the trilogue parties reached agreement on the details of the Omnibus II Directive, including the matching adjustment. We now await publication of this Directive and finalization of the Delegated Acts.

Subject to meeting certain eligibility criteria, the application of the matching adjustment allows companies to take credit for some of the yield in excess of risk free on assets backing certain types of liabilities. This allows the liabilities to be discounted at a higher rate. In addition changes in asset values will, to some extent, flow through to the value of these liabilities reducing balance sheet volatility.
The key criterion impacting holders of equity release assets is that cashflows must be fixed in order for an asset to be eligible for a matching adjustment. Due to contingency on life expectancy and early redemption options, the timing of repayment of an equity release mortgage is uncertain, and this would appear to make these assets ineligible.

Possible solutions

This raises the question as to whether these assets can be restructured or transformed in such a way as to comply with the rules and, if not, what other options are available to insurers.

Insurers will need to assess these options against their view of how the detailed rules will be drafted and how regulators will interpret them. In addition, where risk is transferred, annuity writers need to consider other implications, for example, the impact on counterparty risk and, for internal transfers, how the arrangement will be treated at a group level.

Option 1: Take no action

For some insurers, the size of their equity release portfolio, or the impact on own funds, may be insufficient to warrant immediate action.

Other companies may opt to do nothing until there is greater certainty around the rules and/or the guidance from the regulator is more formal.

Further fuelling this discussion is the option of using transition rules that will allow Solvency II technical provisions for prior portfolios to be phased in. A company considering exercising these rules will need to consider the acceptability of these to its regulator and sector analysts, and how its capital and profit profile emerges under various scenarios, in order to optimize its position. It will also be important to understand the starting point of the transition, for example whether Solvency I Pillar 1 or Pillar 2 bites and how the yield on equity release is reflected.

Option 2: Dispose of assets

Other companies may wish to remove equity release assets from their balance sheet through sale. Bearing in mind the difference in treatment of these assets for Solvency I and II, we may see increased sales of equity release portfolios as the Solvency II implementation date draws closer.

A decision on this may depend on the balance between management’s views of the real world benefits of the increased yield against the implied risk based return of the incoming regulatory measure. Disposal options may involve the full sale of the assets, or other options such as securitising specific parts of the underlying cashflows.

Option 3: Restructure using a special purpose vehicle (SPV)

This option would involve transferring equity release assets to an SPV that issues debt to the originating fund. Debt would need to comply with matching adjustment rules, for example, having fixed cashflows. Return on debt would need to be lower than the return on the underlying assets in order to provide some level of certainty to the debt holders in terms of the risk of default.
There may also be considerations around credit ratings of the debt or SPV, even if matching adjustment rules are not prescriptive.

The cost of the additional administrative, regulatory and potentially rating agency burden of setting up and maintaining an SPV also needs to be considered. Likewise, treatment of the transaction at a group level is a critical factor in the suitability of this option.

The graph below provides an overview of this arrangement. In return for the transfer of the equity release assets, the SPV will pay fixed cashflows to the annuity writer (debt layer), and the remaining cashflows to the holding company (equity layer).

Option 4: Reallocation within a group structure

This option would involve holding equity release assets in a different entity within the group with this entity providing fixed cashflows to the annuity writer. This approach would help to overcome some of the administrative, regulatory, cost and possibly rating considerations associated with setting up an SPV.

Larger, multi-entity insurers would probably be the only ones interested in this option and, again, treatment of the transaction at a group level may present a hurdle for some companies.

Option 5: Transfer through external reinsurance

A reinsurance premium equal to the market value of the equity release assets would be paid to a reinsurer that is outside of the scope of Solvency II.

Reinsurance recoverables, equal to the annuity claims payments that were previously backed by the equity release assets, would be discounted at a lower rate, due to the absence of a matching adjustment. As such, assuming the reinsurer is happy to take credit for the yield on the equity release assets, the reinsurance premium would be lower than reinsurance recoverables thereby capitalising the value of the matching adjustment and increasing own funds.
This structure would increase counterparty risk capital requirements and costs. Further, the group would not realize any potential upside from the uncertain asset or liability cashflows. Depending on the structure the reinsurer may also want a margin for the downside risk taken on.

The cost of reinsurance would need to be measured against the uplift to own funds.

Option 6: Transfer swaps
Another option involves using a combination of lapse and longevity swaps to convert uncertain cashflows into fixed cashflows. This is based on the principle of the insurer continuing to hold the equity release assets on its balance sheet while holding another asset which “hedges away” the problematic features at a portfolio level.

This introduces counterparty risk, increases costs and means that the insurer transfers any potential upside from uncertainty to the third-party provider.

Conclusion
The right solution for a specific company depends on its individual circumstances as well as the eventual rules and the way they are interpreted by the regulator.

By bringing together a combination of specific tax, regulatory, accounting and actuarial experience in this area, EY is able to help you to assess how these options might suit your business and objectives.
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