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Bulk Purchase Annuities and Equity Release Mortgages – PRA Consultation

A consultation by the Prudential Regulation Authority (PRA) on its expectations in respect of insurance and reinsurance companies holding equity release mortgages (ERMs) could potentially have an impact on the cost of bulk purchase annuity policies.

The PRA is concerned that insurers are not adequately assessing the risks that exposure to ERMs are having on their balance sheets. The implementation date for the proposals is expected to be 31 December 2018.

Background

Competition amongst bulk purchase annuity (BPA) providers, combined with limitations in the supply of traditional assets to invest in, is driving the development of innovative new investment solutions as insurers seek to source suitable assets to meet market demand to purchase BPAs.

A number of BPA providers are now investing in equity release mortgages (ERMs). They find these to be attractive investments due to their complementary cash flow profile and the high level of "matching adjustment eligible" investment returns that may be allowed for in their pricing models.

Being "matching adjustment eligible" is critically important to insurers as it enables a proportion of the credit spread to be taken into account when determining the discount rate used in determining the level of solvency capital that must be held. To the extent that insurers incur lower costs as a consequence of not needing to hold as much solvency capital, these savings can be passed through to the premiums they charge customers for their products.

The PRA's Proposals

On 2 July, the PRA opened a consultation on its expectations in respect of firms investing in ERMs as it is concerned that insurers are not adequately assessing the risks associated with such products. Should the PRA impose controls which restrict the value placed on ERM assets, this will increase insurers' cost of capital which, in turn, will increase the premiums insurers charge for BPA policies.

How might this impact the BPA market?

- The inclusion of ERMs within BPA providers' investment portfolios is making pricing very attractive at the current time.
- Consumer demand for ERMs is currently high as borrowers seek to unlock the value of their homes to fund retirement spending.

- Whilst consumer demand for ERMs remains strong, this attractive pricing is expected to continue.
- If regulatory intervention results in consumer demand falling or the extent to which the matching adjustment returns that can be allowed for being restricted, BPA providers' cost of capital will rise, which will lead to an increase in BPA premium rates.
- Given the PRA's stance on this matter, we may currently be in the middle of a "window of opportunity" that may be closed off when the proposals are implemented on 31 December 2018.
- Depending on the outcome of the consultation (which closes on 30 September 2018), subsequent pricing may harden or there may be increased volatility for a period of time whilst insurers assess the long term impact the change will have for their business.

BPA Pricing

The impact on pricing will vary from provider to provider, depending on the extent to which they invest in ERMs.

At present, it is possible to obtain pricing for "pensioner only" deals based on discount rates of up to "gilts + 0.5%". Some providers are also on record saying pricing for "deferred pensioners" is currently based on "gilts flat" discount rates. To the extent that BPA deals can be transacted at current rates (particularly for deferred members where a typical solvency basis will assume a discount rate of "gilts – 0.5%" or lower), this will have a material impact in reducing the level of a pension scheme's solvency shortfall post transaction and will bring forward the timeframe for ultimately winding up their pension schemes.

If prices harden again following the consultation closing, whilst some high profile transactions will continue to be able to access these rates, they are unlikely to be available in the wider market generally, which will give rise to more volatile and less predictable pricing in 2019.

In Closing

If you would like to discuss how a bulk purchase annuity policy could be used to complement your pension scheme's investment strategy, or if it would be helpful to include a training session on bulk annuities at a future trustees meeting, we would be happy to arrange for one of our specialist consultants to attend a future meeting (either in person or via a conference call).

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