Equity Release as an Asset Class

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Agenda

- What is Equity Release?
- What is the market for Equity Release?
- Why is it an attractive asset class?
- Challenges of ERM as an asset class

What is Equity Release?

What is Equity Release?

- Equity Release provides homeowners aged 55. or older, with the facility to release money from their home which they can continue to live in
- Equity release can be used for a number of purposes, including:
  - Adapting or improving a house to allow longer independent living
  - To help provide for domiciliary social care or nursing care
  - To pay off debts or big ticket purchases
  - To provide financial assistance to children or grandchildren, for example with property purchases
  - Ultimately it may help pay for long term care or nursing home costs

Types of Equity Release Mortgages (ERM)

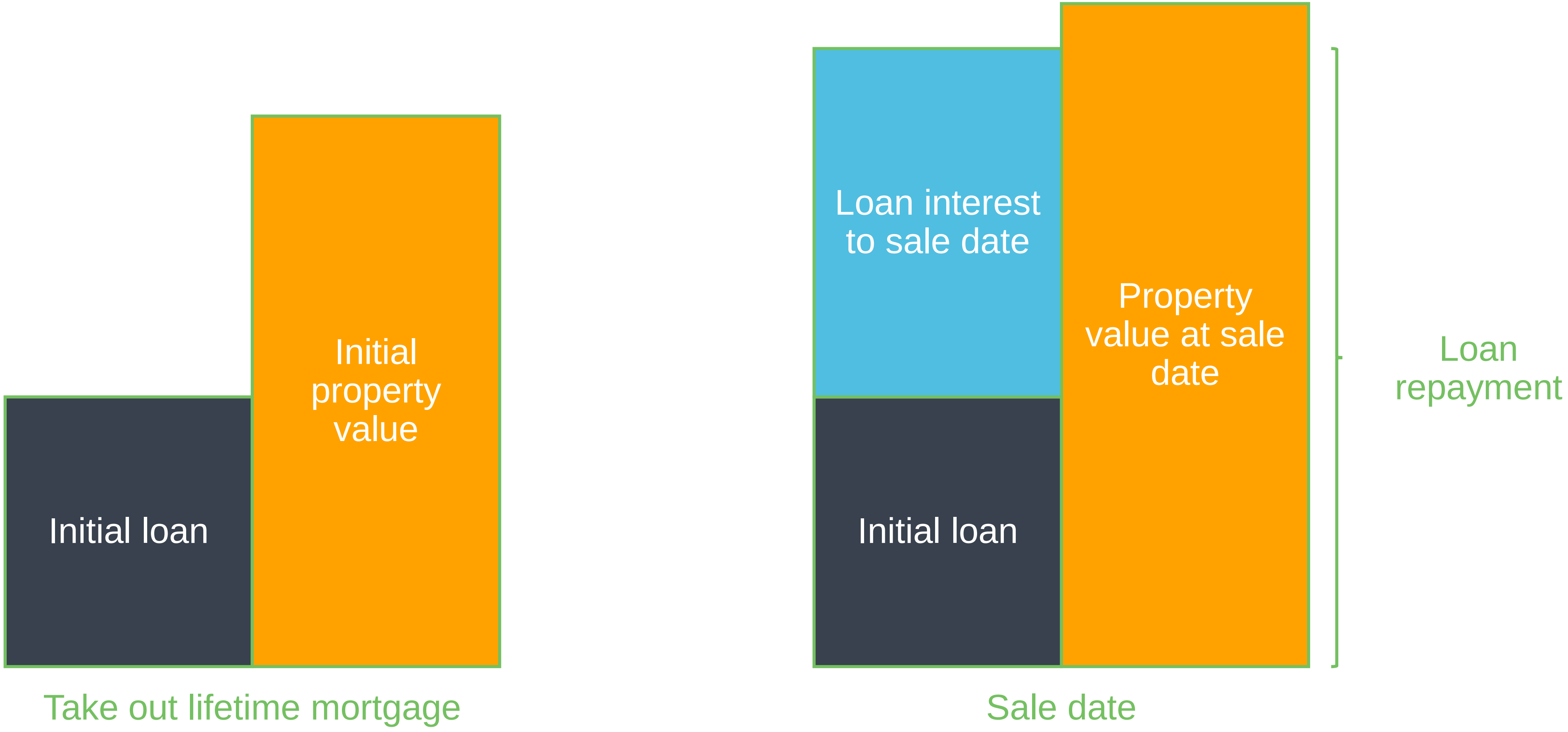
Two main types of Equity Release

- Lifetime Mortgages
  - Policyholder retains full ownership of home
  - Funds are paid as a lump sum or periodic payments up to a maximum limit agreed with the fund provider
  - Interest on the loan can be paid or rolled up
  - Loan and any interest is repaid on death or a move to permanent long term care
  - If a joint life policy repayment is not until the last survivor dies or moves to permanent long term care
  - Some plans allow interest repayments in part or in full to maintain the debt to the initial capital and preserve some equity in the property for passing to the Estate and heirs
  - The most common form of ERM sold in recent years

- Home Reversion Plans
  - The plan provider purchases all, or an agreed percentage, of the home
  - Policyholder retains the right to remain rent free in the property
  - The percentage of the property advanced is fixed unless the policyholder takes out a further advance
  - On death the property is sold and the share proceeds split between the plan provider and the estate according to the remaining proportions of ownership
  - Primarily a heritage product with limited volumes of new mortgages now sold

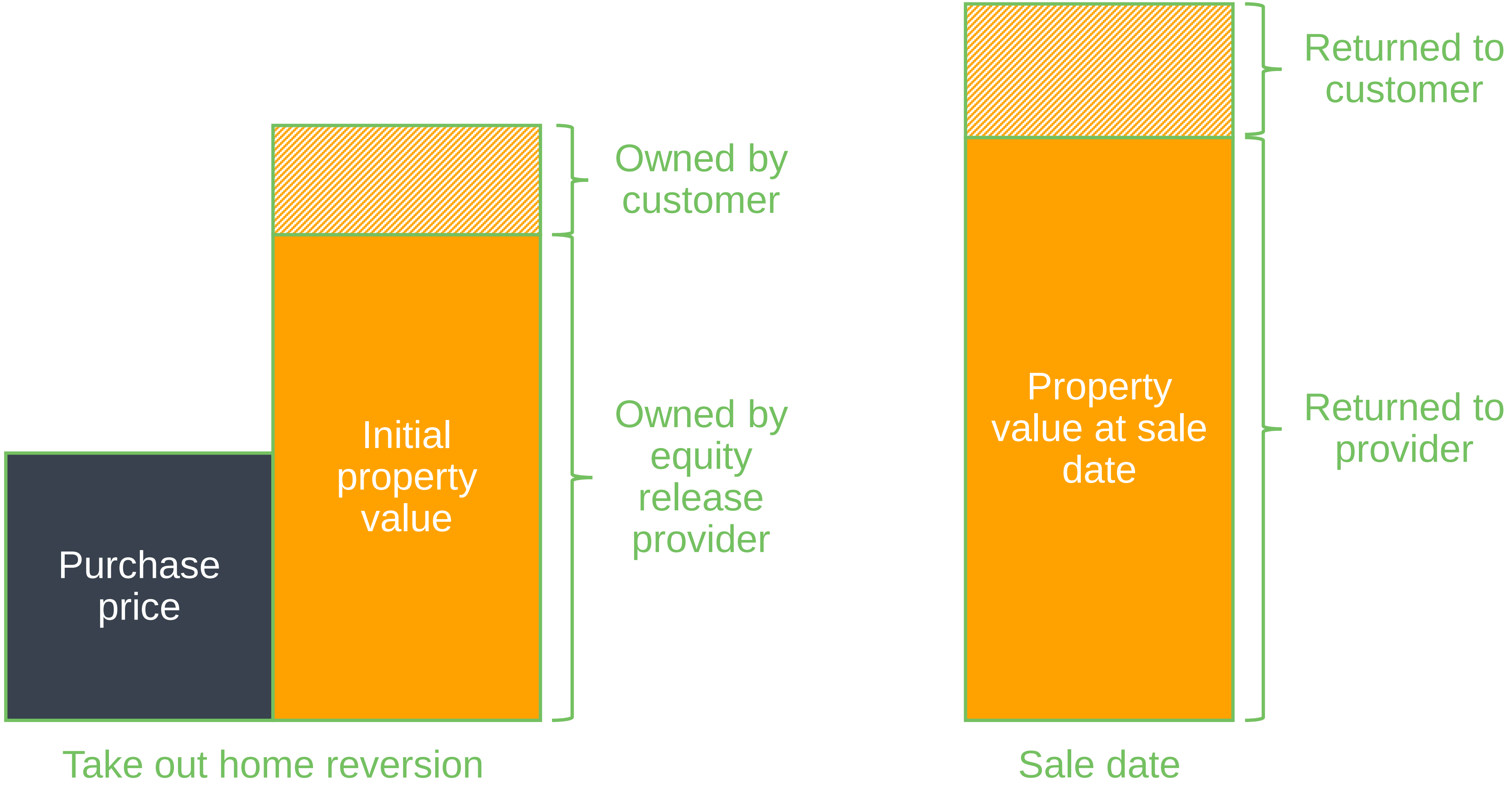
Type of equity release

Lifetime mortgages



Type of equity release

Home reversion plans

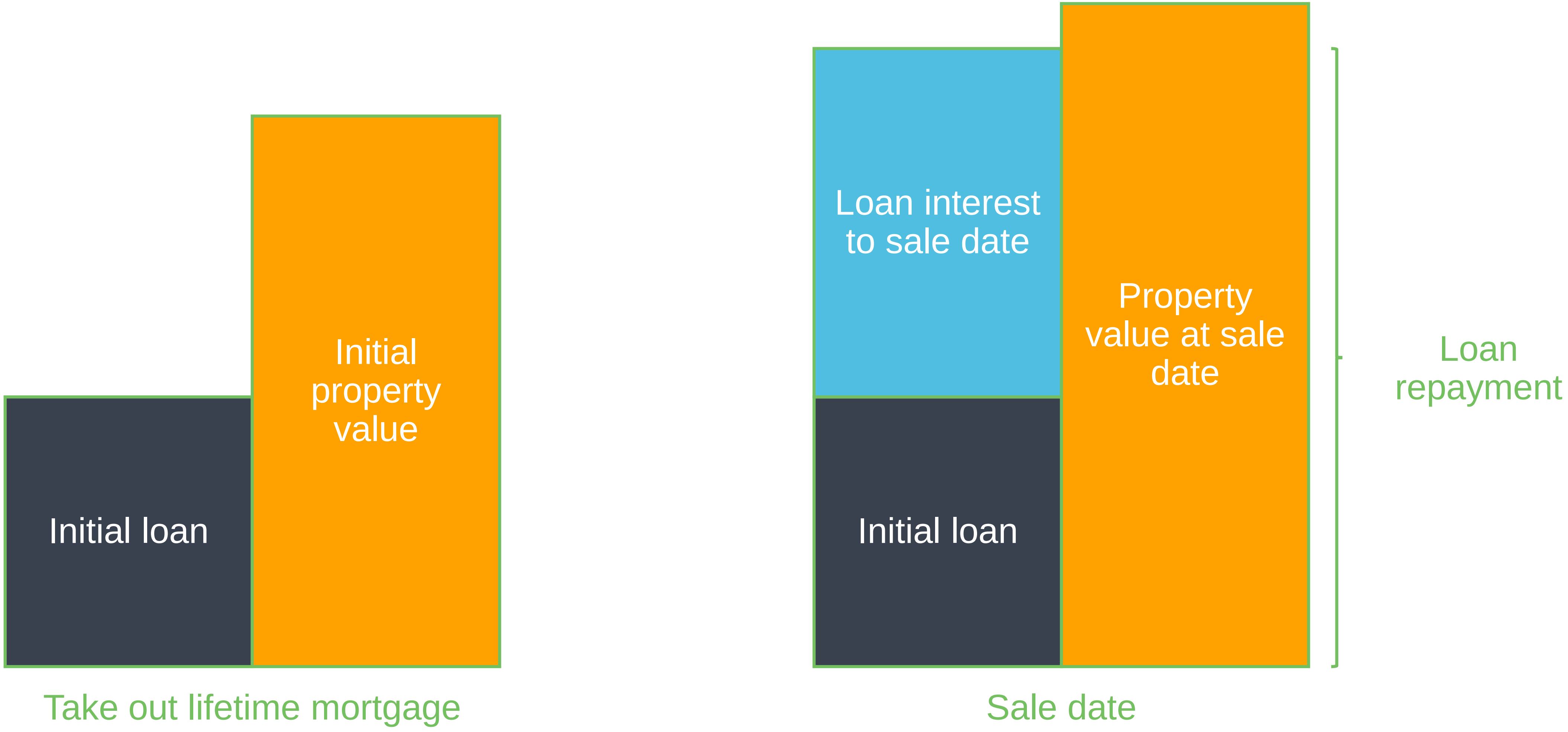


No Negative Equity Guarantee

- Early examples of Equity Release products gained a bad reputation as the total owed under the contract at the death of the policyholder could be more than the value of the property
- To avoid this situation all policies now sold by members of the Equity Release Council include a No Negative Equity Guarantee (NNEG)
- When the property is sold, after sales fees, if the amount left is not enough to repay the outstanding loan, neither the customer or their estate will be liable to pay more
- This is a valuable guarantee to policyholders, but makes the valuation of an Equity Release Mortgages more complicated and has some other consequences when considering the asset class.

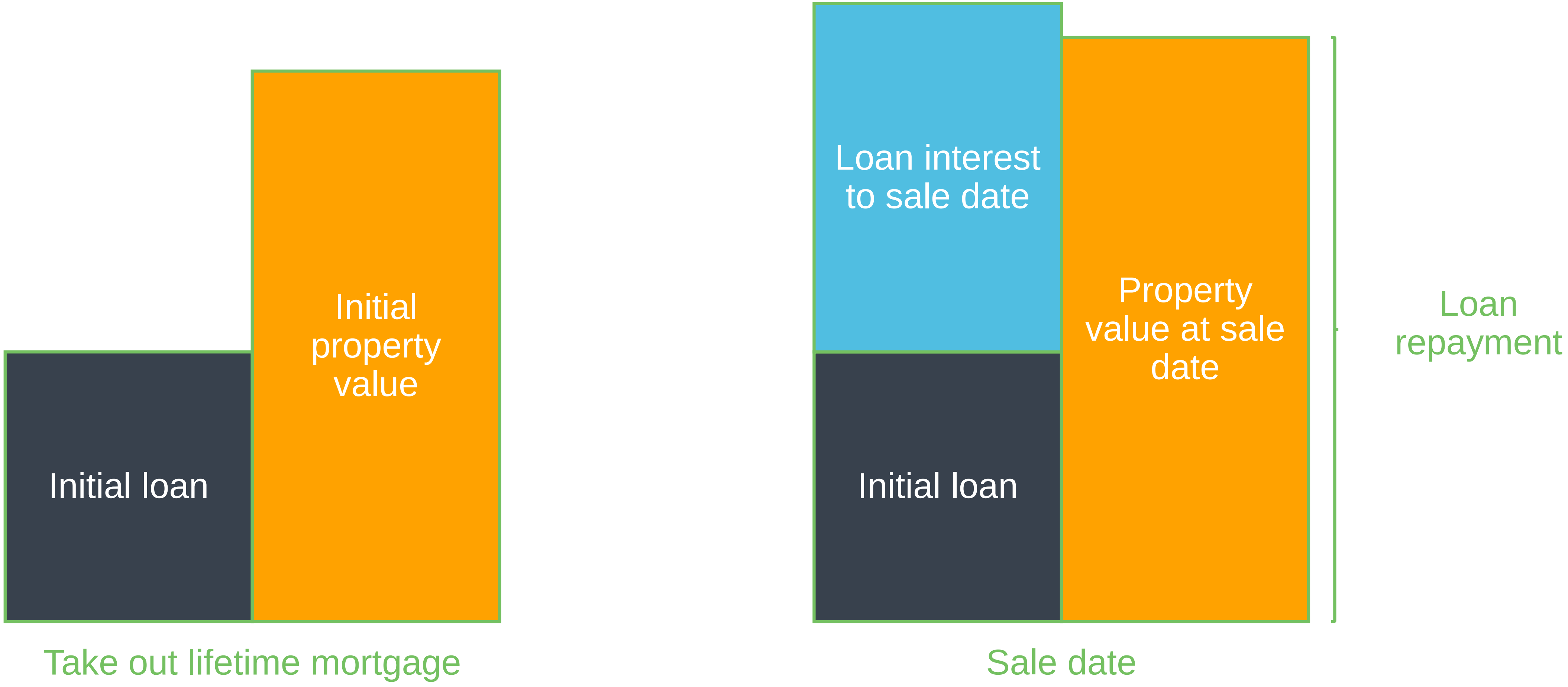
No negative equity guarantee

Doesn’t bite



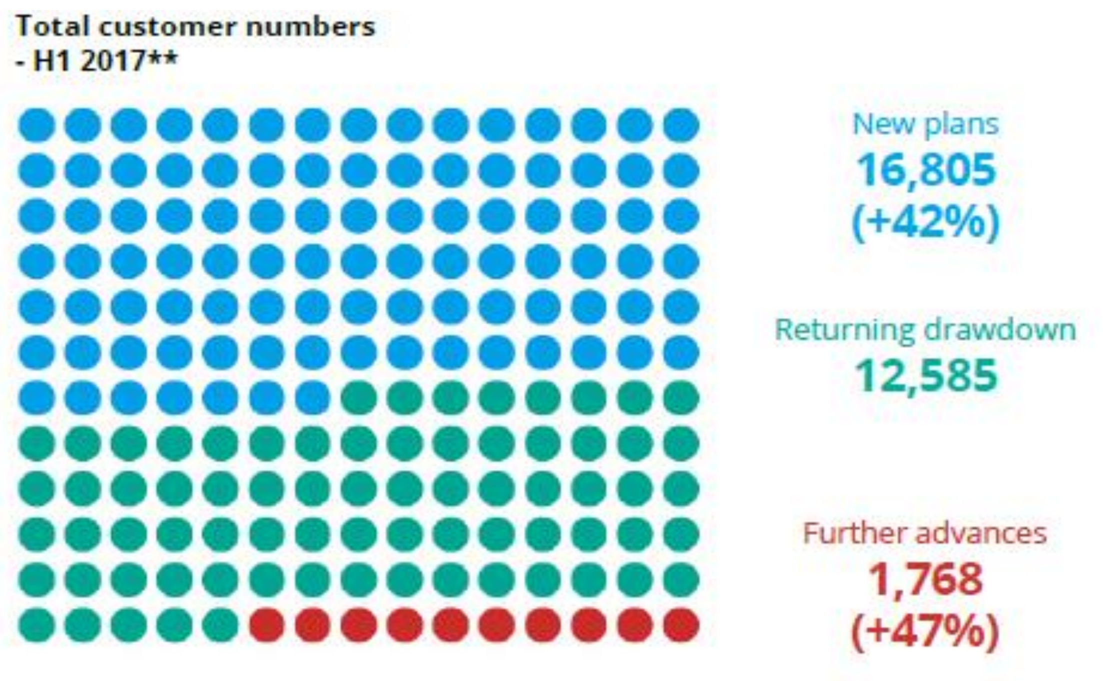
No negative equity guarantee

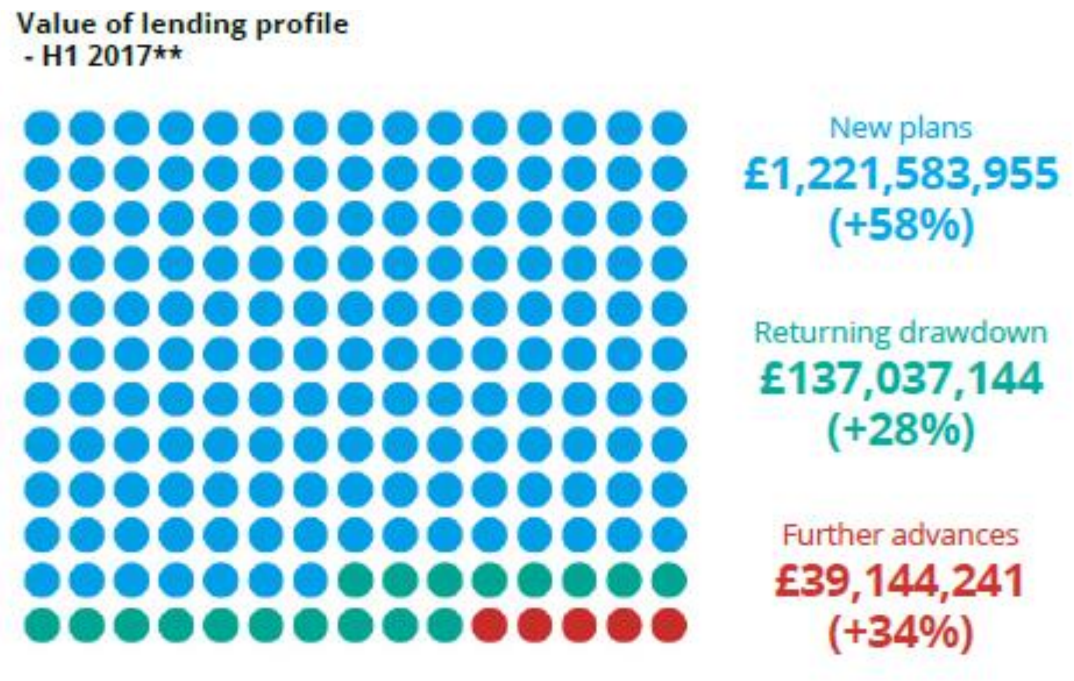
Does bite



What is the market for Equity Release?

Sales of Equity Release Mortgages H1 2017

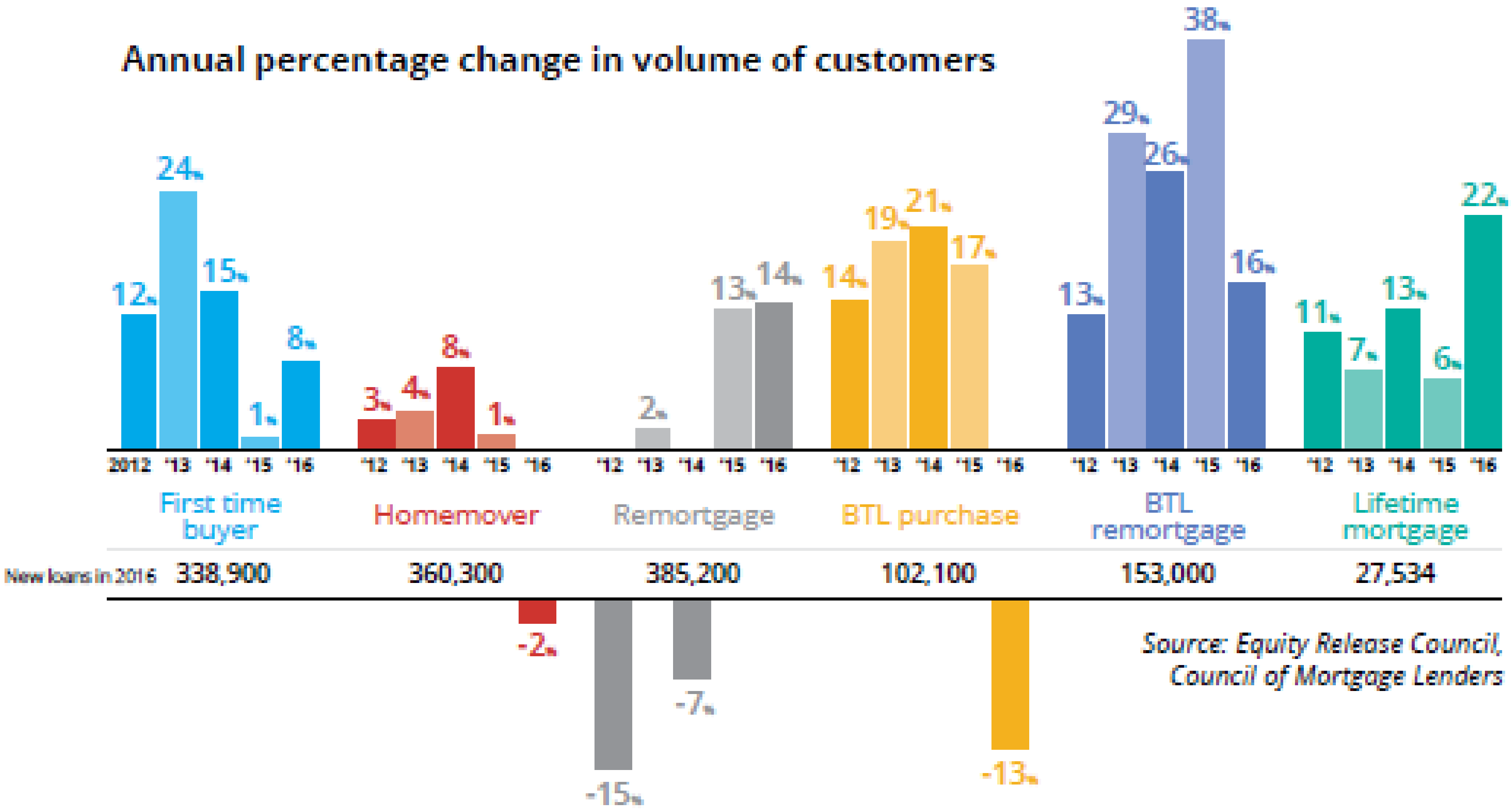




Over 31,000 plans drawing funds

c. £1.4bn funds advanced

Total Mortgage Market and Growth



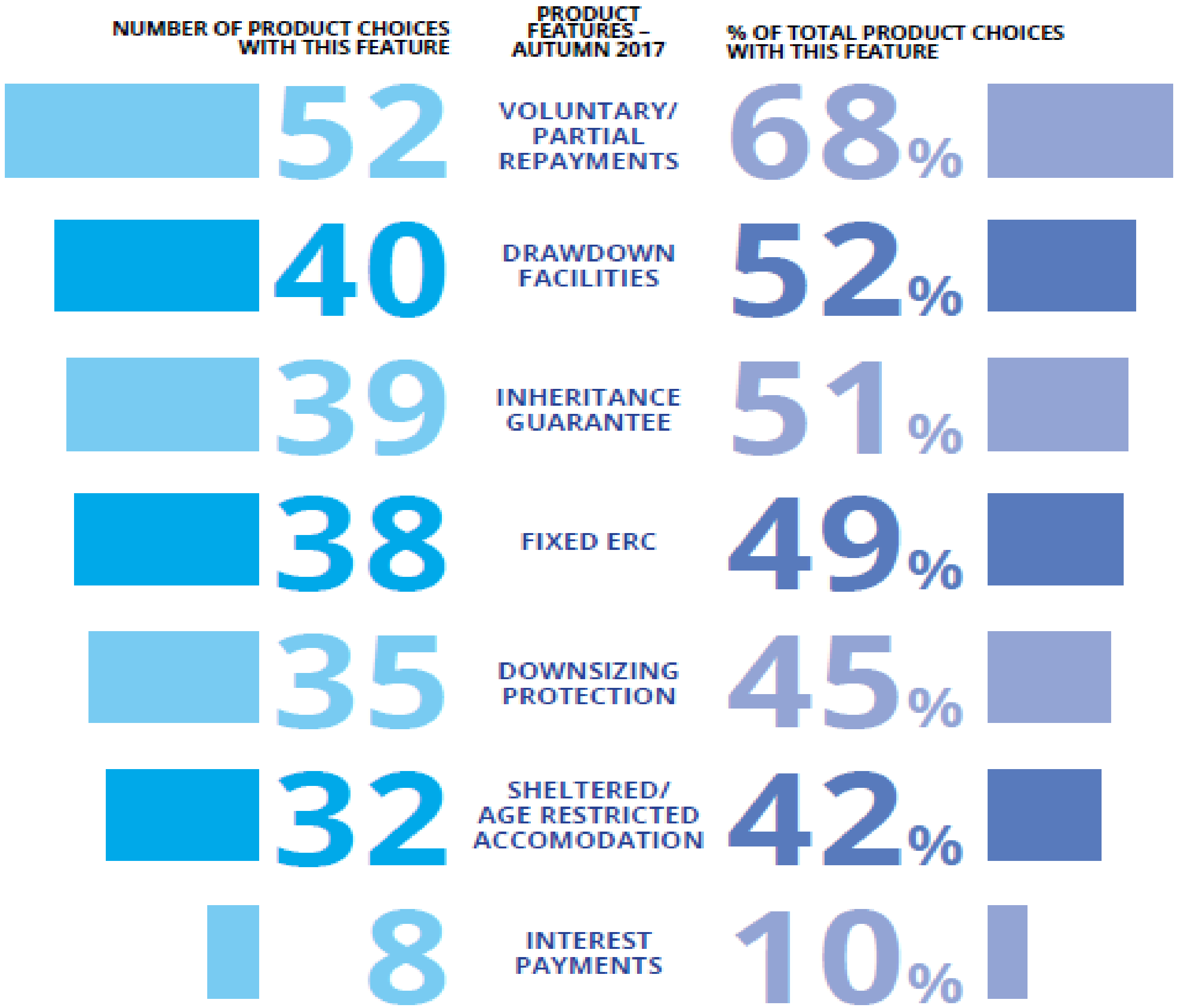
Significant Growth in Choice

Growth in Equity Release Product Plans

PERIOD	NUMBER OF PLANS AVAILABLE	CHANGE IN NUMBER OVER EACH PERIOD	% CHANGE OVER EACH PERIOD	CHANGE IN % SINCE 2007
AUGUST 2017	78	+20	+34%	+225%
AUGUST 2016	58	+31	+115%	+142%
AUGUST 2014	27	+10	+59%	+13%
AUGUST 2012	17	-7	-29%	-29%
AUGUST 2007	24	–	–	–

Source: Equity Release Council

Product Features



Source: Equity Release Council

Why is it an attractive asset class?

Characteristics of Annuity and Pensions

- The IFoA Equity Release Member Interest Group identified the main characteristics of annuity like liabilities and the risks associated with them as:
  - Security - annuity payments are fixed and guaranteed by the provider
  - Term - the fact that payments continue for the life of the policyholder means the duration of cash flows is dependent on longevity and hence is uncertain at an individual policy level, for portfolios, particularly larger ones, the cash flow profile is more reliably predictable
  - Yield - guarantee a fixed yield based on an assumed longevity profile
  - Marketability - annuity liabilities are highly illiquid. The customer has no right to terminate (nor does the issuer)
  - Key risks - annuity liabilities involve very long interest guarantees, which combined with uncertain duration means exposure to liquidity and reinvestment risks

Asset Selection for Annuities

- Based on the above characteristics and risks suitable assets would have the following features:
  - Security - secure cash flows in timing and amount
  - Term - Long-dated
  - Yield - Fixed income
  - Marketability - Liquidity not an absolute requirement
  - Key risks - Capital efficient in terms of risk return trade off
- A traditional asset mix for annuity like liabilities is a mixture of gilts and credit based assets (e.g. corporate bonds and commercial mortgages) of long average duration to match the annuity cash flows.
- Such as asset mix does meet the characteristics of annuity like cash flows and the asset features above, but it also has consequences:
  - The scarcity of long dated corporate bonds can lead to concentration risk, particularly to the finance sector
  - Lack of supply has pushed down yields and credit spreads making these assets less attractive
  - The widening of credit spreads and downgrades in the financial crisis highlighted exposure to credit risk

Suitability of Equity Release Mortgages

	Characteristics of suitable assets for matching annuity liabilities	Characteristics of Lifetime Mortgages
Security	Secure cash flows in timing and amount	Meets criteria, however • Security of cashflows is linked to out of the money NNEG (Cost of “NNEG” option depends on a number of factors including LTV and age of the borrower – we have illustrated possible costs in section 5 below) • Cash flows can be lumpy in small portfolios due to fluctuations in mortality and early repayments
Term	Long dated	Expected to meet criteria (longer duration than bonds – potentially beyond the longest annuity cashflows), however duration is dependent on repayment experience
Yield	Fixed income	Meets criteria (Lifetime Mortgages offer long term fixed returns, with a premium for illiquidity), however yield is dependent on repayment experience
Marketability	Liquidity not an absolute requirement	Meets criteria - Lifetime Mortgage cashflows are illiquid and can be considered “fixed” to a certain extent in a probabilistic sense
Key risks	Capital efficient in terms of risk / return trade off	Meets criteria in terms of its longevity characteristics and exposure to risks such as property values which may offer some diversification from credit risks etc. However they also bring a number of operational risks and reputational risks.

Source: IFoA Equity Release MIG

Benefits of equity release as an asset

- Growing market – increasing need for release of capital
  - Long-term care / dependants in education / support with purchasing first home
  - Provide income in retirement
- Profitable (but increasing competition and market entrants)
- Huge potential given the sums locked away as equity in property
- Asset-Liability Modelling (ALM)
  - ERM assets provide a natural backing to annuities
  - “Matching Adjustment” benefit in Solvency II

Size of ERM Holdings

- Under the new Solvency II public disclosures in firms' Solvency and Financial Condition Report they have to disclose the size of their "Loans and Mortgages to Individuals".
- ERM are the primary asset class in this designation
- At the end of 2016 UK insurers held approximately £15bn of such assets.
- The largest investors were: Just Retirement, Partnership Life Assurance (since merged with Just Retirement), Aviva and Prudential
- Scope of ERM assets held by pension schemes is unknown (to me anyway)

Challenges of ERM as an asset class

Challenges with ERM assets (assumptions and data)

- Infrequent valuations so how to adjust value since from last valuation?
  - Target market less likely to have recently valued their property
  - Age of property and reliability of valuation
- Dilapidation – hair cut to start price or haircut to growth assumption?
  - Older properties, greater risk of damage, subsidence etc.
- House price volatility – how to choose an appropriate measure.
  - National house price index? Adjust for region or average age of properties?
  - Lower volatility due to lower value and age? …or greater volatility due to age and sensitivity to property crashes?
- Managing administration systems and data

Challenges with ERM assets (valuation and accounting)

Primarily for Insurers

- No Negative Equity Guarantees
  - Choice of suitable model and understanding the limitations of chosen model
  - Volatility (again)
  - Inflation
  - Other relevant assumptions and data requirements
- Solvency II balance sheet – IFRS value
  - Choice of liquidity premium or consistency with Matching Adjustment
  - Special Purpose Vehicles and credit ratings
  - PRA
- Liquidity considerations

NNEG valuation

An issue for both Insurers and Pension Funds

- Suitable choice of model
  - Black 76 – forward price closed-form model
  - Limitations and assumptions inherent in this choice of model
  - Stochastic valuation – resources and modelling expertise
- Expert judgement required in a number of places
  - Setting a volatility assumption
  - Dilapidation
  - House price index
  - Appropriate haircuts
- Documentation
- PRA may seek access to the modelling and assumptions underlying the NNEG valuation

Challenges with ERM assets (SII BEL and SCR)

Primarily for Insurers

- Special Purpose Vehicle required to achieve MA benefit
  - Need fixed cash flows
  - Potentially complicated structure (although not *<u>intended</u>* by the PRA)
  - Spread risk capital requirement
  - Floating cash flows not allowed in MA – how to manage these?
- PRA’s view on NNEG valuation (tunnel of reasonableness)
- Potential for capital add-ons if PRA not satisfied with approach
- Transitional arrangements may be further complicated…

Conclusions

- Equity Release Mortgages are a growing and attractive asset class offering diversified risk and potential yield pick up compared to traditional investments
- The characteristics of Equity Release Mortgages make them a suitable matching asset to back annuity like liabilities
- The No Negative Equity Guarantee can be a valuation challenge
- For insurance companies Equity Release Mortgages need to be reconstructed if they are to be included in the Matching Adjustment portfolio
- For pension schemes the Matching Adjustment is not a consideration so potentially they are a more attractive asset than for insurers

Questions?

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