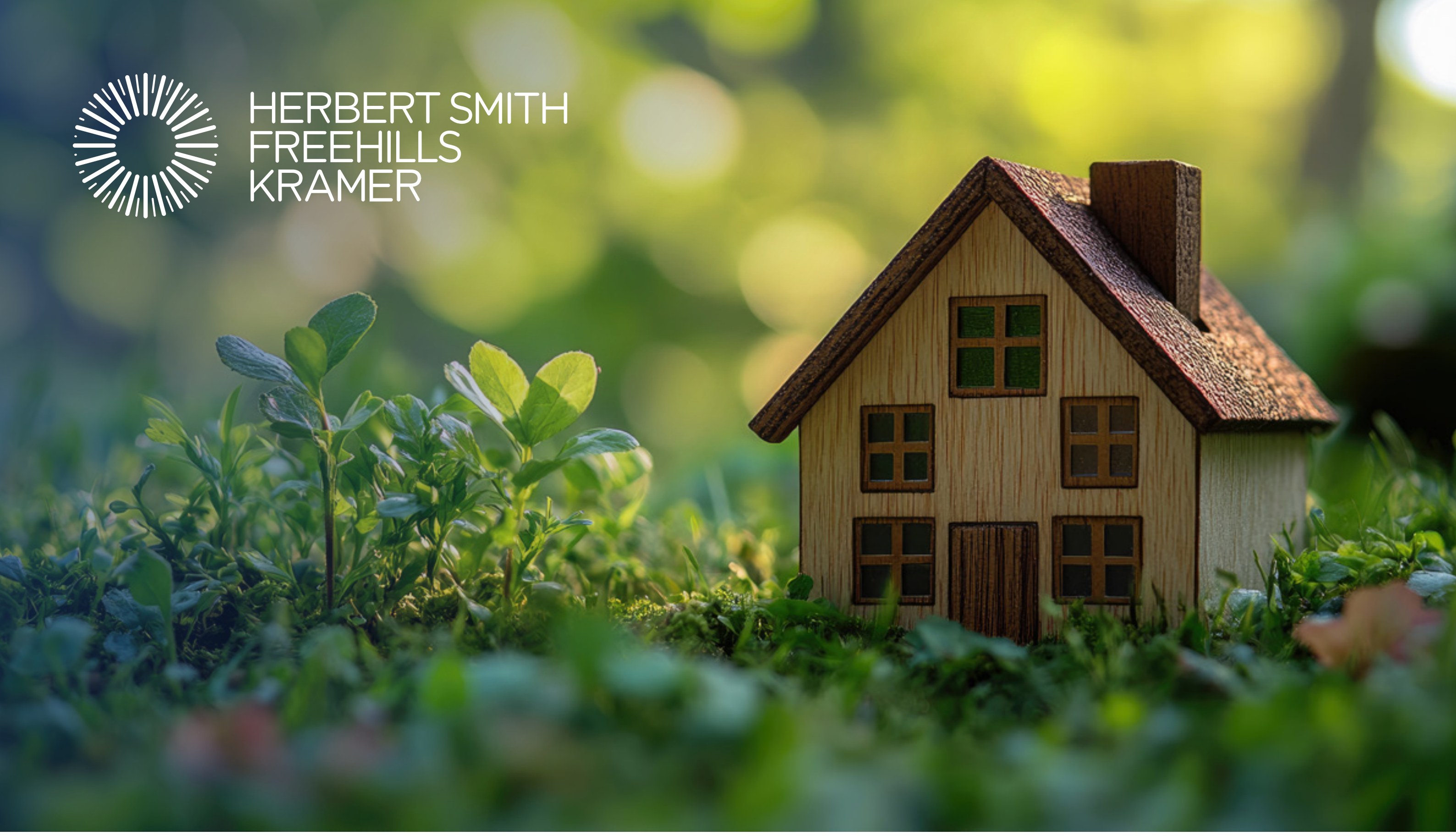

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Insurers in the securitisation market: Securitisations of lifetime mortgages

We have seen a marked increase in the volume of structured finance transactions involving lifetime mortgage products in recent years (both funding transactions and the sale and purchase of lifetime mortgage books through securitisation), and this looks set to continue with investor appetite for these types of investments growing. The characteristics of lifetime mortgages makes them particularly attractive for regulated insurers looking to invest in matching-adjustment eligible securities, and securitisations of lifetime mortgages commonly include tranches of notes with fixed payment schedules that are designed to be eligible to be held in matching adjustment portfolios.

Differences between lifetime mortgages and other residential mortgages

A lifetime mortgage is a mortgage granted to borrowers above a specified age secured against residential property. A lifetime mortgage differs from a standard residential mortgage in a number of ways, including:

- the full capital repayment becomes due only upon the occurrence of certain events, such as the death of the borrower or their move into long-term care. Many lifetime mortgage products also permit interest to roll up and be paid along with the capital at final redemption of the mortgage. This means there is no certainty as to the timing of repayment of the mortgage;
- unlike other residential mortgages whereby the borrower's income would typically be expected to be the primary source of funds to repay the loan, a lender of a lifetime mortgage is in most instances entirely exposed to house price values and the ability to sell the mortgaged property at an amount sufficient to fully discharge the debt. Where house price appreciation fails to keep pace with the rate at which interest rolls up on the underlying loan, it may mean that the sale proceeds fall short of the amount required to repay the loan in full. Absent a default by the borrower, there is usually no recourse for the lender to take early possession of the property;
- most lifetime mortgages include a no negative equity guarantee (**"NNEG"**) feature, such that if the proceeds of the sale of the property are insufficient to discharge the outstanding debt in full, the shortfall will be borne by the lender with no ability to pursue the borrower or their estate. Some lifetime mortgages may also include a "guaranteed inheritance" feature, whereby a percentage of the sale proceeds are ringfenced for the borrower's estate;
- lifetime mortgage products may be structured as either single lump sum advances or amounts that may be drawn down by the borrower in instalments at their discretion, subject to satisfaction of pre-set conditions precedent and (where relevant) new pricing terms.

Structuring lifetime mortgage-backed securitisations

Lifetime mortgage securitisations may include the following structural features:

- Carefully modelled reserving, driven by the relative unpredictability of both the timing and quantum of receipts on the underlying portfolio. The purpose of such reserving includes:
  - where the senior notes have been structured to be matching-adjustment eligible (see further below) and have fixed amortisation schedules, ensuring there is sufficient cash is on an ongoing basis reserved in the structure to make payments due on those notes in accordance with the amortisation schedule, thereby preventing too much cash leaking out to the pass-through notes and the residual certificateholders; and
  - if the portfolio includes loans that have drawdown features or if further advances under those loans are to be sold to the Issuer, ensuring that there are sufficient funds available to the Issuer to pay the purchase price for those advances.

  The reserving needs to be sensitive to both macroeconomic and portfolio-specific factors that may influence the likelihood of losses on the portfolio (such as stagnant house price growth) and timing of receipts as against the payment schedules on the matching-adjustment note (such as accelerated rates of redemptions on the underlying portfolio, both redemption on repayment and early prepayment). This may be achieved through the inclusion of triggers to increase the level of reserving required where the underlying loans redeem more quickly than anticipated and/or where published indices show slower national house price growth (which may be weighted according to the geographic distribution of properties in the securitised portfolio).

  The adequacy of reserves/other liquidity available to the Issuer to make payments on any senior matching adjustment notes will also be a key focus for any rating agencies rating the structure. Those scheduled payments will usually include both an interest and principal element and so will be rated as to timely payment of both interest and principal (as opposed to structures with pass-through notes, which are rated for timely payment of interest and ultimate payment of principal).

- Caps on the amounts that may be paid in any period to the pass-through notes and residual certificates.
- Provisions for the financing of further advances. This may include the ability to draw on reserves or liquidity loans/variable funding notes to enable the Issuer to purchase further advances. It may also or in the alternative include arrangements whereby the seller retains the further advances on a subordinated basis, with or without the ability to repurchase the related loan from the Issuer. Structures providing for loans secured against the same property to be held on a priority basis may need to consider the consequence of possible partial early repayment of the loan and the application of those receipts, as well as practical matters such as ensuring that the servicer keeps accurate records of ownership and provides reporting to the Issuer only on the securitised debt.
- Terms requiring the partial redemption of senior notes and recalculation of payment schedules as a result of loan repurchases by the Seller (whether as a result of warranty breach or repurchase of loans that are subject to further advances). This may also require the payment of a make-whole to the holders of matching adjustment notes, which would need to be factored into the repurchase price.
- Provisions requiring payment of a make-whole on voluntary redemption of the matching adjustment notes (as to which see further below).
- Suspension of enforcement action for non-payment of scheduled amounts due on the matching adjustment notes. Instead, the transaction may continue to operate as usual with interest accruing on unpaid amounts, either indefinitely or until the occurrence of a specified trigger.

Solvency II and lifetime mortgage securitisations

Investment in the senior positions in securitisations of lifetime mortgages may be particularly attractive to insurers due to the possibility of holding the notes in their matching adjustment portfolios. Lifetime mortgages usually have relatively long-dated expected cashflows that can be matched to the modelled liabilities of the insurer. In order for the note investments to qualify for matching adjustment treatment, the relevant firm would usually, under the applicable rules, be required to demonstrate that the timing and amount of cash flows on the notes are fixed and cannot be changed by the note issuer or any third parties. Accordingly, payments of interest and principal on the matching adjustment notes are paid in accordance with a fixed schedule, which specifies the amount due on each payment date from closing to maturity.

There are however certain exceptions to the matching adjustment requirements that cashflows on the notes should be applied in accordance with the notes' fixed payment schedules. These include permitting early redemption provided the noteholder would receive sufficient compensation to enable reinvestment of any repaid funds in alternative assets of an equivalent or better credit quality. As most securitisation transactions include the ability for the Issuer to voluntarily redeem the notes early, the conditions permitting such early redemption would typically include the requirement for the Issuer to pay an additional/make-whole amount to the relevant noteholders, which is structured to meet this requirement.

Certain other redemption rights that are commonly permitted in securitisation transactions may not require the payment of a make-whole amount to remain within the matching adjustment rules, provided the right of the Issuer to redeem is not at its or any third party's unfettered discretion, but is triggered only by events that:

- are outside the Issuer or third party's control;
- cannot be avoided by the Issuer or third party; and
- would otherwise materially change the nature or substance of the obligations of the Issuer or counterparty under, or as a result of, the contract.

Examples of a redemption that might fall within this category include changes in tax law which would subsequently require the Issuer to withhold amounts from payments due on the notes or to gross-up payments to noteholders.

Each prospective investor who subscribes for notes with the intention of holding them in its matching adjustment portfolio will need to carefully consider the terms of its matching adjustment application and the applicable legislation, together with rules and guidance provided by the Prudential Regulation Authority, as against the terms of the securitisation transaction documents.

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