[Address redacted]

Dear Mr Hoogervorst,

I am writing for EUMAEUS, a project dedicated to improving transparency in the accounting and valuation of UK firms. I retired from the Bank of England in January 2018, where I had worked on valuation and accounting issues, particularly the valuation of Equity Release Mortgages (ERMs).

The valuation of the latter has become a hot topic in recent months, with the PRA publishing consultation paper CP 13/18,[1] which set out a method for valuing ERMs on the *Solvency II* balance sheet. The PRA proposals had a serious impact on the value of one firm, which dropped by £1bn between May and August this year, with extreme fluctuations since early September. It has been a disaster for investors, also a concern for annuitants whose pensions are supported by ERM assets.

The PRA will conclude the consultation process at the end of December 2018, so the uncertainty remains until then, but my question is not about the valuation method set by the PRA for the so-called Solvency II balance sheet only, but rather how, or whether, the proposals will impact the IFRS valuation. Note the financial statements of the affected firms have been prepared in accordance with International Financial Reporting Standards.

It will be worth explaining the rationale underlying the PRA proposals. Most ERMs have an embedded 'no negative equity' guarantee that the amount owed cannot exceed the value of the property when the loan is repaid (on death, or exit into long term care), so the borrower will owes the minimum of house price, and rolled up loan value. But 'minimum of two values' implies an option, which has to be valued for purposes of financial reporting. The PRA proposal is based on the principle of rational investor preference, i.e. to value an asset as a rational market participant would.[1] It follows from the definition of an ERM with NNEG that the present value of the ERM cannot exceed either the present value of the loan, or the present value of 'deferred possession' of the property.[2] It also follows from the concept of rational investor preference that such an investor would prefer immediate possession to deferred possession ('jam today better than jam tomorrow').

Most if not all firms are valuing the guarantee in a way *radically* different from this, such that the guarantee is radically undervalued, so that the value of their Solvency II equity is considerably overstated compared to the PRA proposals.[3] Given the PRA proposals are based on rational preference, hence in accordance with IFRS principles, it follows that such radically different valuations cannot be consistent with IFRS.

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[1] You will undoubtedly be familiar with IFRS 13: 'the objective of a fair value measurement in both cases is the same—to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between *market participants* at the measurement date under current market conditions (i.e. an exit price at the measurement date from the perspective of a market participant that holds the asset or owes the liability).

[2] PRA CP 13/18 3.8.ii

[3] CP 13/18 para 13.6.

This concerns the *regulatory* balance sheet. However, as far as I can tell, the IFRS equity is valued in the same way. It therefore follows that IFRS equity is also overstated. I asked the PRA (and the Bank) about this, but their current position is that they have no powers over the IFRS balance sheet ('nothing to do with us'). So my question is who decides whether the method used by firms is consistent with IFRS standards? Is it the Financial Reporting Council? They have declined so far to answer any of my questions. Is it the auditors? They (KPMG, for the main firm affected) also refuse to answer questions. Is it the IASB? I would like an answer to this.

If not the IASB, then we currently have a situation of a firm whose share price is wildly fluctuating, with no clear answer to even its approximate value, and a regulatory system with a number of actors, none of whom have clear responsibility for deciding on the valuation of what is in fact a simple European option. This is profoundly unsatisfactory.

Please let me know how this issue can be resolved. It is a serious matter both for investors and pensioners.

Dean Buckner

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[1] https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/consultation-paper/2018/cp1318.pdf