Amundi
ASSET MANAGEMENT

Regulation for the review of the Solvency II framework adopted by the European Commission on March 8, 2019

Solvency II

This European Commission regulation* is subject to the European Council's a and European Parliament's right to object for a period of three months. It is therefore not in force at the date of publication of this document.

As expected, the Commission has reduced the constraints allowing to attribute a capital charge of 22% to the "Long -term equity investments".
The other provisions specifying the calculation of the Market SCR remain almost unchanged regarding to the project published in earlier November.

Long-term equity investments

The Commission's initial draft, submitted for consultation in November, had been subject to much criticism, as the eligibility criteria to be able to apply the preferred treatment of "Long-term equity investments" were considered too restrictive. In practice, a very small share of equity investments could have benefited from it.

The French Treasury and the Dutch Ministry of Finance conducted a workshop to demonstrate the relevance of a much broader definition of the long-term equity investment portfolio. In January, the President of the European Parliament's Committee on Economic and Monetary Affairs also expressed concerns over the scope of application of the Commission's proposed framework.

Eventually, the regulation adopted by the Commission defines the following criteria:

- Only listed equities in the EEA and unlisted equities of companies with headquarters in an EEA member country are eligible.
- The precise perimeter defining equities benefiting from this favorable treatment must be identified. The latter must belong to a portfolio of assets assigned to identified activities that are managed separately from the other insurance activities. The willingness to maintain this sub-portfolio of equities must be indicated in the investment policy, asset-liability management and risk management.
- The average holding period of the equities inside the defined perimeter must be superior to 5 years (1).
- The solvency and liquidity position of the insurer as well as asset-liability management processes ensure that, at any point in time, this sub-portfolio of equities will not be subject to forced sales for at least 10 years (including under stress scenarios).

The ownership of equities through mutual funds could also benefit from the 22% treatment. In this case, the average holding period superior to 5 years can be calculated at the fund level (and not at the underlying assets held in the fund level). The same is true for equity investments through social entrepreneurship funds (2), venture capital funds (3), ELTIF funds (4) or closed and non-leveraged alternative funds established in the European Union (5).

(1) If the average holding period of the subset of long-term investments is inferior to 5 years, the insurer must not sell any equity of this sub-group as long as the average holding period does not exceed 5 years.
(2) Eligible within the meaning of Article 3 (b) of Regulation (EU) 346/2013
(3) Eligible within the meaning of Article 3 (b) of Regulation (EU) 345/2013
(4) In accordance with Regulation (EU) 2015/760
(5) Or if they are not established in the EU, distributed in the EU in accordance with Articles 35 or 40 of Directive 2011/61 / EU.

The provisions to assign capital charge of Type 1 Equities to some unlisted equities remain unchanged regarding the November proposition

Only ordinary shares not quoted on a regulated market are eligible. A number of criteria restrict the scope of issuers concerned. This approach may only be applied to shares issued by companies:

- that do not belong to the financial sector,
- domiciled in an EEA country,
- that generate over 50% of their revenue in an EEA or OECD currency,
- which employ the majority of their staff in an EEA country,
- that meet at least one of the following 3 conditions:

- the company has an annual revenue of over €10 million,
- the company has a balance sheet total of over €10 million,
- the company employs over 50 people.

Portfolios of unlisted equities must meet a diversification requirement to qualify for this approach: no line may account for more than 10% of the portfolio.

If the portfolio's hypothetical beta is below 0.796 (corresponding to 0.39/0.49 proposed by the EIOPA), the portfolio qualifies for the Type 1 capital charge.

The portfolio's hypothetical beta is determined by calculating the average of the individual hypothetical betas of the equities in the portfolio, weighted by the size of each position.

The beta of each equity investment is calculated using a formula which factors in the average of several issuer's financial ratios over five years:

- Gross margin
- Debt/operational cash flow
- ROCE (Return On Capital Employed)

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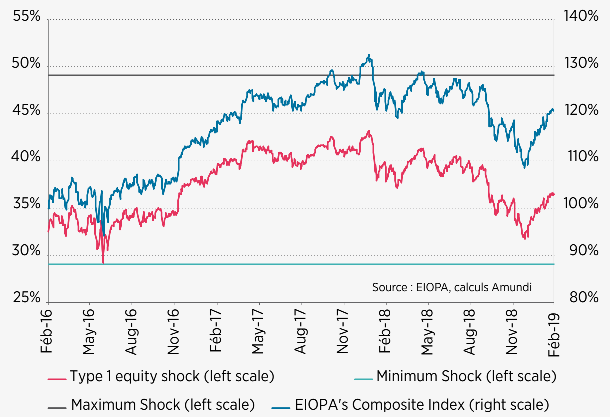
Reminder of the principles for calculating the capital charge for equity investments

In general, equity investments have a capital requirement of 39% (plus a symmetric adjustment ranging from +10% to -10%) or 49% (plus the symmetrical adjustment), depending on whether they are Type 1 or Type 2 equities.

The symmetrical adjustment has a counter-cyclical role. It is calculated using the level of an equity index (representing insurers' equity investments) on the date in question and the index's historical average over the past three years.

Evolution of the Type 1 equity shock over the past three years



By way of illustration, during the fourth quarter of 2018, the equity index composite defined by EIOPA decreased by 11.57%, which resulted in a decrease of 39.14% to 32.66% of the equity shock.

Equities listed on a regulated market in an EEA or OECD member country are classified Type 1 equities. Equities listed in other countries of unlisted equities are Type 2 equities.

Risks on Type 1 and Type 2 equities are assumed to be 75% correlated.

Investments in the capital of infrastructure projects or qualified infrastructure entities are given more favourable treatment than Type 1 equities (but are assumed to be Type 2 equities in the implementation of the correlations).

Furthermore, strategic investments are assigned a capital charge of 22% regardless of the category of shares held, as are equities eligible for the approach set out in Article 304 of the Solvency II Directive (Duration-based equity risk sub-module). This scheme corresponds to retirement-related obligations and its application requires the approval of the supervisory authority.

The "Long-term Equity Investments" defined in the Regulation of March 8th are thus added to the two existing schemes that already allow a reduced capital charge to equities.

Several measures impact the calculation of spread SCR and concentration SCR

Positive changes in the treatment of exposures issued or guaranteed by regional governments and local authorities

Exposures that are fully, unconditionally and irrevocably guaranteed by a regional government or local authority deemed to be "equivalent" to a central government[1] will benefit from a zero spread SCR.

Issues by regional governments and local authorities not deemed "equivalent" to central governments will be treated in the same way as bonds issued by non-European Union member countries (in the issuer's currency), with a CQS of 2. This treatment extends to issues guaranteed by these regional governments and local authorities.

In practice, the capital charge for spread risk determined in this way corresponds to the charge applied to an AA-rated corporate bond.

Reliance on agency credit risk assessments is reduced slightly

If the conditions set out in Article 88 of the Delegated Regulation, which describes the principle of "Proportionality", are met[1], a new simplified approach is proposed to reduce the costs arising from the use of authorised credit risk rating agencies.

This approach authorises the insurer to use a CQS of 3 (i.e. the lowest Investment Grade level) to calculate the spread SCR for all assets not assigned a rating by an External Credit Assessment Institution (ECAI) nominated by the insurance company.

The simplified calculation may only be used if the following conditions are met:

- credit assessments by the nominated ECAI are available for at least 80% of the corporate bonds in question (all securities issued by governments, supranational bodies, local authorities and infrastructure entities are excluded from the ratio calculation),
- these unrated debt instruments are only bonds that pay a regular fixed or floating coupon until maturity (structured notes and collateralised securities are excluded),
- these assets do not cover liabilities that provide for a profit-sharing mechanism, or unit-linked liabilities (and the insurer does not use the matching adjustment for these assets).

The Commission provides for an internal credit assessment to assign a CQS of 2 or 3 to debt instruments not rated by a nominated ECAI

The insurer must have established an internal credit assessment process that takes into account all factors that may significantly impact the spread risk and it must be able to demonstrate that its risk assessment and the allocation of a CQS on the basis of that assessment are reliable and properly reflect the spread risk.

1. "A simplified calculation shall not be considered to be proportionate to the nature, scale and complexity of the risks where the error … leads to a misstatement of the Solvency Capital Requirement that could influence the decision-making or the judgement of the user of the information relating to the Solvency Capital Requirement, unless the simplified calculation leads to a Solvency Capital Requirement which exceeds the Solvency Capital Requirement that results from the standard calculation."

The Commission's proposal includes a non-exhaustive list of factors to be taken into account, such as the issuer's competitive position, its size and the level of diversity in its activities, its financial performance history and trends, the effect of any covenants in place, country risk, etc. The internal credit assessment must be based on relevant qualitative and quantitative information.

The scope of instruments assessed using this process only includes senior debt instruments (bonds or loans) paying regular fixed or floating rate coupons that will be redeemed via the payment of a fixed amount on maturity (or earlier).

The loan agreement (or the bond issuance prospectus) must include a clause providing for the notification of lenders in case of the occurrence of an event that may have a material impact on the spread risk and setting out the obligation to obtain the insurer's approval before making any further issues.

The allocation of a CQS based on an internal credit risk assessment is only permitted for debt issued by companies:

- domiciled in an EEA country,
- that generate most of their revenues in an EEA or OECD country,
- that have not recorded a credit event in the past 10 years,
- that meet at least one of the following 3 conditions:
  - the company has an annual turnover of over €10 million,
  - the company has a balance sheet total of over €10 million,
  - the company employs over 50 people.
- and which do not belong to the financial or infrastructure sector or to the same group as the insurer.

In order for a CQS of 2 or 3 to apply further to an internal assessment, the **issuer's financial results must meet certain quantitative criteria:**

- EBITDA (average) must be positive and greater than 6.5 x the company's interest expense (current)
- Total debt (current) is less than 6.5 x free cash flow (average) • Net debt (current) is less than 1.5 x total equity (current)

The term "average" means the average for the last five financial years. The term "current" means the value at the end of the last financial year.

Yield criteria also apply. The insurer must compare the yield on unrated bonds issued by the company with the average yield of bonds included in a broad index of listed bonds, rated by agencies and which have a similar maturity to the instrument being assessed and the same currency.

To benefit from a CQS of 2 (or 3, as applicable), the yield on issuance of unrated debt issued over the past three years must be below the maximum of two limits:

- the average of yields from the index of CQS 2 (or 3, respectively) bonds and from the index of CQS 4 bonds, and,
- the yield of the CQS 2 (or 3) index +0.5%.

If a co-investment agreement has been set up with a credit institution or another insurer, the co-investor's credit assessment results may be used to establish the CQS for bonds or loans not rated by a nominated ECAI

The co-investment agreement must be established with:

- a credit institution as defined in point (3) of Article 4(1) of Regulation (EU) No 575/2013 which uses the Internal Ratings Based Approach, or
- an insurance or reinsurance company that uses an internal model in accordance with Article 100 of Directive 2009/138/EC (Solvency II Directive)

The allocation of a CQS under a co-investment process is only permitted for debt issued by companies:

- domiciled in an EEA country,
- that generate most of their revenue in an EEA or OECD country,
- that meet at least one of the following 3 conditions:
  - the company has an annual turnover of over €10 million,
  - the company has a balance sheet total of over €10 million,
  - the company employs over 50 people.
- and which do not belong to the financial or infrastructure sector or to the same group as the insurer.

The co-investors must agree in advance on the type of loans covered by the agreement and the applicable assessment criteria. The insurer must participate in all transactions in the scope determined and it must use the results provided by the co-investor to allocate a CQS to these investments.

➤ Use of an insurance company's internal model

If the co-investor is an insurer, the CQS assigned to the debt instrument by the co-investor's internal model is used.

➤ Use of a bank's internal rating model

If the co-investor is a bank, the CQS assigned to the debt instrument is determined based on the latest probability of default (PD) produced by the bank's internal model. It is produced using the table provided in the annex to Implementing Regulation 2016/1799, which sets out the PD thresholds corresponding to each CQS.

It may be necessary, for prudential reasons, to adjust the PD produced by the model before applying this mapping, in order to take into account differences between the assumptions/parameters used in the model and the framework set out in regulation 2016/1799.

➤ There are many constraints for the co-investor

The co-investor – be it a bank or an insurer – must remain exposed to at 20% of the nominal amount (the ratio was 50% in the November 2018 proposition) and it must meet strict transparency criteria vis-à-vis the insurer. The transparency requirement covers:

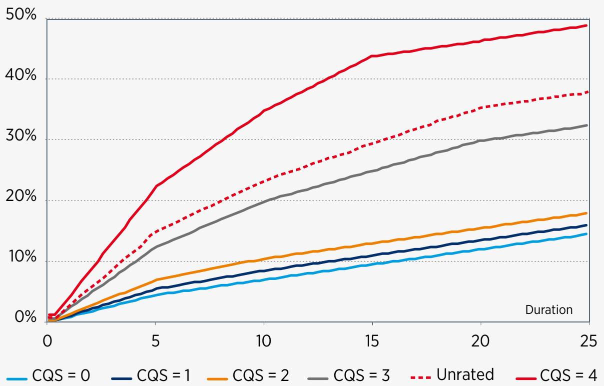
- the selection of loans: description of the loan approval process (criteria, organisation, controls), transfer of data on all debt applications received, details of decisions to approve or reject applications, etc.
- the internal model: methodology, data used, approval process, etc.

Reminder of the principles for calculating spread SCR for investments in bonds and loans

Under Solvency II, issues by member states (in local currency) do not generate spread SCR. A list of regional and local authorities from EEA member countries whose issues are to be treated in the same way as central government issues has also been drawn up[2].

For corporate bonds, the spread SCR calculation depends on the credit quality step (CQS), which is determined by the bond's rating[2] and term.

Spread SCR for corporate bonds



Source: Commission Delegated Regulation (EU) 2016/467 amending Delegated Regulation (EU) 2015/35.

Intermediate rules, between those applicable to EEA government bonds and the rules for corporates, apply to government issues from non-European Union countries (in the issuer's currency). CQS 0 and CQS 1 securities are assigned a zero spread SCR and CQS 2 securities are treated in a similar way to CQS 1 corporate bonds.

Secured bonds and loans used to finance infrastructure projects or entities that meet certain criteria are also given more favourable treatment.

2. The list of regional governments and local authorities whose issues are treated in the same way as exposures to central governments is provided in Commission Implementing Regulation (EU) 2015/2011.

Active risk management is better taken into account in the market SCR calculation

The minimum maturity required so that hedging instruments with a maturity of less than one year that are renewed regularly are fully recognised for their risk mitigation effect has been reduced

The initial maturity of hedging instruments must be at least one month for their risk mitigating effect to be taken into account in full in the SCR calculation and not on a pro rata basis.

In the Commission's regulation, there are only limited constraints on the replacement and adjustment frequency of hedging positions (required, for example, due to a fluctuation in the value of the hedged position). The replacement or adjustment of the protection may take place more than once per week only in exceptional cases where, without the replacement or adjustment, an event would have a material adverse impact on the insurer's solvency position. (The Commission sets no quantitative criteria for authorising additional replacement or adjustment transactions.)

In exchange for the broader rules proposed for the replacement and adjustment, insurers must have a written policy describing the rules applied when replacing and adjusting these positions. The policy must describe the protection strategies used and in particular situations where several contractual arrangements are combined as part of a risk mitigation mechanism.

The other conditions that must be met for the risk mitigation technique to be fully taken into account in the SCR calculation (set out in Article 209 (3)) are maintained: the replacement must not be conditional on any future event outside the insurer's control, the derivatives must be sufficiently liquid, the risk that the replacement cost may increase must be taken into account, etc.

In addition, Article 210 "Effective Transfer of Risk" in the Risk Mitigation Techniques section is amended to better take into account hedging strategies combining several financial instruments (including where some are used for hedging and some are exposures).

Critical changes to the couterparty SCR calculation

Changes to take into account different practices in terms of derivatives transactions

Type 1 counterparty risk must be assessed for all derivative positions (besides those covered by the spread risk module).

The wide range of practices for derivatives contracts is reflected in loss given default calculations and in the calibration of probabilities of default. These changes aim to reflect the difference in risk levels between derivatives cleared by an approved central counterparty, over-the-counter derivatives with a bilateral exchange of collateral under Article 11 of the EMIR, other types of contracts, etc.

It also supplements Article 192 “Loss-Given-Default” to take into account netting agreements covering several derivatives that represent credit exposure to the same counterparty. If a netting agreement is in place, the LGD calculation will be made at the level of the counterparty (the current calculation applies by instrument), taking into account the exposure net of all derivatives, all collateral received and the amount of the risk-mitigating effect (0 if this effect is not positive).

Favourable changes for some mortgage loans

As a reminder, the capital charge on mortgage loans must be included in the counterparty SCR using the formula applicable to Type 2 exposures.

The Commission’s regulation authorises the recognition of additional guarantees provided by an external guarantor (subject to the usual conditions required for guarantees) when calculating the LGD for mortgage loans.

The grouping approach for investments packaged as funds is extended

At present, when the look-through approach is not available, the simplified method for calculating the SCR may only be applied to 20% of the insurance or reinsurance company’s assets.

The Commission amends current provisions so that when the policyholders bear the market risk, the assets corresponding to these obligations are not included in the 20% limit.

Accordingly, as life insurance companies are seeking to diversify their unit-linked policies, the simplified method, such as the grouping of assets held by the funds, is considerably extended. The simplified approach applies to 20% of the assets held to cover euro policies and all assets held to cover unit-linked policies (if the look-through approach is not available).

Data groupings must still be made in such a way as to obtain a prudent calculation of all sub-modules of market SCR, but the conditions for applying the grouping approach have been relaxed slightly and the implementation scope has been extended.

As such, when the insurer has no target asset allocation for the fund, **the capital charge can be calculated using the fund’s last reported asset allocation**, provided that the fund is managed in compliance with this allocation and that exposures and risks do not vary significantly over short periods.

Currently, Article 84 (3) of Delegated Regulation (EU) 2015/35, “Look-through approach”, stipulates:

“Where the look-through approach cannot be applied to collective investment undertakings or investments packaged as funds, the Solvency Capital Requirement may be calculated on the basis of the target underlying asset allocation of the collective investment undertaking or fund, provided such a target allocation is available to the undertaking at the level of granularity necessary for calculating all relevant sub-modules and scenarios of the standard formula, and the underlying assets are managed strictly according to this target allocation. For the purposes of that calculation, data groupings may be used, provided they are applied in a prudent manner, and that they do not apply to more than 20% of the total value of the assets of the insurance or reinsurance undertaking.”

New changes to come

While the provisions of the 2018 revision have not yet come into force, work on the 2020 revision is already under way.

The 2020 revision is planned by the Solvency II Directive. Point (3) of Article 111 prescribes the review of the SCR calculation methods under the standard formula and Article 77f refers to the analysis of the measures in the Sectors package (including the volatility correction, the equalizing adjustment and the extrapolation of the yield curve).

The European Commission mentioned numerous topics in its request for a technical opinion that was sent to EIOPA on 11 February, for example, the calculation of the risk margin and, regarding the SCR market : the SCR sub-modules rate, spread, equities, and the correlation matrices to be applied to aggregate the results of the SCR calculations regarding the different risks.

The Commission requested an answer by June 30, 2020.

In addition, on the February 7th, the Commission also asked EIOPA to examine the possibility of improving the effectiveness of the “country” component of the volatility adjustment mechanism.

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