

To: Long Term Investment Project Group, Solvency II Working Group, Economics and Finance Committee, Public Affairs & Communications Committee

From: ECOFIN Team

Date: 24-08-2017

Reference: ECO-LTI-17-058 UPDATED

Subject: Coordination of efforts on review of Solvency II calibrations for STS - UPDATED

Summary

The secretariat learnt that the Commission asked Council members of the Expert Group on Banking, Payments and Insurance (EGBPI) to review draft proposals on the Solvency II capital requirements for STS securitisations and provide feedback to the EC by 15 September. **The secretariat strongly encourages members to engage with their respective Council members as soon as possible. The secretariat has prepared messages which members can use to inform their engagement.**

Overall, Insurance Europe believes that the EC proposals are positive and reflect material changes/reductions compared to the current capital requirements. The proposals for recalibrations and supporting arguments are in line with the recommendations made by Insurance Europe. The messages that Insurance Europe prepared are aimed at giving reassurance to Council members that material changes are indeed needed, and should actually go even further than the EC proposals. Should members have a different assessment of the proposals, or additional comments, please contact prudential@insuranceeurope.eu.

The document that the EC shared with the Council has been uploaded on the extranet (see [ECO-LTI-17-059](#)) - please note this document is not meant for public use so please treat it accordingly.

Background

As previously reported, the EC committed to review the Solvency II capital requirements for securitisation once the STS legislative process is close to finalisation. Insurance Europe met with the EC in July and reiterated its messages on the need to and justifications for a significant review of the currently punitive capital requirements.

A comparative overview of the EC proposals vs the current situation is provided below. Please note that the overview compares the current type 1/type 2 securitisations with the future STS/non-STS ones. The EC proposal appears to also contain useful grandfathering arrangements from type 1 to STS (check EC note ECO-LTI-17-059).

Credit quality step	0	1	2	3	4	5 and 6
Current SII type 1	2.10%	3%	3%	3%	n.a.	n.a.
<i>STS senior (EC proposal)</i>	<i>0.8-1.2%</i>	<i>1-1.4%</i>	<i>1.5-1.8%</i>	<i>2.3-3%</i>	<i>4.8-5.8%</i>	<i>8.9-9.6%</i>
Current SII junior all securitisations	12.50%	13.40%	16.60%	19.70%	82%	100%
<i>STS junior (EC proposal)</i>	<i>2.3-3.1%</i>	<i>2.6-3.7%</i>	<i>4.4-4.7%</i>	<i>7.9-8.7%</i>	<i>15.3-18.3%</i>	<i>25.4-27.8%</i>
Current SII type 2	12.50%	13.40%	16.60%	19.70%	82%	100%
<i>Non-STS (EC proposal: no changes)</i>	<i>12.50%</i>	<i>13.40%</i>	<i>16.60%</i>	<i>19.70%</i>	<i>82%</i>	<i>100%</i>
Current SII unrated securitisation	100%					
<i>STS unrated (EC proposal)</i>	<i>8.9-9.6%-25.4-27.8% per year of duration</i>					

Note: All charges are per year of duration, with an overall cap at 100%

The messages below could be used to support members' engagement. Insurance Europe understood from the EC that a proposal to review the Solvency II Delegated Regulation on the capital treatment of STS will be put forward in September or October.

Potential key messages for members' engagement with NAs

Targeted messages on the proposals:

- The EC proposals go in the right direction - it should be avoided that the upper bound of every range is selected.
- They are still conservative compared to the real exposure to extreme losses faced by insurers investing in STS. However, if applied at the lower end of the proposed range they would have a material impact on removing barriers for insurers to invest in STS.
- The current proposal to assign all unrated STS securitisations the stress factor of junior-STS is not enough risk-sensitive and is overly conservative. Instead, Insurance Europe proposes that:
 - Unrated STS senior should receive as proxy the charge of STS senior CQS 3 (this would be in line with what the EC proposed for infrastructure project finance)
 - Unrated STS junior should receive as proxy the charge of STS junior CQS 5-6 (as is the current proposal)
- It should be noted that the capital charges for non-STS securitisations remain unreasonably high and the EC should also look into these.

More general messages on STS review:

- The insurance industry supported from the beginning the STS legislative proposal, as a right tool to encourage the creation of high-quality securitisations in Europe and regain investors' trust in this asset class.
- The insurance industry is interested in securitisations, as a means to provide additional return and diversification benefits to insurers' investment portfolios.
- In order for insurers to seriously consider adding securitisations to their investment mix in any meaningful way, a more appropriate recalibration is vital; otherwise securitisations will remain unattractive on a risk-adjusted and capital-adjusted basis.
- The current Solvency II capital requirements remain significantly high compared to the actual risk exposure of insurers in this asset class. For example, the actual accumulative default experience of AA securitisations during the financial crisis was 0.29% in aggregate over a 6-year period (2007-2013)¹. While this may not be quite a 1 in 200 event, it is generally considered to have been one of the worst financial crisis over the last centuries. However, the current Solvency II capital charge meant to cover the risk of losses is 15% for a 5-year AA securitisation. This means that **the current annual capital requirements are 50x higher than the actual "worst case losses" experienced over the recent financial crisis period. The proposed calibrations are therefore more appropriate but still conservative.**
- It makes sense for capital requirements for securitisations to be as close as possible to those of corporate bonds of a similar credit rating. This would be equivalent to a look through approach in which loans in the pool receive, as a proxy, the same rating as the pool. We welcome that the Commission refers to calibration of corporate bonds as a point of reference for securitisations in its note to Council.
- Equally important, Solvency II capital requirements should **avoid cliff effects between the senior and junior** tranches within the same STS transaction. There should be very little/if any differentiating treatment between the senior and junior tranches of a securitisation. In fact, the STS status will be a good indication for the qualitative aspects of the securitisation as a whole, while any rating differences between the senior vs the junior tranches will implicitly impact the capital requirement. Currently Solvency II creates significant cliff effects; for example, the senior tranche of a 5y AA securitisation receives a capital charge of 15% while the junior tranche (assuming the same AA rating) receives a capital charge of 67%. **The proposed changes are a significant improvement on current calibrations but still represent a very conservative increase and double counting of risk; in fact, any increase in risks in junior tranches will be already recognised in lower ratings and therefore higher capital.**

¹ Standard and Poor's data on European ABS

- A wider review of STS calibrations will be needed in 2020, as part of the Solvency II review of long-term measures. **The 2020 review needs to change the calibration approach from a measurement based on spreads/market volatility to a measurement based on credit risk/defaults.** In most cases, 1) insurers do not buy assets to trade them and 2) asset-liability management gives insurers immunity against forced sales of assets. These should be recognised in the 2020 review and capital requirements for a wide range of assets should be recalibrated based on exposure to defaults.