COMMISSION SERVICES NON-PAPER

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EXPERT GROUP ON BANKING, PAYMENTS AND INSURANCE (INSURANCE FORMATION)

15 May 2024

Agenda Item 2

Review of the Solvency II Delegated Regulation

Co-legislators reached a provisional agreement on the Solvency II review in December 2023. However, in view of the significant bottleneck with legal revisions and translations of the many financial services files, the formal adoption of the amending Directive is delayed until the end of the year.

In order to complete the review, the Solvency II Delegated Regulation, which sets many important technical rules, notably in relation to capital requirements, will have to be revised as well. Although no formal step can be taken in relation to the Delegated Regulation before the amending Directive enters into force, DG FISMA suggests resuming technical discussions on Level 2 work.

This non-paper aims to:

- Outline the work programme and the scope of the Level 2 work in the coming months;
- Seek preliminary views from experts on possible bundling of empowerments;
- Seek experts' assessment of the implications of the provisional agreement on the amendments to the Solvency II Directive for Level 2, notably in relation to quantitative requirements**.**

I. Scope of Level 2 work

The scope and number of potential amendments to the Solvency II Delegated Regulation can be quite extensive. DG FISMA is therefore considering a staggered approach as outlined below where some items ('Core Level 2 Review') would be given priority for technical discussions whereas others ('Extended Level 2 Review) would rather be dealt with at a second stage under the next Commission mandate.

A. Content of the 'core Level 2 Review'

- **<u>Topics directly stemming from the provisional agreement on the amending Directive</u>**

The provisional agreement on Level 1 upgrades a number of quantitative parameters from Level 2 to Level 1. However, many important quantitative rules (related to long-term guarantees measures, measures on equity risk, risk margin and interest rate risk) still need to be adopted in the Delegated Regulation. Such rules will determine the actual impact of the review in terms of capital requirements.

The political agreement on Level 1 also includes other mandates for Delegated Acts in relation to reporting and disclosure, governance, proportionality, and group supervision.

In total, there are more than 30 empowerments for Delegated Acts which are either new or amended.

- **Topics where the Commission publicly communicated on the intention to adopt amendments to the Solvency II Delegated Regulation**

At the time of adoption of the proposal for an amending Directive in September 2021, the Commission also published a Chapeau Communication[1] outlining its intentions for Level 2, which were also factored in the staff working document on the impact assessment of the review[2]. Note that Level 2 measures on cross-border and macroprudential supervision are limited to Regulatory Technical Standards.

Furthermore, it was stated in the EMIR Chapeau Communication of December 2022[3] that the Commission "*intends to address the disadvantageous prudential treatment insurers face if they become a direct clearing member*", through amendments in the Solvency II Delegated Regulation.

- **Other topics which were already discussed in expert group meetings prior to Trilogue negotiations**

During the Expert Group meeting of 5 April 2022, DG FISMA organised six roundtables on possible other topics to be included as part of the Solvency II Review:

- Roundtable I: diversification benefits within the market risk module and rules governing risk-mitigation techniques;
- Roundtable II: Recognition of state reinsurance/guarantees as risk-mitigating techniques in the Solvency Capital Requirements (SCR) calculation;
- Roundtable III: counterparty default risk and SCR for mortgage loans;
- Roundtable IV: best estimate, remuneration, reporting and disclosure;
- Roundtable V: group supervision;
- Roundtable VI: other topics, including in relation to minimum capital requirements (MCR), Green Deal elements, expense risk.

NB: some aspects of the above-mentioned topics actually stem directly from the Level 1 agreement, for instance on best estimate where co-legislators mandate the Commission to adopt Delegated Acts specifying the prudent deterministic valuation referred to in the new (provisional) Article 77(7) of the Solvency II Directive.

DG FISMA also mentioned other smaller issues and errors identified by EIOPA as possible candidates for targeted amendments to and clarifications of the Solvency II Delegated Regulation. Some of such smaller issues are included in Annex 1.

B. Content of the 'extended Level 2 Review'

The provisional agreement on an amending Solvency II Directive introduces several mandates for EIOPA in relation to sustainability risks that are expected to be submitted to the Commission in the short or medium-term. This includes:

[1] Communication from the Commission to the European Parliament and the Council on the review of the EU prudential framework for insurers and reinsurers in the context of the EU's post pandemic recover (COM/2021/850)

[2] See SWD/2021/260 final

[3] See COM/2022/696

- A report, by [30 September 2024] assessing, among others, possible risk-based treatments of exposures related to assets and activities which are associated substantively with environmental or social objectives or which are associated substantively with harm to such objectives[4].
- A regular review (at least every five years) of the scope and calibration of standard parameters for non-life catastrophe risk sub-module under the standard formula. It is the understanding of DG FISMA that the first review will be completed by EIOPA by the end of 2024[5].
- A report by 30 June 2025 on existing practices and possible further actions to improve the way undertakings consider their material exposure to risks related to biodiversity loss[6].

It will be for the next Commission to consider whether and how to follow-up on EIOPA's recommendations.

The provisional agreement also introduced a new empowerment on crypto-assets, allowing the Commission to reflect risks posed by such investments in the market risk sub-module and counterparty risk module. No reflection has been conducted so far on this topic. The Commission intends to send a call for advice to EIOPA on this topic.

Finally, **a recital of the amending Directive invites the Commission to assess the appropriateness of existing calibrations for investments in securitisations** and to consider amending the risk factors, where appropriate. Ongoing discussions on securitisation in various fora (see notably the Statement by the ECB Governing Council on advancing the Capital Markets Union[7] or the Statement of the Eurogroup in inclusive format on the future of Capital Markets Union[8]) are not limited to the prudential treatment in Solvency II but follow a more holistic approach by considering all demand and supply factors. Therefore, at this stage, DG FISMA is of the view that discussion on the prudential treatment of securitisation under Solvency II should be part of a wider debate on the future of the securitisation framework.

Questions:

- What are experts' views on the outlined work programme for the review of the Solvency II Delegated Regulation? In particular, are there specific additional topics which the Commission should consider for the 'Core Level 2 review'?
- What is experts' view on the opportunity to investigate the introduction of a dedicated prudential treatment for crypto-assets?

II. Bundling of empowerments

As part of the provisional agreement on the amending Directive, co-legislators introduced a recital stating the following[9]:

[4] Provisional new Article 304a(1) of the Solvency II Directive.
[5] Provisional new Article 304a(2) of the Solvency II Directive.
[6] Provisional new Article 304a(2a) of the Solvency II Directive.
[7] Available at the following link: https://www.ecb.europa.eu/press/pr/date/2024/html/ecb.pr240307~76c2ab2747.en.html#:~:text=It%20is%20clear%20that%20the,follow%2Dup%20will%20be%20critical
[8] Available at this link : https://www.consilium.europa.eu/en/press/press-releases/2024/03/11/statement-of-the-eurogroup-in-inclusive-format-on-the-future-of-capital-markets-union/
[9] See provisional recital 43b of the amending Directive.

"*The Commission has bundled all empowerments provided for under Directive 2009/138/EC in Commission Delegated Regulation (EU) 2015/35. That approach has worked well for the implementation of that Directive and made ensuring compliance with that delegated regulation easier. Therefore, Delegated Regulation (EU) 2015/35 should be kept in force and all necessary amendments under existing empowerments as well as the implementation of new empowerments under this Directive should be effected exclusively as amending acts to Delegated Regulation (EU) 2015/35. Where such amendments are to be bundled in the future into one or more amending delegated acts, the Commission, in accordance with paragraph 31 of the Interinstitutional Agreement of 13 April 2016 on Better Law-Making, in the course of the consultations in the preparation of such delegated acts, should also indicate which empowerments are considered to be substantively linked, for which the Commission is expected to provide objective justifications based on the substantive link between two or more empowerments*."

Any decision regarding the possible bundling of empowerments will have to be made under the next Commission.

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Questions:

- What are experts' views on the possible implementation of this recital as part of the Solvency II review? In particular, do experts consider that the 'Core Level 2 review' could be adopted through one amending act to the delegated regulation, or should it be divided into at least two amending acts?
- If the 'Core Level 2 review' was to be adopted through more than one amending act, a possible approach could be to distinguish the quantitative aspects directly arising from the Level 1 agreement (long-term guarantees [LTG], long-term equity, risk margin and interest rate risk) from the rest. Another approach could be to further split amendments related to the quantitative aspects directly arising from the Level 1 agreement into two acts – one dedicated to valuation rules (LTG measures and risk margin) and the other to capital requirements (long-term equity and interest rate risk). What are experts' views on such possible approaches?

III. First discussions on certain items of the review

The Chapeau Communication accompanying the Commission proposal for an amending Directive provided a high-level overview of all the quantitative parameters which the Commission was considering to adopt as part of the review of the Solvency II Delegated Regulation. However, the approach outlined in this communication will need to be adjusted in light of the level 1 agreement.

Indeed, as part of interinstitutional negotiations on the amending Directive, co-legislators agreed to upgrade in the Directive some parameters currently set out in Level 2, with values that are different from the current Level 2. Other related technical parameters which will contribute to the overall quantitative impact of the review will have to be set in an amending Delegated Regulation.

A. Extrapolation

In the Chapeau Communication, the Commission indicated building on the formula and parametrisation proposed by EIOPA in relation to extrapolation.

- **Convergence parameter (Art. 86(1)(b)(i))**

The main item underlying the new extrapolation method is the so-called 'convergence parameter'. In particular, EIOPA was recommending a convergence parameter of 10%[10].

However, the provisional agreement provides that for maturities of at least 40 years past the first smoothing point the weight of the ultimate forward rate (UFR) shall be at least 77,5%. In view of the mathematical formula to be used when determining extrapolated rates, this implies that the convergence parameter cannot be lower than 10,975%.

- **Residual volume criterion (Article 86(1)(b)(ii))**

According to the provisional agreement, the first smoothing point (FSP) is the longest maturity for which the two following conditions are met:

(a) The markets for financial instruments of that maturity are deep, liquid, and transparent;
(b) The percentage of outstanding bonds of that or a longer maturity among all outstanding bonds denominated in that currency is sufficiently high ('residual volume criterion').

The conditions for changing the FSP are quite strictly framed. In fact, the FSP for a given currency cannot be modified, unless the residual volume criterion points to a different value (be it higher or lower) during at least two consecutive years. The use of the term 'at least' in the enacting provision of the forthcoming amending Directive implies that there is no automatic modification of the FSP at the end of a two-year period, even if data would point to a different value.

In addition, co-legislators decided that at the date of entry into force of the new rules, the FSP for the euro should be set to 20 years.

The Commission is empowered to specify in Delegated Acts the currency-related percentages related to the residual volume criterion. In line with previous EGBPI meetings held until 2022, as well as EIOPA's advice, DG FISMA is considering setting this percentage to 6%, i.e. the same threshold as under current rules (see Recital 21 of Commission Delegated Regulation (EU) 2015/35).

Although further assessments may be needed for non-euro currencies, it is the understanding of DG FISMA that such an approach would result in a first smoothing point for each currency that is largely in line with EIOPA's impact assessment accompanying its Opinion on the 2020 Review. In particular, at all reference dates of EIOPA's impact assessment supporting its Opinion, as well as at year-end 2023 for which EIOPA staff conducted an additional assessment at the request of DG FISMA, the above specifications would result in a first smoothing point for the Euro of 20 years. Said differently, if the 'new' extrapolation rules had already applied since 2011, the FSP for the euro would have remained at 20 years since then, with no possibility to change (increase or decrease) its value.

NB: in 2022, due to a temporary change in markets conditions, the above specifications would have pointed to a FSP for the Euro of 24 years. However, as this higher outcome of the calculation was only temporary in nature, and did not last at least two years, this could in no case have resulted in an increase in the actual value of the FSP for the Euro.

- **Phasing-in mechanism (Article 77a(2))**

The provisional agreement provides that changes to extrapolation rules may be subject to a phasing-in. At the application date, the parameters determining the speed of the convergence of the forward rates towards the ultimate forward rate of the extrapolation should be such that the risk-free interest

[10] With the exception of the Swedish Krona where, for purely technical reasons, EIOPA concluded that the parameters could be set to 40%. See EIOPA's Opinion at the following link: https://www.eiopa.europa.eu/publications/opinion-2020-review-solvency-ii_en

rate term structure is sufficiently similar to the risk-free interest rate term structure on the date determined in line with the rules for the extrapolation applicable one day before the application date.

At this stage, it is therefore too early to indicate which convergence parameter should be used for the purpose of the phasing-in. EIOPA will be invited to share its assessment under one of the next EGBPI meetings.

Question: What are experts' views on the points outlined in this section?

B. Risk margin

Under current rules, the key driver of the value of the risk margin is the so-called 'cost-of-capital rate'. The current value of the cost-of-capital rate is 6%. EIOPA recommended not amending the cost-of-capital rate. The Commission indicated in the Chapeau Communication that it was considering reducing the cost-of-capital rate from 6% to 5%. In their provisional agreement, co-legislators decided to set in the Directive the value of the cost-of-capital rate to 4.75%.

The provisional agreement on Level 1 also mandates the Commission to introduce in Level 2 an 'exponential term-dependent factor' in the calculation formula. EIOPA recommended to set the value of this factor to 97.5% but to also cap the possible effect of this factor. In its Communication, the Commission indicated considering using the same value of 97.5% but without a cap.

A recital of the amending Directive[11] provides that the introduction of the term-dependent factor should result in a reduction of the sensitivity of the risk margin to changes in interest rates. Technically speaking, this implies that the mitigating effect of the term-dependent factor for long-term maturities should not be higher than for short-term maturities. *De facto*, this recital implies the reintroduction of a cap to the effect of the term-dependent factor.

The below table (based on EIOPA's previous calculations) provides estimations of the capital reliefs with reference date year-end 2019 of the following:

- EIOPA's Opinion;
- The Commission's intentions as described in the Chapeau Communication;
- A cost-of-capital rate of 4.75% as provisionally agreed by co-legislators, and a term-dependent factor set in accordance with the Chapeau Communication.

	EIOPA's Opinion	Chapeau Communication	Provisional agreement on Level 1 + Chapeau Communication on term-dependant factor
Cost-of-capital rate	6%	5%	4.75%
Exponential term-dependent factor	97.5% with a ceiling to the potential effect of the parameter	97.5% without ceiling	97.5% with ceiling
Capital relief	EUR 24.9 bn	EUR 43.6 bn	EUR 47.5 bn

Questions:

- What are experts' views on the impact of the provisional Level 1 agreement (in relation to the cost-of-capital rate) on the setting of the exponential term-dependent factor? In particular, what should be the value of the term-dependent factor?
- What are experts' views on the appropriate ceiling to the effect of the term-dependent parameter?

[11] Provisional recital 33a

C. Volatility adjustment

The Commission is empowered to specify, for each relevant asset class, the percentage of the spread that represents the portion of the spread that is attributable to a realistic assessment of expected losses, unexpected credit risk or any other risk.

EIOPA proposed the following formula for the determination of the risk-correction:

- For government bonds issued by EEA countries:

$$\text{Risk correction} = 30\% \cdot \min(S^+, LTAS^+) + 20\% \cdot \max(S^+ - LTAS^+, 0)$$

- For other fixed income investments in the representative portfolio:

$$\text{Risk correction} = 50\% \cdot \min(S^+, LTAS^+) + 40\% \cdot \max(S^+ - LTAS^+, 0)$$

Where:

- S denotes the average spread of the relevant asset classes in the representative portfolio;
- S^+ denotes the maximum of S and zero;
- LTAS denotes the long-term average spread of the relevant asset classes in the reference portfolio;
- $LTAS^+$ denotes the maximum of LTAS and 0.

The provisional agreement on the Directive introduces two additional requirements in relation to risk-correction:

- First, while EIOPA's approach distinguishes spreads depending on whether they are below or above the long-term averages, the provisional agreement empowers the Commission to take into account an additional layer, namely whether spreads exceed twice the long-term average;
- Second, the Commission should ensure that the risk correction does not exceed a certain threshold, expressed as a percentage of long-term average spreads.

In view of those constraints and taking into account EIOPA's approach to which the Commission's Chapeau Communication refers, a possible way forward could consist in the following:

- For government bonds issued by EEA countries

$$\text{Risk correction} = \mathbf{min}\left[30\% \cdot min(S^+, LTAS^+) + 20\% \cdot max\{0, min(S^+ - LTAS^+, LTAS^+)\} + \mathbf{15\%} \cdot \boldsymbol{max}\{\mathbf{0}, \boldsymbol{S^+ - 2 \cdot LTAS^+}\}; \mathbf{105\%} \cdot \boldsymbol{LTAS^+}\right]$$

- For other fixed income investments in the representative portfolio:

$$\text{Risk correction} = \mathbf{min}\left[50\% \cdot min(S^+, LTAS^+) + 40\% \cdot max\{0, min(S^+ - LTAS^+, LTAS^+)\} + \mathbf{35\%} \cdot \boldsymbol{max}\{\mathbf{0}, \boldsymbol{S^+ - 2 \cdot LTAS^+}\}; \mathbf{195\%} \cdot \boldsymbol{LTAS^+}\right]$$

Question: what is experts' view on the possible approach to risk correction in light of the provisional agreement on the amending Directive?

D. Interest rate risk

Discussions on the recalibration of the standard formula interest rate risk sub-module were already quite advanced prior to the Trilogues.

However, as part of the political agreement, co-legislators introduced a new recital inviting the Commission to consider introducing a floor to interest rates that is not flat but time-dependent. At this stage, the Commission has no data to introduce such term-dependent floor.

In addition, the new provisional Article 111(2a) provides that the Commission may phase-in changes to the interest rate risk sub-module over a period of up to five years. Where such phasing-in is

introduced in the Delegated Regulation, it shall be mandatory to all insurance and reinsurance undertakings.

Questions:

- What is experts' views on the opportunity to introduce a term-dependent floor in the standard formula interest rate risk sub-module?
- If experts agree with the introduction of a term-dependent floor, do they have data supporting the determination of such potential term-dependent floor, or do they recommend that FISMA seeks data and/or possible technical inputs from EIOPA to support discussions during one of the forthcoming EGBPI meetings?
- What is experts' view on the need to introduce a phasing-in mechanism in the Delegated Regulation, bearing in mind that where introduced, such phasing-in becomes mandatory for all undertakings?

E. Long-term equity investments

The provisional agreement inserts a new Article 105a which introduces the long-term equity category in Level 1, including the criteria and the applicable risk factor.

However, the new provisional Articles 105a and 233b of the Solvency II Directive provide that the Commission shall adopt delegated acts specifying:

- The conditions for eligibility at individual level, as well as the approach to be used at group level;
- The type of collective investment undertakings which shall be considered as presenting a lower risk;
- The information to be included in the solvency and financial condition report (SFCR) and the regular supervisory report (RSR), both at individual and group levels.

As regards the conditions at individual level, DG FISMA identifies that paragraph 1, second subparagraph, point (d) of Article 105a – demonstration of the ability to avoid force selling – requires further specifications. In that regard, it is planned to resume discussions on this topic during one of the next EGBPI meetings. EIOPA recommended using the concept of illiquidity of liabilities for life activities, and of liquidity buffer for non-life business. However, such approach raised several concerns from certain experts, notably the difference in approaches of approach between life and non-life. DG FISMA presented at EGBPI meetings in 2022 an alternative approach based on a 'liquidity test'. It is the understanding of DG FISMA that such an approach, while requiring further fine tuning, was deemed a reasonable way forward.

DG FISMA is currently assessing whether the other conditions require further specifications in the Delegated Regulation.

In addition, DG FISMA will reflect on the type of collective investment undertakings which should be considered as presenting a lower risk, taking into account past EGBPI discussions on this topic, and on the reporting and disclosure rules related to long-term equity.

Finally, during EGBPI meetings in 2022, DG FISMA presented a simplified approach for the recognition of long-term equities at group level, where by default, no assessment at group level would be needed in addition to the one carried out at solo level.

Questions:

- Do experts identify the need to further specify other points of Article 105a paragraph 1, second subparagraph of the provisionally agreed Solvency II amending Directive?
- Do experts agree to investigate further the liquidity test approach?

F. Matching adjustment

The provisional agreement introduces a recital according to which "*insurance and reinsurance undertakings which use the matching adjustment should be allowed to calculate their Solvency Capital Requirement based on the assumption of full diversification between the assets and liabilities of the portfolio and the rest of the undertaking, unless the portfolios of assets covering a corresponding best estimate of insurance or reinsurance obligations form a ring-fenced fund*".

Accordingly, DG FISMA will consider amending rules governing the calculation of the Solvency Capital Requirement set out in the Delegated Regulation (Articles 216, 217 and 234)

Question: Do experts have comments in relation to the possibility to allow undertakings using the matching adjustments to calculate their SCR on the basis of full diversification?

G. Direct exposures to central clearing counterparties (CCPs).

As part of the EMIR Chapeau Communication of December 2022[12], the Commission indicated that it "*intends to address the disadvantageous prudential treatment insurers face if they become a direct clearing member*", through amendments in the Solvency II Delegated Regulation.

Under banking rules, Articles 303 to 311 of Regulation (EU) No 575/2013 specify the rules governing exposures to CCPs. Due to differences in capital requirements between credit institutions and insurance companies, it may not be relevant to replicate banking rules in Solvency II.

Therefore, DG FISMA intends to send a call for advice to EIOPA in order to implement the statement included in the EMIR Chapeau Communication.

Question: Do experts have comments or suggestions in relation to the prudential treatment of direct exposures to CCPs?

H. Empowerments on proportionality

In accordance with the provisional agreement on Level 1, co-legislators decided to empower the Commission to adopt delegated acts specifying, in addition to the eligibility criteria for small and non-complex undertakings and groups, the following:

- The methodology to be used when classifying undertakings or groups as small and non-complex;
- The conditions for granting or withdrawing supervisory approval for proportionality measures to be used by undertakings that are not classified as small and non-complex.

On both aspects, EIOPA did not provide technical advice. In relation to the second aspect, two pitfalls should be avoided:

- If the conditions are too light, the lack of safeguards may result in supervisory authorities lacking a legal basis to oppose the use of certain proportionality measures, to the detriment of policyholder protection;
- If the conditions are too strict, access to proportionality measures by undertakings that are not small and non-complex may be excessively limited.

For this reason, DG FISMA intends to send a call for advice to EIOPA on those topics.

Question: Do experts have comments or suggestions in relation to the above-mentioned proportionality items?

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I. A few ‘other issues’

Annex 1 describes a few issues and obvious mistakes identified by various stakeholders which could be addressed as part of the review.

Annex 1

Missing cross-reference in mass lapse life risk

Issue

An omission has been identified when comparing Article 159(6) with 142(2).

- Article 159(6) only includes 2 events, the "main event" (point (a)) and a specific case for reinsurance (point (b)). The second subparagraph of that paragraph refers to both points.
- In Article 142(2) there are 3 events. Points (a) and (b) from previous Article 159 correspond to points (b) and (c) in article 142, and the new specific event for life mass-lapse is described in point (a) (group risk). The second subparagraph, (which is drafted in the same manner as in Article 159(6)), omits the reference to point (b) (the main event), which is inconsistent with Article 159(6).

Possible way forward

In Article 142(2), the second subparagraph could be amended as follows (see change **in bold**):
'The events referred to in the first subparagraph shall apply uniformly to all insurance and reinsurance contracts concerned. In relation to reinsurance contracts, the event referred to in point**s** (a) **and (b)** shall apply to the underlying insurance contracts.'

Uncertain treatment of equity investments with negative values in the equity risk and market risk concentration submodules

Issue

Under current rules, it is not clear how equity investments with negative Solvency II values should be treated. The rules should be clarified. In particular, for equity, it should be made clear that where the company is of limited liability, the capital requirement for equity risk is zero on a negative equity.

Possible way forward

- In Article 169, a new paragraph 5 could be added:

'5. For the purposes of paragraphs 1 to 4, where the value of an equity investment is negative, and where the losses that may be incurred on the investment can exceed the amount invested by the insurance and reinsurance undertaking, the following shall apply:

(a) the term 'value of type 1 equity investments' shall mean 'absolute value of type 1 equity investments';
(b) the term 'value of type 2 equity investments' shall mean 'absolute value of type 2 equity investments';
(c) the term 'value of qualifying infrastructure equity investments' shall mean 'absolute value of qualifying infrastructure equity investments'; and
(d) the term 'value of qualifying infrastructure corporate equity investments' shall mean 'absolute value of qualifying infrastructure corporate equity investments'.

For the purposes of paragraphs 1 to 4, insurance and reinsurance undertakings shall assume that equity investments with negative values other than those referred to in the first subparagraph shall be assumed to have a value of 0'.

- In Article 184(2), the following point (g) (**in bold)** could be added:

‘2. The calculation base of the market risk concentration sub-module *Assets* shall be equal to the value of all assets held by an insurance or reinsurance undertaking, excluding the following:

(…)

(g) the value of an equity investment, where such value is negative.’

Inappropriate reference to covered bonds

Issue

References to covered bonds should include a reference to the new Union legal framework for covered bonds (Directive 2019/2162)

Possible way forward

Amending Article 180(1) and Article 187(1) to refer to covered bonds ‘***within the meaning of Article 3, point (1), of Directive (EU) 2019/2162 of the European Parliament and of the Council”.***

Conflicts in provisions (market risk concentration)

The issue (and related COM reading) is described in Q&A 2408.

Under current rules, it is difficult to calculate for instance market risk concentration where an insurer is exposed to bonds issued by a MS in its local currency as well as bonds issued by that same MS in a foreign currency.

The actual reading of the relevant provision is as follows:

- Delegated Regulation (EU) 2019/981 amended Delegated Regulation (EU) 2015/35, among others, to clarify the sequence of the calculation in the market risk concentration sub-module, namely that “[individual] exposures should […] first be mapped to credit quality steps and relative excess exposure thresholds, and risk factors should subsequently be applied at the level of single name exposures.” (see recital 31 of that Regulation).
- Where insurance and reinsurance undertakings have exposures of the types referred to in Article 187(4), (4a) or (4b) as well as other exposures not in the scope of the same paragraph to the same counterparty, they should derive an implied credit quality step in order to be able to follow the sequence for the calculation explained above. The implied credit quality step for a specific exposure in the scope of Article 187(4), (4a) or (4b) should be the credit quality step which would produce the same risk factor g_i for a single name exposure pursuant to Article 186(1) as the risk factor g_i for the specific exposure determined in accordance with Article 187(4), (4a) or, as applicable, (4b).

Possible way forward

- Article 182 could be amended as follows:
  - In paragraph 5, a sentence could be added – see **in bold** (*justification: non EEA government bonds in local currency get the same capital requirements for concentration risk as corporates of one credit quality step higher)*

‘5. For the purposes of paragraph 4, exposures for which a credit assessment by a nominated ECAI is available shall be assigned a credit quality step in accordance with Chapter 1 Section 2 of this Title. **The credit quality step for exposures to central governments and central banks shall be reduced by one where all of the following applies:**

(a) those exposures are other than those referred to in Article 187(3), point (b);

(b) those exposures are denominated and funded in the domestic currency of that central government and central bank;

(c) the credit quality step for such exposures is two or larger.'

- The following paragraphs could be inserted (*explanation: moved from Article 187(4a) and Article 187(4b); Track changes refer to amendments to those migrated paragraphs)*

'**5**a. Exposures to Member States' regional governments and local authorities not listed in Article 1 of Implementing Regulation (EU) 2015/2011 shall be assigned ~~*a risk factor g i for market risk concentration corresponding*~~ to ~~*weighted average*~~ credit quality step 1 ~~*2 in accordance with paragraph 4*~~.

5b. Exposures that are fully, unconditionally, and irrevocably guaranteed by a Member State's regional government or local authority that is not listed in Article 1 of Implementing Regulation (EU) 2015/2011, where the guarantee meets the requirements set out in Article 215 of this Regulation, shall be assigned ~~*a risk factor g i for market risk concentration corresponding*~~ to ~~*weighted average*~~ credit quality step 1 ~~*2 in accordance with paragraph 4*~~.

- In Article 187, paragraphs 4a and 4b could be deleted **(***explanation: migrated to Article 182***)**

<u>Regulatory arbitrage in the application of the look-through to investment vehicles.</u>

Issue

The rules governing look-through of related undertakings were amended in 2019. However, the new Article 84(4) raises practical challenges, as it is possible for insurance groups to circumvent the new look-through requirement by establishing an investment vehicle which not only manages assets on behalf of the participating undertaking, but also of several related undertakings in the group. As a consequence, in such cases, the condition in Article 84(4), point (c), is not met ("*the related undertaking does not carry on any significant business other than investing for the benefit of the participating undertaking*").

In addition, in order to skirt the application of the look-through, certain insurers tend to identify holdings in investment vehicles as 'strategic participations', due to the absence of cross-referencing between Article 84 and Article 171 (e.g. an investment vehicle in real estate being treated as strategic equity investment to avoid the application of the look-through approach and the capital requirement for property risk).

Possible way forward:

- <u>Changes (**in bold**) to Article 84(4) as follows:</u>

'4. Paragraph 2 shall not apply to investments in related undertakings, other than investments in respect of which all of the following conditions are met:

(a) the main purpose of the related undertaking is to hold and manage assets on behalf of the participating undertaking **or of any other undertaking of the group to which the participating undertaking belongs**;

(b) the related undertaking supports the operations of the participating undertaking related to investment activities, following a specific and documented investment mandate;

(c) the related undertaking does not carry on any significant business other than investing for the benefit of the participating undertaking **or for any other undertaking of the group to which the participating undertaking belongs**.

For the purposes of this paragraph, 'related undertaking' and 'participating undertaking' shall have the meaning given to those terms in Article 212(1) and (2) of Directive 2009/138/EC.'

- Changes (**in bold**) to the introductory wording of Article 171:

'For the purposes of Article 169(1), point (a), (2), point (a), (3), point (a), and (4), point (a), and of Article 170(1), point (b), (2), point (b), (3), point (b) and (4), pint (b), equity investments of a strategic nature shall mean equity investments **to which the look-through approach does not apply and** for which the participating insurance or reinsurance undertaking demonstrates the following:'

Wrong references as regards loss-given default for reinsurance subject to collateral arrangements

Issue

Article 192 of Delegated Regulation (EU) 2015/35 (DR) was amended by Commission Delegated Regulation (EU) 2019/981. Since, the calculation of the loss-given-default on a derivative is more granular (from one formula to four formulas) as detailed in Articles 192(3a), 192(3b), 192(3c) and 192(3d) DR. New factors F'' and F''' were introduced in the formula, and the value of the factor F' from the previous version of Article 192(3) DR is now equal to the value of F''' mentioned in the latest version of Article 192(3c) DR. The value of the factors F, F', F'' and F''' states in Article 197(7) DR and was amended in 2019 too.

Nevertheless, there is one formula in Article 192(2) which contains the factor " F' " and this formula was not amended by Commission Delegated Regulation (EU) 2019/981. Consequently, in this formula the value of F' was 90% before the amendment in 2019 and is now equal to 18% in the current DR. This was not intentional.

Possible way forward

- In Article 192(2), the formula could be corrected:

'LGD = max{90% * (*Recoverables* - 50% * *RMre)* - F''' . *Collateral*; 0}'

- Article 197(7) could be amended as follows (in **bold**):

'7. Where, in case of insolvency of the counterparty, the determination of the insurance or reinsurance undertaking's proportional share of the counterparty's insolvency estate in excess of the collateral does not take into account that the undertaking receives the collateral, the factors *F*, *F'*, *F''* and *F'''* referred to in Article 192(2) to (3c) **and Articles 194 to 196** shall all be 100 %. In all other cases these factors shall be 50 %, 18 %**,** 16 % and 90 % respectively.'

[NB: the insertion allows capturing loss-given default formulas related to reinsurance pools]

Formula not working where probability of defaults are equal to 0

Issue

In Article 201(2), the formula does not work where $PD_j = PD_k = 0$.

Possible way forward

In Article 201(2), point (a) could be amended as follows (in **bold**):

'(a) the sum covers all possible combinations (j,k) of probabilities of default on single name exposures in accordance with Article 199**, except the case where $PD_j=PD_k=0$**;'

Denomination of countries

Issue

The designation ‘former Yugoslav Republic of Macedonia’ is no longer the appropriate one.

In addition, there are several places where a misspelling of ‘Liechtenstein’ has been identified.

Possible way forward:

- In Annex III, replace ‘former Yugoslav Republic of Macedonia’ with ‘North Macedonia’
- In Annexes V, VII, VII and VIII, replace “Lichtenstein” with “Liechtenstein”.

Error on flood risk weights for Bulgaria

Issue

Annex IX sets out only 28 risk zones for flood risk for Bulgaria whereas Annex X sets out risk weights for 29 risk zones for BG. However, the correlation matric for that risk and country does only set out 28x28 correlation parameters. Therefore, it is not appropriate to have the 29th entry for Bulgaria in the table with flood risk weights.

Possible way forward:

Delete the row starting with ‘29’.