

# **2020 Review of Solvency II**

## **Long Term Equity**

Any views provided in this document are tentative views at working group level and should not be understood as EIOPA positions.

# **1. Equity risk**

## **1.1. Review of the criteria for the use of LTE**

### **1.1.1. Current situation**

The current legislation enabled in practical terms that only a little share of equity currently held by insurers is allocated to long-term equity (LTE). The low use of LTE is not a problem in itself, provided that undertakings could make use of it when deemed necessary and appropriate. However, undertakings also indicate that the low use of LTE is to a large extent the result of the overly restrictive nature of the set of criteria specified.

The analysis did not enable the identification of evidence which corroborates the conclusion that equity investment for a longer duration justifies a lower capital charge. For this reason the work focussed on the criteria which enable the classification of equity as LTE.

### **1.1.2. EIOPA position for consultation**

EIOPA focused its work on the eligibility criteria which needs to be fulfilled in order for equity to be assigned to the LTE category, by proposing some additional criteria in the Consultation Paper on the Opinion on the 2020 Review of Solvency II.

Following the Consultation, further work has been made in the development of the criteria and in the holistic impact assessment (HIA) and complementary information request (CIR) exercises, two alternative specifications and some sensitivities were tested.

### **1.1.3. Consultation feedback**

Stakeholders mainly requested that the new LTE equity category is made operational in practical terms, by relaxing the restrictive criteria in place.

The additional criteria proposed by EIOPA was criticized as being unnecessary and further adding to the complexity and restrictiveness of the LTE.

HIA results indicated that the use of LTE could potentially increase to some extent under the revised criteria, but its use would remain low. The number of undertakings applying LTE increased from 17 under the current requirements to 27. The proportion of equity allocated to LTE remained low, amounting on average to 2.83% of the equity held for those undertakings which allocated at least some equity to LTE. Taking all equity reported by the undertakings into account, the amount allocated to LTE did not exceed 0.8%. The impact in the reduction of the equity sub-module SCR was also low, representing about 4.5% on average for the undertakings reporting at least some LTE. The impact in the overall SCR could not be accurately estimated but it can be reasonably expected to be very small.

These results should be interpreted carefully. It should be noted that about 40% of all undertakings participating in the HIA did not report any exposures in the equity tab, which was most likely driven by lack of interest in the LTE framework rather than a total absence of equity exposures. There was also some indication in the HIA results that at least some undertakings could potentially have used the LTE category, but chose not to do so. If those undertakings would have allocated equity to LTE, the number of users

could have potentially doubled. However, even in such circumstances, the number of LTE users and the share of equity classified as LTE would have remained small.

Preliminary analysis of CIR results points to a generally similar outcome as that described for the HIA. The most relevant difference concerned the results of Sensitivity A (enlargement of eligibility to Category II liabilities), which had a material impact in the ability to classify equity as LTE for Life undertakings.

#### 1.1.4.Options

Against this background, work on the refinement of the new set of criteria continued, with the aim to make the criteria practical and aligned with the objectives underlying the introduction of the LTE category.

#### ISSUE 1

One of the areas of work is the specification of criteria 1 b) and 1 c), which were deemed overly restrictive and potentially leading to the interpretation that the allocation of equity to LTE should lead to the establishment of ring fenced funds. Changes were deemed important for the clarification of the requirements, enabling a more consistent application and supervision. The HIA results (on which these requirements were excluded in the default approach) illustrated the potential impact of the issue. Although the quality of data was poor, it indicated that keeping the requirements in place unchanged could lead to a reduction of the LTE reported in the HIA exercise by about 50%.

Proposed modifications:

*1.b) the sub-set of equity investment is included within a portfolio of assets which is assigned to cover the best estimate of a portfolio of insurance or reinsurance obligations corresponding to one or several clearly identified businesses, and the undertaking maintains that assignment ~~over the lifetime of the obligations~~;*

Rationale

The reference to the "lifetime of the obligations" in 1.b) is deemed problematic as in many instances the lifetime of the contracts exceeds the lifetime of the corresponding Solvency II obligations. This means that assets are typically held longer than what is recognized in technical provisions, e.g. in case of 1-year non-life or life contracts with typically high renewal rates. It was therefore not clear, how this provision should work in practice and what it was targeting. This could lead to insurers interpreting that the eligibility criteria are not satisfied from a year to another. What is considered important is that there is no switch in allocation of LTE between liabilities.

Proposed modifications:

*1.c) ~~the portfolio of insurance or reinsurance obligations, and~~ the assigned portfolio of assets referred to in point (b) are identified, and managed ~~and organised~~ separately from the other activities of the undertaking ~~and the assigned portfolio of assets cannot be used to cover losses arising from other activities of the undertaking~~;*

1.e) A policy for long term investment *management* is set up for each long-term equity portfolio and reflects undertaking's commitment to hold the global exposure to equity in the sub-set of equity investment for a period that exceeds 5 years on average. *The AMSB of the undertaking has signed off these investment management policies and these policies are frequently reviewed against the actual management of the portfolios.*

## Rationale

Two elements of the requirement 1.c) could lead to an understanding that LTE can only be applied very restrictively. In particular, the reference to a separated organisation is generally interpreted as requiring an additional burden for the organisation in requiring a strict separation of teams managing the assets. EIOPA considers that a separate identification and management should be sufficient, i.e. the LTE should be identified and managed within a separate fund/account, it is not necessary though to have a separate team of people managing those investments. In addition, a reading *stricto sensu* of the second part of the sentence would also lead to a strict interpretation in that there is a formal restriction existing that makes it impossible to cover losses elsewhere. EIOPA considers that this is typically not the case and thus overly restricts the use of LTE. Instead, EIOPA considers it important that insurers are able to hold their equity long-term and commit themselves to do so – which should be reflected in the investment policy. EIOPA considers it sufficient to safeguard these requirements by disallowing insurers to apply LTE for the next 3 years, where they breach those requirements. Therefore, EIOPA propose to clarify 1.c) by deleting the above points and to strengthen requirement 1.e).

## ISSUE 2

The main issue affecting LTE relates to its very limited use. This is the case under the current specification, and it continued to be an issue in the HIA despite the changes which have been incorporated in the specification of the criteria. In the CIR exercise, EIOPA tested some sensitivities, of which only Sensitivity A seemed to indicate a positive effect of the proposed modifications to be introduced to the set of criteria required for the use of the LTE category.

From EIOPA's analysis, changes should be focused on life business, because:

- LTE is mainly justified by the ability of undertakings to buy and hold equity for a long term, thereby enabling them to be live through short-term market fluctuations. Life insurers are the natural long-term investors, due to the nature of their business;
- HIA results evidenced a substantial decrease in the use of LTE by life undertakings (reduced by 2/3).

In contrast, HIA evidenced an increase in application of LTE by non-life and composite undertakings (more than doubled on both cases), so the amendment of criteria in the HIA has already shown effect and further changes do not seem immediately necessary;

- CIR Sensitivity A demonstrated potential to enable a wider application of LTE backing life insurance obligations.

Therefore, changes to criterion 1 g) could be made, enlarging the eligibility of liabilities which can be backed by LTE from only Category I to also include Category II.

Such change has the potential to lead to a wide use of LTE, at least in some jurisdictions, given that the sum of Category I and II liabilities includes most of the total liabilities in most jurisdictions (above 80% of total liabilities in most cases). To balance this change with the stated objective of ensuring a prudentially sound application of the LTE framework, the following criteria are necessary:

- The requirement for a minimum duration of 10 years should be kept to ensure that LTE applies solely to long term business.

On the basis of HIA results, about 56% of total BE liabilities (in all currencies) were reported as having a modified duration above 10 years. Most of these (about 48% of total liabilities) were allocated by undertakings to Category II, compared to less than 5% of total liabilities allocated to Category I.

- A proportionality limit between assets and liabilities should be introduced, to avoid the potential abuse of the framework by undertakings, which could be an issue in particular where there is no specific allocation of assets to specific liabilities. For example, one undertaking where 40% of total life liabilities would meet the LTE criteria and 20% of total assets are invested in equity, could potentially argue that the entirety of its equity investments are backing those specific liabilities, therefore assigning 100% of its equity investments to the LTE category. Under the proposed approach, only a maximum of 40% of the equity exposure would be eligible for the LTE category.

### 1.1.5.Possible way forward

The following criteria is proposed to be adopted for the classification of equity as LTE:

Baseline (Article 171a DR)	Proposal
1. For the purpose of this Regulation, a sub-set of equity investments may be treated as long-term equity investments if the insurance or reinsurance undertaking demonstrates, to the satisfaction of the supervisory authority, that all of the following conditions are met:	
a) the sub-set of equity investments as well as the holding period of each equity investment within the sub-set are clearly identified;	a) the sub-set of equity investments is clearly identified;
b) the sub-set of equity investment is included within a portfolio of assets which is assigned to cover the best estimate of a portfolio of insurance or reinsurance obligations corresponding to one or several clearly identified businesses, and the undertaking maintains that assignment over the lifetime of the obligations;	b) the sub-set of equity investment is included within a portfolio of assets which is assigned to cover the best estimate of a portfolio of insurance or reinsurance obligations corresponding to one or several clearly identified businesses, and the undertaking maintains that assignment.
c) the portfolio of insurance or reinsurance obligations, and the assigned portfolio of assets referred to in point (b) are identified, managed and organised separately from the other activities of the undertaking, and the assigned portfolio of assets cannot be used to cover losses	c) the assigned portfolio of assets referred to in point (b) are identified and managed separately from the other activities of the undertaking.

<p>arising from other activities of the undertaking;</p>	
<p>d) the technical provisions within the portfolio of insurance or reinsurance obligations referred to in point (b) only represent a part of the total technical provisions of the insurance or reinsurance undertaking;</p>	<p>[See new number 2]</p>
<p>e) the average holding period of equity investments in the sub-set exceeds 5 years, or where the average holding period of the sub-set is lower than 5 years, the insurance or reinsurance undertaking does not sell any equity investments within the sub-set until the average holding period exceeds 5 years;</p>	<p>e) a policy for long term investment management is set up for each long-term equity portfolio and reflects undertaking's commitment to hold the global exposure to equity in the sub-set of equity investment for a period that exceeds 5 years on average. The AMSB of the undertaking has signed off these investment management policies and these policies are frequently reviewed against the actual management of the portfolios.</p>
<p>f) the sub-set of equity investments consists only of equities that are listed in the EEA or of unlisted equities of companies that have their head offices in countries that are members of the EEA;</p>	<p>f) the sub-set of equity investments consists only of equities that are listed in the EEA or of unlisted equities of companies that have their head offices in countries that are members of the EEA;</p>
<p>g) the solvency and liquidity position of the insurance or reinsurance undertaking, as well as its strategies, processes and reporting procedures with respect to asset-liability management, are such as to ensure, on an ongoing basis and under stressed conditions, that it is able to avoid forced sales of each equity investments within the sub-set for at least 10 years;</p>	<p>g) Where undertakings can demonstrate that either</p> <ul style="list-style-type: none"> <li>i. particular homogeneous risk groups (HRGs) of the life insurance and reinsurance liabilities belongs to categories I or II as defined for the purpose of the calculation of the VA and the Macaulay duration of the liabilities in this HRG exceeds 10 years or</li> <li>ii. a sufficient liquidity buffer is in place for the portfolio of non-life insurance and reinsurance liabilities and the assigned portfolio of assets;</li> </ul> <p>[The liquidity buffer should follow the specification tested in the HIA/CIR]</p> <p>The sub-set of equity investments backing the liabilities identified in i. or ii. can be applied a risk charge of 22% provided the other conditions of this Article are met.</p>
<p>h) the risk management, asset-liability management and investment policies of the insurance or reinsurance undertaking reflects the undertaking's intention to hold the sub-set of equity investments for</p>	<p>h) the risk management, asset-liability management and investment policies of the insurance or reinsurance undertaking reflects the undertaking's intention to hold the sub-set of equity investments for</p>

<p>a period that is compatible with the requirement of point (e) and its ability to meet the requirement of point (g).</p>	<p>a period that is compatible with the requirement of point (e) and its ability to meet the requirement of point (g). Those elements are reported in the ORSA of the undertakings.</p>
	<p>i) the sub-set of equity investments shall be properly diversified in such a way as to avoid excessive reliance on any particular issuer or group of undertakings and excessive accumulation of risk in the portfolio as a whole.</p>
	<p>2. The proportion of equity backing life technical provisions that is assigned to the LTE category does not exceed the proportion of life technical provisions compliant with the criteria specified in number 1 on the total life technical provisions of the insurance or reinsurance undertaking;</p>
<p>2. Where equities are held within collective investment undertakings or within alternative investment funds referred to in points (a) to (d) of Article 168(6), the conditions set out in paragraph 1 of this Article may be assessed at the level of the funds and not of the underlying assets held within those funds.</p>	<p>3. Where equities are held within collective investment undertakings or within alternative investment funds referred to in points (a) to (d) of Article 168(6), the conditions set out in paragraph 1 of this Article may be assessed at the level of the funds and not of the underlying assets held within those funds.</p>
<p>3. Insurance or reinsurance undertakings that treat a sub-set of equity investments as long-term equity investments in accordance with paragraph 1 shall not revert back to an approach that does not include long-term equity investments. Where an insurance or reinsurance undertaking that treats a sub-set of equity investments as long-term equity investments is no longer able to comply with the conditions set out in paragraph 1, it shall immediately inform the supervisory authority and shall cease to apply Article 169(1)(b), (2)(b), (3)(b) and (4)(b) to any of its equity investments for a period of 36 months.;</p>	<p>4. Insurance or reinsurance undertakings that treat a sub-set of equity investments as long-term equity investments in accordance with paragraph 1 shall not revert back to an approach that does not include long-term equity investments. Where an insurance or reinsurance undertaking that treats a sub-set of equity investments as long-term equity investments is no longer able to comply with the conditions set out in paragraph 1, it shall immediately inform the supervisory authority and shall cease to apply Article 169(1)(b), (2)(b), (3)(b) and (4)(b) to any of its equity investments for a period of 36 months.;</p>
	<p>5. Controlled intra-group equity investments shall be excluded from the sub-set of equity investments.</p>

In addition to the proposal of revised criteria, in cases where the allocation of equity to LTE has a material impact on the overall SCR of the undertaking, enhanced reporting

requirements could apply (e.g. through the RSR). These requirements could focus on the assessment of the undertaking's ability to effectively hold equity in the long term from a risk management perspective, as well as a sensitivity analysis of the impact of LTE on its solvency position.