

Insurance Europe views on long-term equity criteria (Article 171a)

Introduction

Insurance Europe welcomes the EC's stated intention to revise the eligibility criteria for the long-term assets class. However, the detail of any changes will be key to achieve the improvements needed so that a significant portion of standard formula insurer's equity holdings would qualify.

The insurance industry is Europe's largest institutional investor and, as such, it has a direct interest in long-term investment, especially given that most of these assets back long-term liabilities (eg pension and savings products).

The Solvency II framework should recognise these long-term investments with appropriate capital requirements that reflect their true long-term risks. In this respect, the industry appreciates the EC's work in this area so far and acknowledges the steps taken with the objective to improve the framework for long-term equity (LTE) in Article 171a of the Delegated Regulation. However, the LTE sub-module must appropriately recognise the fundamentals of long-term investments. Long term-investing is not simply about maturity or duration of assets or about restricting individual assets to be held to maturity or for a certain number of years. Instead, it is about the nature of the liabilities and the overall risk and investment strategy, which allows the insurer to hold its investment portfolio over a long-term horizon. The ability and willingness to invest long-term is directly related to the nature of the liabilities of insurance companies and is not in contradiction with dynamic management of the investment portfolio in line with best risk management practices.

Industry proposal on LTE criteria (article 171a)

Insurance Europe proposes the following amendments on Article 171a regarding the criteria to recognise when equities could be classified as long-term investments.

Industry proposal on Article 171a
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 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, its risk margin and share of the own funds of a portfolio of insurance or reinsurance obligations corresponding to one or several clearly identified businesses.
c) The assigned portfolio of assets referred to in point (b) are identified separately from the other activities of the undertaking.
d) [Replaced by new number (2)]
e) A policy for long-term investment management is set up for each long-term equity portfolio and reflects undertaking's strategic asset allocation 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 this strategic allocation in the investment management policies and these policies are frequently reviewed against the actual management of the portfolios.
f) The sub-set of equity investments consists only of equities that are listed in the EEA or in the OECD or of unlisted equities of companies that have their head offices in countries that are members of the EEA or of the OECD.

<p>g) Where undertakings can demonstrate that either</p> <ul style="list-style-type: none"> i. particular homogeneous risk groups of the life insurance and reinsurance liabilities belongs to categories I or II as defined in paragraph 2 and the Macaulay duration of the liabilities in this HRG exceeds 6 years; or ii. a sufficient liquidity buffer is in place for the portfolio of non-life insurance and reinsurance liabilities and the assigned portfolio of assets; or iii. 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 the sub-set of long-term equity investments for at least 5 years by complying with the positive liquidity test, as defined in paragraph 3.
<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 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. (i) The proportion of equity backing life technical provisions that is assigned to the long-term equity investment category does not exceed the proportion of life technical provisions compliant with the criteria specified in paragraph 1(g) (i) on the total life technical provisions of the insurance or reinsurance undertaking;</p> <p>(ii) Category I liabilities are defined as contracts without any surrender/cancellation option or where the surrender value does not exceed the market value of the assets and with low mortality risk and catastrophe risk.</p> <p>Category II liabilities are defined as contracts with limited surrender risk:</p> <ul style="list-style-type: none"> • including disincentives for surrender • low risk charge for the risk of a permanent increase in lapse rates <p>And with low mortality risk and catastrophe risk.</p>
<p>3. The liquidity test, specified in paragraph 1 (g) (iii) relies on the demonstration that, every year of the 5-year time horizon, in a deterministic stressed scenario, the difference between asset cash flows and liability cash flows is always positive. To this end:</p>
<p>a) the asset cash flows shall be derived in a proportionate manner and include:</p> <ul style="list-style-type: none"> – projected asset revenues (eg coupons, rental income and dividends); – projected future premiums income, including renewals estimated on a prudent basis; – cash and cash financial instruments; – income from the sales of bonds backing the own funds or in the limit of the proportion of the bonds backing the own funds, bonds with a CQS of 0,1 or 2 and redemptions; – income from any sales of equities or other assets not included in the long-term equity submodule; – income from collateral cashflows.
<p>b) the liability cash flows shall be derived in a proportionate manner and include:</p> <ul style="list-style-type: none"> – projected claims and benefit payments; – projected expenses and taxes; – financing of insurer's activities (eg. distributed dividends, debt interest and redemptions); – collateral requirements arising from derivative positions assessed.
<p>c) The stressed scenario is assessed to be consistent with the SCR shocks calculated in accordance with the standard formula, as referred to in article 105 of Directive 2009/138/EC and aggregated using the correlation coefficients, as referred to in the article 104 of Directive 2009/138/EC. Based on the calculated</p>

SCR, the insurance or reinsurance undertaking determines the relative contribution of each sub risk to the SCR.
d) The liquidity requirement in the stressed scenario is set to be the aggregated value of the shocks within the SCR which create an explicit cash outflow within the 5 year period, The losses caused by the operational risk result in a cash outflow.
e) The assumptions used by the insurance undertaking in the liquidity test should be realistic, consistent with the insurer's business planning, policies and ORSA scenarios and approved by the AMSB. For the projecting period exceeding the time horizon of ORSA, the undertaking shall ensure that the underlying assumptions account adequately for any future uncertainty and that the profitability of the undertaking does not exceed the profit observed during the last projection year of ORSA.
4. Where equities are held within collective investment undertakings or within alternative investment funds or within investments in related undertakings, 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.
5. 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 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. The supervisory authority can cease to allow the company to apply Article 169(1)(b), (2)(b), (3)(b) and (4)(b) to any of its sub-set equity investments for a period of 12 months.

Proposed changes to EIOPA's proposal on criterion (g)

The liquidity buffer used for the purpose of criteria g) ii should be tested on the level of the whole non-life insurance and reinsurance liabilities. The liquidity buffer should be calculated on the basis of the assets backing the undertaking's non-life insurance and reinsurance obligations. Where the liquidity buffer as outlined in the following paragraph is bigger or equal than 1, all equity backing the non-life insurance and reinsurance obligations fall under the scope of the provisions of Article 171a can apply a risk charge of 22% (provided that the other criteria set out above are met). Where the liquidity buffer is smaller than 1, a limited amount of equity falls under the scope of Article 171a.

The liquidity buffer for the purpose of criteria g) is to be calculated as follows:

$$\frac{HQLA}{BE_{portfolio}}$$

- where the numerator is high-quality liquid assets (HQLA) backing the non-life liabilities, applying a liquidity haircut as defined below;
- the denominator is the non-life best estimate liabilities net of reinsurance.

Where the liquidity buffer is less than 1, the portion of equity which is in scope of Article 171a is given by

$$\max\left(0, \frac{(equity - BE_{portfolio} + HQLA)}{equity}\right)$$

where equity is value of the equity portfolio.

HQLA is comprised of two categories of assets: "Level 1" and "Level 2" assets. Level 1 assets can be included without limit, while a haircut is applied to Level 2 assets which can comprise up to 40% of the stock of HQLA. Level 2 assets are further split into Level 2A and Level 2B. Level 2B assets cannot represent more than 15% of the stock of HQLA. Level 1 and Level 2 assets can be considered as HQLA assets for the purpose of the buffer also when they are comprised within collective investment undertakings or within alternative investment funds.

The determination of the HQLA follows a two-step process: Firstly, the haircut outlined in the following paragraph is applied. Secondly, the before mentioned limitations apply.

HQLA Item	Eligible	Haircut
Level 1 assets	Cash and cash equivalent Bonds and loans from: <ul style="list-style-type: none"> - The European Central Bank - EU Member States' central government and central banks denominated and funded in the domestic currency of that central government and the central bank - Multilateral development banks referred to in paragraph 2 of Article 117 of Regulation (EU) No 275/2013 - International organisations referred to in Article 118 of Regulation (EU) No 275/2013 	0% 0%
Level 2A assets	Bonds and loans rated CQS 0 or 1 Covered bonds rated CQS 0 or 1, excluding those emitted by a bank which is part of the same group	15% 15%
Level 2B assets	Qualifying RMBS Receivables / amounts ceded to insurers / other liquidity sources Bonds and loans rated CQS 2 or 3 Undrawn committed line Certificates of deposit Common equity	50% 50% 50% 50% 50%

Finally, we note that it should be made clear that internal model users are also able to apply concepts similar to this improved LTE submodule in their methodologies.

Annex I

Tracked changes version of EIOPA's proposal to Insurance Europe's position on Article 171a

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 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, **its risk margin and share of the own funds** of a portfolio of insurance or reinsurance obligations corresponding to one or several clearly identified businesses, ~~and the undertaking maintains that assignment.~~
 - c) the assigned portfolio of assets referred to in point (b) are identified ~~and managed~~ separately from the other activities of the undertaking.
 - d) [Replaced by new number (2)]
 - e) a policy for long-term investment management is set up for each long-term equity portfolio and reflects undertaking's **strategic asset allocation 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 **this strategic allocation in the these** investment management policies and these policies are frequently reviewed against the actual management of the portfolios.
 - f) the sub-set of equity investments consists only of equities that are listed in the EEA **or in the OECD** or of unlisted equities of companies that have their head offices in countries that are members of the EEA **or of the OECD**;
 - g) where undertakings can demonstrate that either
 - i. particular homogeneous risk groups of the life insurance and reinsurance liabilities belongs to categories I or II as defined ~~in paragraph 2 for the purpose of the calculation of the VA~~ and the Macaulay duration of the liabilities in this HRG exceeds ~~6 ± 0~~ years or
 - ii. a sufficient liquidity buffer is in place for the portfolio of non-life insurance and reinsurance liabilities and the assigned portfolio of assets; ~~or~~
 - iii. **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 the sub-set of long-term equity investments for at least 5 years by complying with the positive liquidity test, as defined in paragraph 3.**
 - 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 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.

 - 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.
2. (i) The proportion of equity backing life technical provisions that is assigned to the long-term equity investment category does not exceed the proportion of life technical provisions compliant with the criteria specified in paragraph 1 (g) (i) on the total life technical provisions of the insurance or reinsurance undertaking;

(ii) Category I liabilities are defined as contracts without any surrender/cancellation option or where the surrender value does not exceed the market value of the assets and with low mortality risk and catastrophe risk.

Category II liabilities are defined as contracts with limited surrender risk:

- including disincentives for surrender

- low risk charge for the risk of a permanent increase in lapse rates
And with low mortality risk and catastrophe risk.

3. The liquidity test, specified in paragraph 1 (g) (iii) relies on the demonstration that, every year of the 5-year time horizon, in a deterministic stressed scenario, the difference between asset cash flows and liability cash flows is always positive. To this end:

- the asset cash flows shall be derived in a proportionate manner and include:
 - projected asset revenues (eg coupons, rental income and dividends);
 - projected future premiums income, including renewals estimated on a prudent basis;
 - cash and cash financial instruments;
 - income from the sales of bonds backing the own funds or in the limit of the proportion of the bonds backing the own funds, bonds with a CQS of 0,1 or 2 and redemptions;
 - income from any sales of equities or other assets not included in the long-term equity submodule;
 - income from collateral cashflows.
- the liability cash flows shall be derived in a proportionate manner and include:
 - projected claims and benefit payments;
 - projected expenses and taxes;
 - financing of insurer's activities (eg. distributed dividends, debt interest and redemptions);
 - collateral requirements arising from derivative positions assessed.
- The stressed scenario is assessed to be consistent with the SCR shocks calculated in accordance with the standard formula, as referred to in article 105 of Directive 2009/138/EC and aggregated using the correlation coefficients, as referred to in the article 104 of Directive 2009/138/EC. Based on the calculated SCR, the insurance or reinsurance undertaking determines the relative contribution of each sub risk to the SCR.
- The liquidity requirement in the stressed scenario is set to be the aggregated value of the shocks within the SCR which create an explicit cash outflow within the 5 year period, The losses caused by the operational risk result in a cash outflow.
- The assumptions used by the insurance undertaking in the liquidity test should be realistic, consistent with the insurer's business planning, policies and ORSA scenarios and approved by the AMSB. For the projecting period exceeding the time horizon of ORSA, the undertaking shall ensure that the underlying assumptions account adequately for any future uncertainty and that the profitability of the undertaking does not exceed the profit observed during the last projection year of ORSA.

~~3.~~ 4. Where equities are held within collective investment undertakings or within alternative investment funds or within investments in related undertakings 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.

~~4.~~ 5. 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 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 The supervisory authority shall can~~ cease to allow the company to apply Article 169(1)(b), (2)(b), (3)(b) and (4)(b) to any of its sub-set equity investments for a period of ~~12~~ 36 months.;

~~5.—Participations shall be excluded from the sub-set of equity investments.~~

Tracked changes version of EIOPA's proposal to Insurance Europe's proposal on criterion (g)

The liquidity buffer used for the purpose of criteria g) ii should be tested on the level of the whole non-life insurance and reinsurance liabilities. The liquidity buffer should be calculated on the basis of the assets backing the undertaking's non-life insurance and reinsurance obligations. Where the liquidity buffer as outlined in the following paragraph is bigger or equal than 1, all equity backing the non-life insurance and reinsurance obligations fall under the scope of the provisions of Article 171a can apply a risk charge of 22% (provided that the other criteria set out above are met). Where the liquidity buffer is smaller than 1, a limited amount of ~~no~~ equity falls under the scope of Article 171a.

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Level 2A assets	Bonds and loans rated CQS 0 or 1, excluding those from financial institutions Covered bonds rated CQS 0 or 1, excluding those emitted by a bank which is part of the same group	15% 15%
Level 2B assets	Covered bonds rated CQS 0 or 1, excluding those emitted by a bank which is part of the same group Qualifying RMBS Receivables/ amounts ceded to insurers/ other liquidity sources Bonds and loans rated CQS 2 or 3, excluding those from financial institutions Undrawn committed line Certificates of deposit Common equity	25% 50% 50% 50% 50% 50%