EIOPA Consultation Paper on the Opinion on the 2020 review of Solvency II

Measures on equity risk and long-term guarantees

In October 2019, EIOPA published a consultation paper on its opinion on the Solvency II 2020 review. This briefing note summarises the section of the consultation paper on long-term and strategic equity measures. EIOPA has requested stakeholders to provide feedback on this consultation paper by 15 January 2020.

Overview

On 11 February 2019, the European Commission (**EC**) issued a formal Call for Advice[1] to the European Insurance and Occupational Pensions Authority (**EIOPA**) on the review of the Solvency II Directive. This relates to the full review of the Solvency II rules required by the end of 2020 (**2020 Review**) as required by the Solvency II Directive.

On 25 June 2019 EIOPA published a first wave of consultation papers on its proposals for the 2020 Review regarding supervisory reporting and public disclosure and Insurance Guarantee Schemes.

On 15 October 2019 EIOPA published a Consultation Paper entitled "Consultation Paper on the Opinion on the 2020 review of Solvency II" (the **CP**). The CP covers a wide range of topics as follows:

- LTG measures
- Technical Provisions
- Own funds
- SCR
- MCR
- Reporting & disclosure
- Proportionality
- Group supervision
- FoS and FoE
- Macroprudential policy
- Recovery and resolution
- Insurance guarantee schemes
- Other

Milliman has produced a briefing note giving a brief overview of the CP and further briefing notes covering each of these topics in more detail. This briefing note covers topics related to the measures on equity risk and long-term guarantee measures.

Long-term and strategic equity measures

EIOPA conducted a comprehensive review of the equity risk sub-module, in particular the duration-based equity risk sub-module, strategic equity investments, long-term equity investments, and the symmetric adjustment.

This briefing note provides a summary of the opinion provided by EIOPA regarding the Solvency II 2020 review.

The note will cover the following topics:

- Long-term and strategic equity investments
- Symmetric adjustment to the equity risk charge
- Transitional measure on equity risk
- Extension of the recovery rate

LONG-TERM AND STRATEGIC EQUITY MEASURES

The following sections detail EIOPA's comprehensive review of the equity risk sub-module, and the corresponding advice.

1. "Standard" equity type 1 and type 2

EIOPA proposes no advice regarding the categorisation and calibration of the equity risk sub-module.

2. Duration based equity risk sub-module (DBER)

EIOPA proposes phasing out of DBER as a category, as these investments are covered under long-term equity investments.

EIOPA's predecessor, CEIOPS, advised a 22% equity risk charge for DBER[2] in 2010, which remains in place as the Standard Formula risk charge. In the March 2019 amendments to the Delegated Regulation, a treatment of long term equity investment (LTE) was included (Article 171a). The LTE category aims to address the risks of equity over longer time horizon, similar to the DBER.

Maintaining two separate treatments is deemed unnecessary. EIOPA therefore suggests that the approved use of the DBER category should be phased out, and new approvals of DBER should not be granted anymore.

[1] Formal request to EIOPA for technical advice on the review of the Solvency II Directive

[2] Detailed in Article 304 of Directive 2009/138/EC

3. Strategic equity investments

EIOPA suggests that the lower capital requirement for strategic equity investments is justified only where the risk is lower, as measured by the volatility of the investment. EIOPA suggests that the lower capital requirement be justified by a demonstrated lower volatility of strategic equity investments. Further, the minimum ownership and control threshold should remain at 20% at least, and it should be emphasized that this control threshold applies to investment in related undertakings.

The following elements have been identified as critical in the framework for strategic equity investments:

- The approach for evaluating strategic participation based on lower volatility
- The minimum ownership and control threshold of 20%
- Correlation of risks

These critical elements are outlined below.

Lower volatility

The lower capital requirement for strategic partnerships is justified only where the risk is lower. EIOPA proposes that the requirement for lower volatility (stated in Article 171a of the Delegated Regulation) not be removed.

EIOPA suggests that further clarification be provided on the method of performing the assessment of lower volatility. EIOPA proposes to test the beta of the equity investment, such that if the calculated beta is below a predetermined level, the risk is considered sufficiently low so as to allow the type 1 equity capital charge rather than the type 2. This is known as the "beta method".

Control threshold

EIOPA proposes that the minimum ownership and control threshold requirement of 20% should remain. At this threshold level, the volatility of the own funds of the related undertaking (i.e. the strategic equity investment) can be materially influenced by the participating undertaking (i.e. the holding entity subject to the Solvency II regulation).

EIOPA further suggests a change to the title and first sentence of Article 171 of the Delegated Regulation, making reference to "participations" rather than "equity investments". This will be beneficial to emphasise that this requirement applies also to investments in related undertakings.

Correlation of risks

A lower capital requirement may not be justified where the value of the participation depends on, or is significantly correlated with, the performance of the undertaking.

EIOPA advises to clarify that the treatment of a strategic participation is based on the assumption that the valuation does not significantly depend on the performance of the insurance undertaking itself, nor that the valuation is significantly correlated with changes in the own funds of the undertaking.

4. Long-term equity investments (LTE)

In March 2019, Article 171a of the Delegated Regulation set out a reduced risk charge of 22% for the equity investments that meet specific conditions to be classified as long-term equity investments (LTE).

In EIOPA's view, the 22% capital charge for LTE is not justified. The analysis performed by EIOPA indicate a larger stress may be more appropriate. No specific capital charge is proposed.

5. Infrastructure investments

There is no new advice on the identification and calibration of infrastructure investments. EIOPA's advice on infrastructure investments remains unchanged relative to its previous advice, regarding the identification and calibration of infrastructure investments and infrastructure corporates.

6. Unlisted equity

There is no new advice on the criteria to identify unlisted equity which could benefit from the same risk factor as listed equity. EIOPA's advice remains unchanged relative to its previous advice on unlisted equity. This advice includes criteria to identify unlisted EEA equity which could benefit from the same capital charge as listed equity.

7. Diversified LTE portfolios

LTE risk measures should apply only to well-diversified LTE portfolios.

Analysis on equity risk based on diversified portfolios or equity indices was performed over long time horizons. The requirement that only EEA equities are eligible for inclusion in LTE portfolios does not prevent a portfolio to be well-diversified, as sufficient possibilities for diversification exist within the EEA.

EIOPA advises the following text be added to Article 171a (1), to ensure that LTE applies only to diversified LTE portfolios:

"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."

8. Controlled intra-group undertakings

EIOPA advises that controlled intra-group investments be excluded from the scope of LTE. Where controlled intra-group investments are classified as LTE, it is likely that the rest of the equity portfolio could be traded everyday while the total portfolio still meets the average holding period requirements for LTE.

EIOPA suggests the following text be added at the bottom of the Article 171a:

"(4) Controlled intra-group equity investments shall be excluded from the sub-set of equity investments."

9. Diversification between LTE and other risks

Correlation matrices are determined based on a one-year time horizon. Since LTE investments are included within other type 1 and type 2 short-term equity risks, they benefit from the same diversification.

While the empirical analysis performed is not conclusive on the correlation coefficient between short-term and long-term risk, EIOPA's view is that it can be justified that short-term and long-term equity risks should not be treated in the same manner.

EIOPA poses the following three questions to stakeholders:

1. *Should the correlation of risks between the participation and the participating undertaking be taken into account in determining whether a participation can benefit from the lower capital charge for strategic equity investment?*
2. *Considering the diversification of long-term equity risk with other risks: Do you have evidence to support any of the options set out in this section?*
3. *Do you consider that the illiquidity of liabilities (and more broadly the characteristics of insurance business) are reflected in an appropriate manner in the current equity risk sub-module?*

SYMMETRIC ADJUSTMENT TO THE EQUITY RISK CHARGE

EIOPA advises that the composition of the equity index for the symmetric adjustment does not currently need to be updated.

The adjustment is calculated based on a prescribed equity index, the composition and calculation of which is detailed in Commission Implementing Regulation (EU) 2015/2016.

The composition of the equity index used for the symmetric adjustment was set in 2015. Since then, the composition of equity investments of insurance and reinsurance undertakings may have changed. A significant mismatch between the insurer's assets and the equity index may distort the effect of the measure.

Relevant equity investments of insurance undertakings were compared to the prescribed equity index to identify any mismatches. The results show that the index weights do not match the reference portfolio equity investment distribution: The weights for the two main national indices (CAC40 and DAX) appear to be underestimated in the current index, while the weights appear to be overestimated for all the other indices.

An analysis was conducted to study the correlations between the different indices in a crisis situation, in order to assess the need for changes to the current equity index. The "crisis period" used was 2007-2009. The results show that some indices (Nikkei 225, S&P 500 and WIG30) appear less correlated to others indices during a crisis period. However, updating or changing the weights of the current equity index does not appear to be a high priority given the high overall level of correlation among the main stock markets in Europe.

TRANSITIONAL MEASURE ON EQUITY RISK

In EIOPA's view, no change should be made to the equity transitional of Article 308b(13) of the Solvency II Directive.

The transitional measure for equity allows for a linear scaling of the standard equity risk parameters, from 22% in 2016 to the full capital charges in 2023 (39% for type 1 equity and 49% for type 2 equity). This allows insurers a reduced equity risk parameter for the calculation of the equity risk sub-module of the SCR standard formula. The reduced risk parameter applies to equities purchased on or before 1 January 2016.

Feedback from an information request to NSAs in 2019, regarding the equity transitional showed its limited use. NSAs generally reported an immaterial impact of the transitional, including three where material use of the transitional was reported. No NSA reported a negative impact of the transitional with respect to policyholder protection or a level playing field.

It is not expected that the investment behaviour of insurers would be different without this transitional measure, with only one NSA (Finland) believing that there could be a slight difference. Thus, the evidence suggests that there is no indication of any issue with the equity transitional.

EXTENSION OF THE RECOVERY PERIOD

The extension of the recovery period in the case of non-compliance with the SCR is one of the LTG measures.

In view of the analysis performed, EIOPA has considered the need to clarify in the text of the Directive the role of the European Systematic Risk Board (ESRB) with respect to the extension of the recovery period.

The process would be made more efficient through a clarification of the role of the ESRB. EIOPA would be able to consult the ESRB earlier in the process (i.e. before declaring an exceptional adverse situation). The ESRB could then provide valuable input for the assessment of the criteria in Article 288 of the Solvency II Regulation, in particular with regard to the EU financial market.

EIOPA advises to amend the first two paragraphs of Article 138(4) of the Directive as follows:

"*In the event of exceptional adverse situations affecting insurance and reinsurance undertakings representing a significant share of the market or of the affected lines of business, as declared by EIOPA, ~~and where appropriate after consulting the ESRB~~, the supervisory authority may extend, for affected undertakings, the period set out in the second subparagraph of paragraph 3 by a maximum period of seven years, taking into account all relevant factors including the average duration of the technical provisions."*

"*Without prejudice to the powers of EIOPA under Article 18 of Regulation (EU) N° 1094/2010, for the purposes of this paragraph EIOPA shall, following a request by the supervisory*

authority concerned, and where appropriate after consulting the ESRB, declare the existence of exceptional adverse situations. The supervisory authority concerned may make a request if insurance or reinsurance undertakings representing a significant share of the market or of the affected lines of business are unlikely to meet one of the requirements set out in paragraph 3."

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