Solvency II update

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For professional investors only

European Commission proposes reduced capital charges for qualifying equities and fixed income assets

On 8 March 2019, the European Commission published a proposed update to the Solvency II directive, aiming to remove certain constraints to the financing of the economy, and to better align insurers' capital charges with those of banks. The proposals contain a number of significant reductions in both the equity and spread risk capital charges for specific types of investments. In this article, we discuss the EC updates, and the requirements for investments to qualify for the proposed reduced capital charges.

Equities

Solvency II capital charges for equities are currently either 39% (Type 1) or 49% (Type 2), in both cases plus or minus a maximum of 10% based on the value of the Symmetric Adjustment from time to time. There is a 22% capital charge for strategic investments. Unlisted equities such as private equity investments receive the type 2 treatment and there is no special treatment for long-term investments which are not strategic in nature. These high capital charges are the result of a calibration of Solvency II to a 99.5% 1-year confidence level. This has had a significant impact on the equity investments of most insurers: many currently hold less than 5% of equities in their general account's strategic asset allocation. This means that a large pool of long-term insurance funds is effectively excluded from investing in the European economy.

The proposed amendments aim to improve this situation by introducing several new concepts, and in particular Qualifying Unlisted Equities ("QUE") and Long-term Equity Investments ("LTEI").

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Qualifying unlisted equities can receive type 1 treatment (39% +/- 10%) if they satisfy specific conditions, which include the following:

- The investment must be in ordinary shares of a company not listed in any regulated market;
- The head office of the company needs to be within the European Economic Area (EEA);
- More than half the company's revenue must be generated from EEA or OECD countries;
- More than half the employees must be based in the EEA;
- The balance sheet or turnover must exceed EUR10 million and staff must be greater than 50;
- They cannot be financial institutions, pension funds or investment vehicles/investment managers.

The proposal also defines a beta calculation combining the company's margins, return on equity, balance-sheet leverage and cash flow into a single number, which must not be exceeded for the investment to qualify.

The second new concept is that of **Long-term equity investments (LTIE)**. Insurers can apply for LTIE treatment and receive a 22% capital charge if they can demonstrate to the regulator that a number of conditions are satisfied, including:

- The equity investments must be clearly identified and part of a distinct portfolio designated to cover the liabilities of a specific book of insurance contracts, which has also been clearly identified;
- The book of insurance contracts cannot constitute the entirety of the insurer's business;
- The average holding period must exceed 5 years;
- Stocks must be listed in the EEA or, if not listed, must be stocks of companies headquartered in the EEA;
- The insurer must be able to hold on to the position for 10 years if need be, without being forced to sell.

Interestingly, where equities are held within a collective investment fund or an alternative investment fund, these requirements will apply at the fund level. This could create opportunities for insurers wanting to invest in active equity funds for the long term.

Today, infrastructure equities can receive the 22% capital charge if they are strategic investments. Under the proposals, they could also qualify for treatment as long-term investments, provided they met the LTIE requirements.

Fixed Income Investments

For fixed income investments, the European Commission has proposed a new set of criteria to allow unrated bonds or loans to receive CQS2 (Single A) or CQS3 (BBB) treatment. As with the new equity categories, the bonds or loans need to satisfy certain conditions.

Unrated bonds or loans may be assigned CQS2 (single A equivalent) treatment if:

- The insurer has a robust internal rating methodology which assesses the credit risk to the satisfaction of the regulator;
- Where the unrated investment is a co-investment, the originator is 1) a bank using an Internal Ratings Based Approach as defined in CRD IV[1], or 2) an insurer using an approved internal model under Solvency II;
- The issuer is not an insurer or other financial institution, investment fund, pension fund or infrastructure entity;
- The loan or bond is senior;
- The issuer is headquartered in the EEA and generates over 50% of its revenues from EEA or OECD countries;
- The issuer's balance sheet or turnover are greater than EUR10 million and its staff exceed 50;
- The issuer has been profitable over the last 5 years and is not highly leveraged;
- The yield is not too high. It must be no higher than the average yield of 1) representative single-A and BB bond indices and 2) a representative single-A index + 0.5%.

Alternatively, unrated securities may be assigned CQS3 (BBB equivalent), subject to the same conditions, with the exception that the yield should be no higher than the average yield of 1) representative BBB and BB bond indices and 2) a representative BBB index + 0.5%.

The proposal contains a specific article (176b) to describe the requirements for the internal credit assessment systems insurers may deploy to assign a CQS level to unrated loans. The second paragraph states that insurers must be able to demonstrate that their internal ratings are reliable and properly reflect the spread risk of the asset. From this, we can infer that, if an insurer wants to assign a CQS2 or CQS3 rating to an unrated bond or loan, as a minimum the insurer's internal model needs to indicate this as the appropriate rating level.

A further article (176c) describes the conditions under which an insurer may rely on the ratings generated by the internal rating model of the bank or insurer which has originated the assets.

[1] *Regulation (EU) No 575/2013 for banks*

Will these proposals have a major impact on insurers' investment strategies?

It is clear that for the right assets, the reduction in the capital charge can be significant, particularly for equities, where it can go beyond 50%. The question is whether the conditions required for an investment to qualify, although fully understandable given the EC's objectives, are not overly onerous.

No doubt, insurance companies wanting to make a long-term investment in specific European equities will be satisfied. For example, the proposals could allow them to target specific companies for investment as part of an ESG impact investment strategy. European private equity and infrastructure equity look particularly attractive, given that they are typically buy-and-hold investments, highly structured in terms of financial covenants and, in the case of infrastructure, have a clear geographical focus. However, there are possible snags for both categories. Private equity investments may fall foul of the requirements around financial leverage and the maximum holding of 10% of a company. For infrastructure equity, the requirement for the issuer to employ at least 50 staff within the EEA could be difficult to satisfy given that many issuers are special purpose vehicles.

Where insurers want to take advantage of the opportunity to get improved capital treatment for an active European equity strategy as part of their Strategic Asset Allocation for a set of insurance liabilities, they will need to ensure that the manager of the strategy conforms to the requirements for long-term equity treatment. A new category of European equity funds may develop as a result, just for European insurers.

Among the fixed income proposals, the explicit possibility to rely on the internal ratings of the originators of co-investments may have the most significant impact. This avoids the need for insurers to replicate the effort of building an internal ratings model where the originator (often a bank) has already gone through the process of obtaining regulatory approval for its model. It also creates a more level playing field between banks and insurers in unrated fixed income. The proposed language may entice more European insurers to look into co-investments in unrated credit by lowering the barriers to entry.

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