

18.03.2019 / Opinion

Insurance Strategy & Advisory Solvency II Update

Unlisted Equities, Long-term Equity Investments and Unrated Debt

Summary

Based on the technical advice of EIOPA, the European Commission (EC) delegated regulation of 8.3.2019 amends the Solvency II regulation in different areas. Most notably, from an investment management perspective, the capital charges for qualifying investments in long-term equities, unlisted equity and unrated debt have been reduced.

Main Takeaways

Unlisted equity

Certain investments in unlisted equities may be eligible for a treatment as type 1 equities, allowing for a reduced capital charge of 39% compared to 49% for type 2 equities. Aside from a range of qualitative and diversification conditions, the equity investment need to show a low beta coefficient on a portfolio level. Since it is not possible to calculate a beta based on the unlisted equities return (since they are not listed), a formula based on financial ratios is defined to approximate beta. The new provisions are mainly relevant for direct private equity investments while many investments via funds may already subject to a type 1 equity charge.

Long-term equity investments

Long-term investments in equities with an average holding period of more than 5 years can benefit from the same capital charge as strategic participations, given that specific criteria regarding asset-liability and risk management are met. Long-term equities and strategic participations are subject to a favorable capital charge of 22% without an asymmetric adjustment. The fact that a long-term equity portfolio must be assigned to a specific pool of insurance obligations over the entire lifetime of these obligations may limit the applicability to a smaller group of insurer, e.g.

insurers in the UK or Spain that also use the matching adjustment or France where the liability structure is more favourable. The concept of long-term equity investments is very similar to the duration-based equity risk sub-module.

Unrated debt

Unrated bonds and loans with proven quality can be assigned to a credit quality step (CQS) of either 2 or 3 (corresponding to an 'A' or 'BBB' rating). The Spread SCR for those bonds will decrease by up to 20 percentage points if a bond or loan can qualify as such. There are two different ways for loans to qualify. The first is based on an internal credit assessment taking into account qualitative and quantitative factors. This internal credit assessment is a complex process which may require a substantial amount of research. The alternative way is for an insurer co-invests into a loan with a bank if the bank discloses sufficient information on the credit quality and methodology of the credit assessment to the insurer. However, we deem this challenging since banks would probably be reluctant to share this kind of information.



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Unlisted equity

Under the amended regulation, certain investments in unlisted equities can qualify for a treatment as type 1 equities, subject to a 39% capital requirement compared to 49% for type 2 equities. The table below specifies the criteria that unlisted equity portfolios have to meet in order to be treated as type 1 equities.

Investments via unleveraged closed-ended EU-AIFs, for which a look-through is possible, are always treated as type 1 equities regardless of the underlying private equity portfolio. Hence, the new provision is mainly relevant for direct investments in private equity which typically only make up a smaller portion of an insurer's private equity portfolio. Therefore, this provision should have a limited impact on insurers and asset managers alike.

FIGURE 1. EQUITY CAPITAL REQUIREMENT

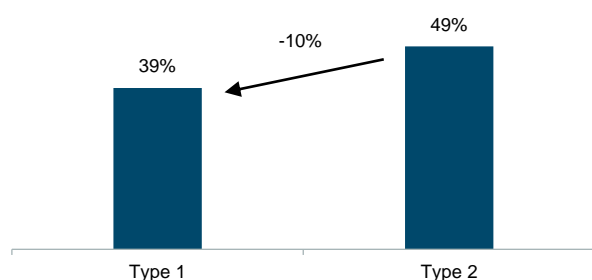


FIGURE 2. CRITERIA FOR QUALIFYING UNLISTED EQUITY PORTFOLIOS

Qualifying companies	Unlisted non-financial companies with head office in the EEA meeting following criteria: <ul style="list-style-type: none"> – 50% of annual revenues are denominated in EEA or OECD currencies; – 50% of staff employed in EEA countries; – Annual turnover > EUR 10m or – Total balance sheet > EUR 10m or – Number of staff > 50
Diversification	Each individual investment must not exceed 10% of the entire portfolio
Beta	Portfolio beta must not exceed 0.796

The approach to approximate the beta of unlisted equity is based on a regression of listed non-financial stocks from the STOXX® Europe 600 Index. The regression suggested the coefficients in the formula below. The four variables have been determined by EIOPA as the ones with a significant influence on beta. The underlying assumption here is that a company's risk profile does not materially change whether it's public or private. The portfolio beta is the average of all

individual betas (as calculated using the formula below) weighted by the book value of the equity stakes.

The beta of a qualifying unlisted equity portfolio must not exceed 0.796.

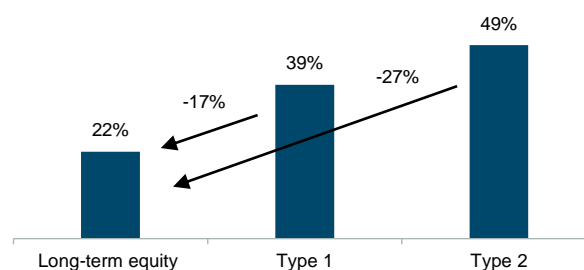
As with unrated debt, EIOPA proposes that the total amount of unlisted equity and unrated debt which is treated preferably through the aforementioned approaches is limited to 5% of the overall investment portfolio. **However, the European Commission decided not to follow this proposal. Hence, the amount of unlisted equity and unrated debt with a preferential treatment will remain unregulated.**

$$\beta = 0.9478 - 0.0034 * Avg\ Gross\ Margin + 0.0139 * \frac{Total\ Debt}{Avg\ CFO} - 0.0034 * Avg\ ROCE$$

Long-term equity investments

Not only qualified unlisted equities can benefit from a reduced capital charge but also long-term investments in equities (listed or unlisted) are eligible for a significantly reduced capital requirement of 22%. In this way, long-term equity investments are treated in the same way as strategic partnerships. To be considered as a long-term equity investment, the average holding period must be at least 5 years and specific criteria regarding asset-liability management as well as risk and investment management must be met. Most importantly, a long-term equity portfolio must cover a clearly defined pool of insurance obligations over the entire lifetime of these obligations.

FIGURE 3. EQUITY CAPITAL REQUIREMENT



In this way, the concept of long-term equity investments is very similar to the duration-based equity risk sub-module. In general, only equity instruments listed in the EEA or unlisted equities of companies with their head offices in the EEA are eligible for a favorable treatment. Where equities are held within a fund, the criteria mentioned above are assessed at the level of the fund and not of the underlying assets.

The Solvency II Equity Risk Module has become more granular offering capital reliefs for certain type of equity investments (see table below)

FIGURE 4. CAPITAL CHARGES FOR DIFFERENT TYPE OF EQUITY INVESTMENTS

	Stress (in %)	Symmetric Adjustment (SA)*
Equity Type I (listed EEA/OECD)	39%	100%*SA
Equity Type II (listed non-EEA/OECD)	49%	100%*SA
Qualifying infrastructure equity	30%	77%*SA
Qualifying infrastructure corporate equity	36%	92%*SA
Strategic participations	22%	-
Long-term equity investments (listed or unlisted)	22%	-
Qualifying unlisted equity portfolios	39%	100%*SA
Unlisted equity (unqualified)	49%	100%*SA

*Variable component of the equity risk charge ranging between +/-10%

We believe that the favorable treatment of unlisted equity can further drive the attractiveness of this asset class for insurers, also taking into account the beneficial return profile of private equity investments. However, the new provisions are mainly relevant for direct private equity investments while most investments via private equity funds may already be subject to a type 1 equity charge. Additionally, the reduced capital charge for long-term equity investments can drive insurer's allocations to equities in general. But the fact that long-term equity portfolios must be assigned to a clearly identified pool of the insurance obligations over the entire lifetime of these obligations may limit the applicability to a smaller group of insurer, e.g. insurers with UK-like annuity business.

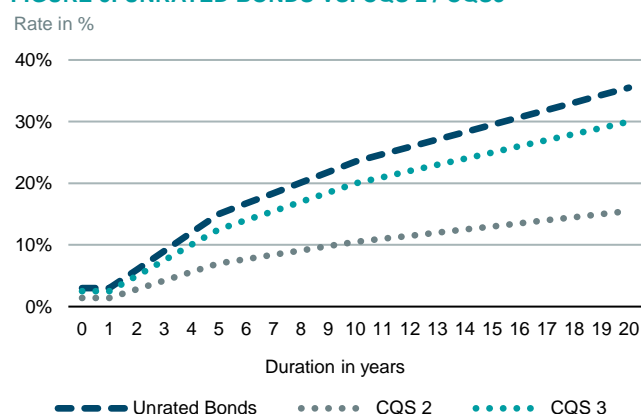
Unrated debt

Given certain quality conditions, unrated debt instruments can be assigned to a credit quality step (CQS) of either 2 or 3, which corresponds to a "A" or "BBB" rating. This way, the Spread SCR on unrated debt may be reduced by up to 20 percentage points.

For a bond to be eligible for the preferred treatment, two assessment approaches are available:

- _ The Internal Assessment Approach &
- _ The use of approved internal banking models.

FIGURE 5. UNRATED BONDS VS. CQS 2 / CQS3

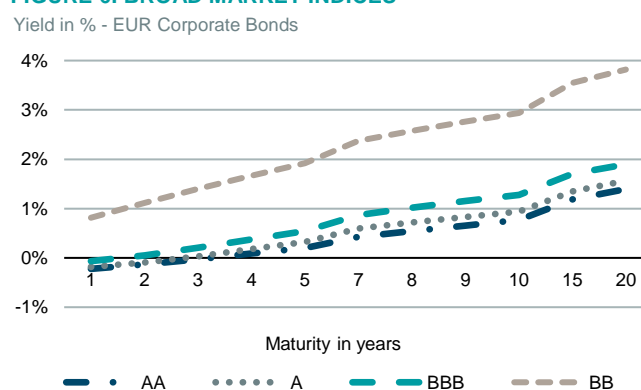


Internal Assessment Approach

Under the Internal Assessment Approach, following criteria need to be fulfilled to allow for A or BBB spread risk capital charge for unrated debt:

- _ **Borrower characteristics:** The borrower must be a limited liability company with headquarter in the EEA meeting certain criteria regarding financial ratios, credit history and reporting
- _ **Debt instrument:** Additional conditions regarding the structure of the debt instrument must be met, e.g. senior debt
- _ **Internal process:** An internal process has to classify the bond as eligible for preferred treatment, taking into account a variety of qualitative and quantitative factors
- _ **Comparable yield criterion:** The yield of the bond must not be substantially higher than that of a broad market index with corresponding currency and maturity. The distance to the market yield determines if an unrated bonds receives an A or BBB rating capital charge (see Figure 6 and 7).

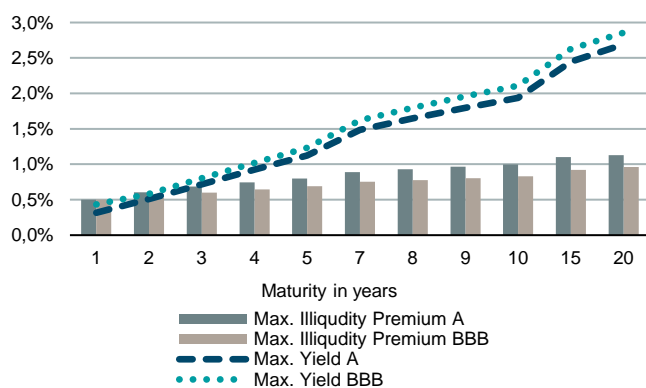
FIGURE 6. BROAD MARKET INDICES



*As of 1st of April 2019; Source: Bloomberg LP

FIGURE 7. COMPARABLE YIELD CRITERION

Yield in % - EUR Corporate Bonds

*As of 1st of April 2019; Source: Bloomberg LP

Approved Internal Bank Models

When a bank provides a loan to a **corporate** and lets an insurer co-invests into that loan, preferable treatment is possible, however tied to strict rules regarding **disclosure of information about the loan**. Specifically, the bank has to **provide transparency and detailed information on the internal model** used to evaluate the loan. Furthermore, the bank is required to **keep at least 20% of the nominal value** of the bond. If the bank decided to provide the required information to an insurer, a Probability of Default (determined by the bank) will be converted into a CQS, which the insurer can use.

We believe that banks will typically be unwilling to provide the necessary information to insurance companies, essentially allowing the insurer to outsource the credit analysis. The Internal Assessment Approach appears more feasible, although it does require substantial initiative and resource devotion to comply with all criteria if an internal rating approach is not already established. Especially since the Internal Assessment Approach is in part based on qualitative assessment, insurance undertakings should carefully consider if the additional gain they could achieve through preferential SCR treatment compensates for the costs associated with the process. Additionally, the requirements under the internal assessment approach

clearly limit the securities which are potentially eligible to those which from a risk and return profile are trading in line with a A or BBB rating. This classification is completely unrelated to private debt or direct lending. The idea here is to enable lending to SMEs on an unrated basis where quality is sufficient and to facilitate the private placement market across Europe. This is the first step away from the reliance on rating agencies shifting towards internal rating processes.

Other material changes

Besides the discussed changes related to capital charges for certain type of investments in equities and unrated debt, the EC regulation also amends Solvency II in many other areas. The most material changes include:

- _ Bonds and loans that are fully, unconditionally and irrevocably guaranteed by an EU member state's **regional government or local authority (RGLA)** can benefit from a reduced capital charge of up to 0%. This way, Solvency II is aligned with banking regulation.
- _ The recognition of **risk-mitigation techniques** has been further refined to reflect common practices in risk management. For example, the minimum maturity for derivatives to be used in hedge programs has been reduced to one month.
- _ Going forward, an investment fund's **last reported asset allocation** can be used to calculate the capital charge for those funds for which a look-through or target allocation is not available. For the purpose of that calculation, data groupings may be used but only for 20% of an insurer's assets. Under the amended regulation, unit-linked assets will be **excluded when calculating the 20% limit**.
- _ All derivatives – weather used for hedging or other purposes – are now treated as type 1 exposures in the **counterparty default risk module**.
- _ Some **risk calibration parameters** for non-life premium and reserve risk, and health and non-life catastrophe risk have been updated to reflect additional data gathered since the last calibration.

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