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Solvency II: Improvements needed to unleash capacity for equity investment

While Solvency II in general works well, it has also created unnecessary costs and barriers, in particular in relation to insurers' ability to offer long-term products and to invest in long-term assets that can help drive recovery, sustainable growth and the transformation needed to meet climate goals. This includes a detrimental impact on investments in equities (ie listed equity, private equity and venture capital) which is a particular focus for the Capital Markets Union (CMU) project. These barriers result from measurement flaws in Solvency II, which means it does not appropriately capture the real economics and risks for insurers' long-term products and investments. These flaws unnecessarily reduce insurers' capacity to take risks, such as investing in equities, and also overstate the capital needed for such equity investment. The review of Solvency II must therefore be used to address these issues and unleash insurers' full capacity and natural interest to invest in equities for the benefit of their customers and the wider economy.

Given the need for private investment to support economic recovery and Europe's transition to sustainability, it is important that the review of Solvency II brings about much needed improvements to enable insurers, who are key institutional investors, to make long-term investments in the European economy and to contribute fully to EU objectives set out in the Green Deal and the CMU.

To achieve this, the review of Solvency II must achieve three things. It must:

1. Free-up insurers' risk taking capacity via appropriate reductions in the risk margin and improvements to the volatility adjustment (VA) and the matching adjustment (MA).
2. Improve the treatment of equities in Solvency II. This can be done by changing the criteria for the long-term equity (LTE) sub-module so that it works in practice.
3. Avoid unnecessary and excessive increases in capital requirements by:
   - Not lowering the risk-free curve used for valuation;
   - An appropriate increase in capital to account for negative interest rates in the interest rate capital module by using an appropriate floor and extrapolation; and by
   - Avoiding changes relating to macro prudential measures which add to the capital requirements and go beyond those agreed at international level.

This joint position focuses on the improvements required to the long-term equity (LTE) submodule (Article 171a).

The creation of this sub-module, a few years ago, was an essential step towards giving a more appropriate capital charge to portfolios of equities where insurers are exposed to long-term underperformance rather than market price volatility. The need to remove barriers and disincentives is clear. For example, and according to the European Insurance and Occupational Pensionfunds Authority (EIOPA), only 0,6% of insurers' investments are made in private equity funds. Over the past five years insurers made up only 9% of the total investor base in all private equity — three times less than pension funds — despite the fact that insurers' investment portfolio is equal to 58% of the EU's GDP.

Unfortunately, the current criteria of the LTE sub-module made it too difficult for insurers to set up these portfolios. It is widely recognised, including by EIOPA, that some improvements are necessary to the LTE sub-module. While EIOPA presented changes intended to address the concerns in its advice to the

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European Commission, its proposals require some improvements to ensure that the LTE sub-module actually works in practice.

As representatives of both insurers and the managers of the funds in which they invest, Insurance Europe and Invest Europe would like to **jointly present a series of changes to the application criteria for the LTE sub-module**. Based on the experience of our respective members, who collectively require and provide investment opportunities, our common view is that changes to the following aspects of the LTE sub-module are required for insurers to make use of the LTE category. We are calling for:

- **Asset-liability management (ALM) requirements that are usable** (criteria (a) to (d))
  Changes must be introduced for the criteria to work across the EU, so that it accounts for differences in legal requirements and practices in relation to the separation of assets.

- **Liquidity requirements that are operational** (criteria (g))
  Given the differences between the types of equities (listed and unlisted), the types of portfolios and national regimes, a sufficient range of options should be available for insurers to demonstrate that they will not be forced to sell their equities.

- **Geographic conditions that are appropriate** (criteria (f))
  Broadening the geographic scope from the EEA to the OECD (as for infrastructure) will lead to more diversified — and therefore less risky — portfolios. This is also important for customers, as many OECD markets have generally performed better than the EEA zone.

Changes to these areas, which are detailed in the annex below, would not alter the intended scope of the category, would remain risk-based and maintain the necessary level of customer protection. However, they would also account better for the way insurers prudently set up and manage their long-term portfolios. Introducing these improvements to the LTE module, along with the other improvements to Solvency II noted earlier, will not only drive the interest of insurers for this new category, but will also increase their capacity and appetite to increase their investments, either directly or through funds in all types of equity including private equity, venture capital and infrastructure.

Contact details

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ANNEX – Joint suggestions on the changes to be made to Article 171a

The table below includes the proposed wording necessary for the LTE module to improve the usability of the sub-module (black colour represent the current wording of Article 171a, red colour indicates EIOPA's proposals and green colour indicates proposed changes by the industry).

Industry proposal for 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 ~~as well as the holding period of each equity investment within the sub-set are~~ 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 over the lifetime of the obligations~~;
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 arising from other activities of the undertaking;~~
~~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;~~ [Replaced by new number (2)]
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;~~ 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 asset 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;
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 for the purpose of the calculation of the VA and the Macaulay duration of the liabilities in this HRG exceeds ~~10~~ 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 ~~each equity investments within~~ the sub-set of long-term equity investments for at least ~~10~~ 5 years;
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. 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 on the total life technical provisions of the insurance or reinsurance undertaking;

~~2~~ 3. 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.

~~3~~ 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 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 ~~and shall~~ 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 ~~36~~ 12 months.;

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

The following table outlines the industry's proposed changes (indicated in green) to EIOPA's proposal on the liquidity buffer used for the purpose of criteria g) subpoint ii.

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 ~~no~~ equity falls under the scope of Article 171a.

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

$HQLA/BE_portfolio$

- *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(0,(equity- $BE_portfolio$+HQLA)/equity),

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:* - *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~~, 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~~*	~~*25%*~~ *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.

About Insurance Europe

Insurance Europe is the European insurance and reinsurance federation. Through its 37 member bodies — the national insurance associations — it represents all types and sizes of insurance and reinsurance undertakings.

Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers pay out almost €1 000bn annually — or €2.7bn a day — in claims, directly employ nearly 950 000 people and invest over €10.4trn in the economy.

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About Invest Europe

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members' role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry. Invest Europe is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

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