Position Paper

Insurance Europe comments on amendments to Solvency II Delegated Regulation

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Contact person:	Insurance Europe's Economics and Finance department	E-mail:	ecofin@insuranceeurope.eu
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General comments

Insurance Europe welcomes the opportunity to provide comments to the EC draft proposals for changes to the Solvency II Delegated Regulation.

Insurance Europe welcomes the EC proposals aimed at introducing a number of simplifications and a more proportional application of the framework in a number of areas. However, Insurance Europe is concerned that the 2018 review lacks ambition in key areas such as the recalibration of long-term equity and the review of the risk margin – both of which would have a significant and direct impact on long-term investments and would in fact support the EC in achieving the objectives of its CMU project.

With respect to the **recalibration of long-term equity investments**, Insurance Europe appreciates recognition by the European Commission that action is needed. However, Insurance Europe believes that the technical proposal will not work in practice for any undertaking because of the way in which the criteria are defined. Insurance Europe calls on the EC to take swift action to amend its proposal in a way that makes it workable in practice.

With respect to the **review of the risk margin cost of capital**, Insurance Europe reiterates its strong concerns on the current calibration of the cost of capital and more broadly the design of the risk margin. There is extensive evidence that the 6% cost of capital is too high and the industry believes that ignoring such evidence and preserving the status quo is in fact a missed opportunity not only to correct the flaws of the framework, but also to remove the current barriers to provision of long-term business and investment by the industry.

Furthermore, the current EC proposals on **LAC DT** contradict key elements of Solvency II, such as the going concern principle and supervisory judgement and dialogue. Insurance Europe calls for adjustments to the draft text to remove arbitrary limits.

Insurance Europe aisbl
Rue Montoyer 51, B-1000 Brussels
Tel: +32 2 894 30 00
E-mail: info@insuranceeurope.eu
www.insuranceeurope.eu

Insurance Europe welcomes the EC's intention to fully review the **volatility adjustment** as part of the review of the Directive in 2020. However, the current year has provided significant additional evidence of the improper functioning of the volatility adjustment and it is disappointed that the EC has not proposed any short-term improvements to allow an improved, although not perfect, functioning of the national market component. Insurance Europe calls for clarifications to be made in the Delegated Regulation regarding the activation criteria governing the national market component, which are in line with the Directive.

With respect to the **application date** of the proposed changes, Insurance Europe calls for the application date of the new LAC DT proposals to be 1 January 2020. This is an area that will not only require internal adaptation of companies' systems to the prescriptive EC requirements, but also an area expected to largely have a negative capital impact. The EC itself acknowledges that the potential increase in the capital requirement is the key reason behind the later application date for the credit and suretyship segment – so Insurance Europe believes that this is a very valid argument for LAC DT as well.

Detailed comments

Insurance Europe notes that a number of the proposed changes introduce the requirement to demonstrate certain features "***to the satisfaction of the supervisory authority***". Insurance Europe advocates that these references be removed, as they add more confusion rather than real value for supervision. Such a provision may increase reporting burden at the discretion of the supervisor and may in essence be misleading and lead to incentives for gold-plating – which is the opposite of the EC objective of harmonisation. Existing prudential supervision is already based on the principle that the supervisor, when observing the application of the legal requirements, needs to be "satisfied". It would be absurd to imagine that individual Solvency II requirements would have attached to them an explicit extra requirement of "supervisory satisfaction" — a relative concept with no obvious definition.

Simplified calculations (with reference to articles 84, 88, 90a, 90b, 90c, 91, 95a, 96a, 97, 102a, 105a, 107, 108, 110, 111, 112a, 112b, 112c)

Overall, Insurance Europe is disappointed with the EC's decision to follow EIOPA's advice regarding the simplified methods allowed for use. While some new simplified calculations have been allowed, the EC did not reduce the burden for the use of the simplifications. Moreover, the double counting of the lapse risk in non-life and the level of mass lapse risk have not been addressed.

On the <u>positive</u> side:

- The allowance of simplified calculations for the lapse risk, catastrophe risk, spread risk, loss-given default for reinsurance, market risk for type 1 exposures, risk mitigating effect are welcome.

On the <u>negative</u> side:

- There remains an unnecessary high administrative burden, restrictive of the use of simplifications. Moreover, there has been a lack of convergence in the application of Article 88 regarding the "*evaluation in qualitative or quantitative terms, as appropriate, of the error introduced in the results of the simplified calculation*", resulting in a burdensome requirement of quantitative evaluation in any case from some national supervisor. The draft DA as proposed does not address that issue. Insurance Europe is of the view that provisions should be introduced in order to prevent the dissuasion of the use of simplified calculations, and to ensure the effective application of the principle of proportionality.
- Only simplified methods prescribed in the delegated regulation are allowed for use. Insurance Europe is of the view that a wider than prescribed use of simplified calculations is needed. Therefore, in addition to the simplifications that will be expressly listed in the legal texts, the Delegated Regulation

should allow companies to take one of the following options to simplify their calculations as part of the proportionality principle:

  - set the SCR to zero for any risk to which they have no exposure.
  - set the SCR to a fixed amount that they can show is no less prudent than the standard formula.
- A double counting between lapse risk module and premium risk remains. The latter being based on historical premium volumes already includes lapse, therefore the lapse risk within the non-life underwriting risk sub-module from the standard formula should be removed.
- Insurance Europe continues to believe that the level of the mass lapse risk should be addressed.

Treatment of guarantees, exposure guaranteed by a third-party and exposures to regional governments and local authorities (RGLA) (with reference to articles 180, 187, 192d)

Insurance Europe welcomes the EC proposals with respect to the treatment of guarantees, exposure guaranteed by a third-party and exposures to regional governments and local authorities (RGLA).

On the positive side:

- Insurance Europe supports consistency in the treatment of **guarantees issued by RGLAs** in the Solvency II regulation across risk modules. Since RGLAs by entities listed in Implementing Regulation (EU) 2015/2011 and central governments do not differ in risk exposure due to their revenue raising powers, they should receive the same capital charge as exposures to central government. Therefore, in line with the treatment of RGLA guarantees in the counterparty default risk module, direct guarantees by RGLA listed in the Commission Implementing Regulation (EU) 2015/2011 should be treated as guarantees for Member States central governments also within the market risk module. The extension of this recognition to the spread and concentration risk sub-modules materially improves the extent to which RGLAs are appropriately recognised in the SCR calculation, especially considering that most of the debt guaranteed by RGLAs falls in fact within the scope of the market risk module.
- Insurance Europe welcomes the EC's introduction of the **intermediate treatment** in the Solvency II Delegated Regulation, whereby the capital charge of the spread risk and the concentration risk for Member States' RGLA exposures that are not listed in the Commission Implementing Regulation (EU) 2015/2011 is calculated as exposure in the form of non-EEA governments bonds of credit quality step (CQS) 2. Such a provision ensures not only a level playing field in financial markets between insurers and banks but also a more accurate reflection of risks, which are currently overstated for RGLA exposures falling outside the scope of ITS (EU) 2015/2011, as they are currently treated as normal corporate bonds without any guarantees.
- Insurance Europe supports the proposal to **recognise the risk mitigating effect of a partial guarantee for type 2 mortgage loan exposures** in the counterparty default risk module provided that the partial guarantee meets the requirements of Art 215 of the Delegated Regulation, except for Art 215(f). This contract design is the only one allowed for state agencies in eg the Netherlands. Therefore, recognizing partial guarantees is a prerequisite that these loans can benefit from a more risk-sensitive treatment under Solvency II. Specifically, regarding the LGD proposed formula, Insurance Europe welcomes that it allows for (partial) guarantees under the type 2 counterparty default sub-module and effectively recognises central government guarantees for Type 2 exposures in the counterparty default risk module, such as the National Mortgage Guarantee (NHG) scheme in the Netherlands. Apart from recognising the risk-mitigating effect of schemes like the NHG, this will further lead to a better alignment with Article 235 of the CRR. Furthermore, Insurance Europe also supports the EC's proposal to relax the requirement for a full guarantee contained in Article 215 (f) of the Delegated Regulation, as partial recognition also improves the risk sensitivity of the Solvency II framework, which currently fails to account for the reduction in risk arising from an existing partial guarantee. This is also illustrated by the case of Dutch residential mortgages, which benefit from a partial central government guarantee. Moreover, Insurance Europe highlights that recognition of

partial guarantees will further foster the success of infrastructure project bonds which are partially guaranteed by the European Investment Bank (EIB) as well as other initiatives aimed at improving the financing of the real economy. Investors fully support the positive effect that recognising partial guarantees can have on the better recognition of the risk/return profiles of such assets.

On the negative side, Insurance Europe highlights that:

- Regarding the introduction of the intermediate treatment in the Solvency II Delegated Regulation, the EC should apply the intermediate treatment also to the counterparty risk module, following the same reasoning applied for the treatment of the market risk module of the Solvency II Delegated Regulation.

Looking ahead:

- Insurance Europe believes that the list in the Implementing Regulation 2015/2011 (complementing the Solvency II Directive) should be aligned with the RGLA list in the banking framework in a flexible and principle-based manner, aligned with the intention of Article 85 of the Delegated Regulation. This will allow for some flexibility in determining the RGLAs that qualify for equivalence with central governments.
- The alignment of both lists must not lead to the lowest common denominator but instead consider at least all RGLAs already covered by either the insurance or the banking framework. Such a list always comes with the caveat that it needs regular updates and that there might be situations in which an undertaking invests in an RGLA not yet covered by the list. Consequently, the undertaking would then be unable to benefit from a lower capital requirement. The same is true for an instrument guaranteed by such a RGLA. The alignment of the banking list to insurance list should also consider the fact that the insurance list is built on clear and relevant criteria and is more recent.
- To eliminate the disadvantage of a quite inflexible list, the new list should be non-exhaustive and there should be the possibility to add RGLAs in close collaboration with the national competent authority. Going forward, Insurance Europe supports a regular update of the list to add with RGLAs that have been approved by national competent authorities in the meantime.
- As the list in the Implementing Regulation (EU) 2015/2011 currently only covers RGLAs within the EEA, non-EEA RGLAs should also be added within the list in the Implementing Regulation (EU) 2015/2011. Excluding non-EEA RGLAs would unnecessarily restrict undertakings' investment options and hamper further diversification of assets. This can be avoided by the introduction of a non-exhaustive list as described above. No change would leave the insurance sector at an unjustified disadvantage compared to banks.

Risk-mitigation techniques (with reference to Articles 208-213)

Insurance Europe welcomed the Commission's request in its Call for Advice to EIOPA to the investigate recognition of risk mitigation techniques and suggest updates to the framework, where necessary.

Risk mitigation techniques are a fundamental part of insurance risk management and, as foreseen by Article 101 of the Directive, should be properly reflected in the calculation of the SCR. As the Commission noted in its Call for Advice, risk mitigation techniques have evolved significantly over the past few years and are expected to continue to evolve in future.

Insurance Europe supports changes to the Solvency II framework which improve risk sensitivity and broaden the scope of eligible risk-mitigation techniques where appropriate. It is, therefore, disappointed that, despite several proposals from industry, the Commission has not put forward any improvements for the recognition of non-proportional reinsurance and Adverse Development Covers in particular.

On the positive side:

- The proposal to extend the recognition of financial instruments which qualify as risk-mitigation techniques to those which have an initial contract maturity of at least one month as well as weekly replacements/adjustments improves risk sensitivity and further aligns the regulation with normal business practice.
- The proposal to alter the requirements for the partial recognition of risk-mitigation provided by a reinsurer temporarily in breach of the its SCR removes unrealistic impediments to the application of the regulation.

On the negative side:

- It is disappointing that, despite several proposals from industry, the Commission has not put forward any improvements for the recognition of non-proportional reinsurance and Adverse Development Covers, in particular.

Undertaking specific parameters (with reference to Article 218, 220 and Annex XVII)

Insurance Europe welcomed the Commission's ambition to extend the usage of the USP framework, as stated in its Call for Advice to EIOPA. However, it is disappointed that the level of proposals put forward by the Commission do not match the level of initial ambition.

Insurance Europe remains strongly supportive of the use of USPs which, together with the proportionality principle, are meant to ensure that Solvency II works for all companies, irrespective of their size. However, as illustrated by EIOPA's analysis, the use of USPs is very limited at present.

On the positive side:

- The newly proposal USP methodology for the calculation of the adjustment factor for non-proportional reinsurance represents an improvement to the existing permitted calculations and, in that respect, should further extend the usage of the USP for the adjustment factor.

On the negative side:

- The scope of the USP framework, as outlined in Article 218, remains restricted relative to that foreseen under Article 104 (7) of the Solvency II Directive.
- In particular, the USP framework has not been extended to include the possibility of using USPs in the lapse risk submodule. Insurance Europe considers the current calibration for lapse risk to be inappropriate as there is no clear evidence for the current discontinuance of 40 % of the insurance policies by default and for all types of contract.
- The requirement to assess completeness, accuracy and appropriateness of the data remains very stringent and inhibits the use of USPs. The strong requirement, as set out in Article 219 (b) and (d), which mandate the data to be capable of being used in standardised methods does not allow undertakings to exert expert judgement when dealing with the set-up of the USPs (in terms of data, assumptions and methods).

Looking ahead:
Insurance Europe strongly believes that the scope of USPs should not be restricted to certain areas, as is currently set out in the Delegated Regulation, but rather expanded to life, health, non-life catastrophe and even operational risk.

Loss-absorbing capacity of deferred taxes (LAC DT) (with reference to articles 207, 260(1), 297, 311)

Insurance Europe is disappointed with the decision of the EC to follow EIOPA's own-initiative proposals in the area of LAC DT. Insurance Europe notes that EIOPA was asked by the EC to report on the various methods currently applied across the EEA on LAC DT, and on their impact. Insurance Europe therefore believes that, by submitting its analysis, EIOPA had already fully delivered on its mandate.

In addition, the EC's proposal does not take into account the significant differences in national tax regimes across Europe (eg unlimited or temporary loss carry forwards). In many cases, this prevents the real loss absorbing capacity of deferred taxes from being properly reflected in the calculation of the solvency capital requirement.

On the positive side

- The proposed approach is principle based.
- While Insurance Europe agrees with the provision that 'in case future management actions are assumed, these should be subject to the provisions foreseen in Art 23'.
  Insurance Europe notes that Article 23 refers to best estimate calculations and not to SCR calculations. Therefore, it believes that a reference to Art 236(1) would be more appropriate.
- The draft DA proposes that the validation of the LAC DT should reside either with the risk management function or with the actuarial function.

On the negative side, Insurance Europe does not support the following EC proposals and believes they should be removed, as they are too prescriptive, they introduce artificial limits and they go against supervisory dialogue. Specifically:

- The conditions for demonstrating availability of **future taxable profits are not appropriate**:
  - New business sales cannot exceed those projected for business planning
  - New business sales cannot go beyond the business planning horizon, with a maximum horizon of 5 years.
    Insurance Europe highlights that this requirement implies that an insurer is no longer in 'going concern' after 5 years, this conflicts with Dir Art 101 (2), which states that 'The SCR shall be calculated on the presumption that the undertaking will pursue its business as a going concern.
  - If undertakings set a projection horizon for profits from new business that is longer than the business planning horizon, a finite projection horizon has to be set and appropriate haircuts shall be applied to the profits from new business projected beyond the business planning horizon. The haircuts shall increase the further the profits are projected into the future.
  - The returns in excess of the risk-free rates are only allowed when undertakings are able to provide credible evidence of likely returns in excess the risk-free rates. These returns are limited to the level assumed in the pre-shock DTA calculation.
    Insurance Europe notes that this implies that no pull-to-par and no equity market rebound assumptions are permitted. In addition, the condition to provide credible evidence entails more unnecessary and burdensome requirements for undertakings.
  - No assumptions will be applied that are more favourable than those used for the valuation and utilisation of deferred taxes in accordance with article 15.

- The proposals strengthening the RSR and the SFCR with regard to LAC DT will increase (as opposed to decrease) the reporting burden of undertakings. Furthermore, Insurance Europe disagrees with the disclosure of competitive information in the SFCR. In particular:
  - The wording included in the draft changes to Article 297 & Article 311 is currently ambiguous, with the meaning of 'amount of deferred tax assets without assessing their probable utilisation' being open to multiple interpretations in practice. Different interpretations of this requirement between undertakings may lead to a lack of useful comparability.
  - The proposed disclosures are likely to require significant development work to generate the required data, the majority of which would provide no additional benefit to management beyond meeting the disclosure requirements.

- The proposed requirement to disclose the underlying assumptions used for the projection of probable future taxable profit would necessitate the disclosure of sensitive competitive information, given that it may be possible to approximately reverse engineer the disclosures to estimate the planned levels of future profits. Furthermore, different assumptions and interpretations are likely between different markets and product lines such that an aggregated disclosure of assumptions may not yield useful information.

Looking ahead:
Insurance Europe calls for adjustments to the draft text to remove these arbitrary limits, as the current EC proposals contradict key elements of Solvency II, such as the going concern principle and supervisory judgement and dialogue.

Recalibration of standard parameters of premium and reserve risks (with reference to Annexes II and IX)

Overall, Insurance Europe is disappointed with the recalibrated standard parameters put forward by the EC in the DA. The overall direction across the lines of business is to increase capital requirements. Insurance Europe has challenged EIOPA's approach for recalibration of the standard parameters, because of the disproportionate weighting by country has led to overall calibrations that are dominated by a few countries.

On the positive side, Insurance Europe appreciates that the premium risk parameter for medical expense remains unchanged.

On the negative side, in particular, for credit and suretyship the premium calibration increases by around 50%, which coincides with a material reduction in volumes used in the 2017 exercise. Insurance Europe has doubts on whether the data is representative of the industry as a whole, and it is not clear whether there is likely to be significant variation between companies as a result of different mix of business. In addition, in order to be consistent with the initial calibration methodology (see report Joint Working Group on Non-Life and Health NSLT calibration from December 2011), the new calibration should be rounded to the nearest integer.

Looking ahead:
Insurance Europe believes that before changing the standard parameters for premium and reserve risks, further analysis is necessary.

Volume measure for premium risk (with reference to article 116(3)(d) and article 147(3)(d))

Overall, Insurance Europe welcomes the changes proposed in the Delegated Acts, the proposed formula recognises the overstatements introduced in the capital required when applying volatility factors beyond N+1.

On the positive side:

- Insurance Europe welcomes the update of the formula to determine the volume measure for premium risk, where it is proposed to make a distinction between annual and multiyear contracts regarding the definition of FP_{future}:
  - For annual contracts: FP_{future} definition remains unchanged.
  - For multiyear contracts, the EC followed EIOPA's advice to close the gap, and to apply an adjustment factor of 30%

On the negative side:

- Unfortunately, the updated Delegated Acts still consider the notice period in the initial recognition date leading to inconsistency with calibration principles (estimated sigma factors are based on one-year earned premiums) and inconsistencies across markets and undertakings. For instance, the capital charge is overestimated by 8.3% where notification periods equal 1 month and overestimated by 16.7 % where notification periods equal 2 months.

- Furthermore, the updated Delegated Acts do not apply an adjustment factor to $FP_{existing}$ for multiyear contracts.

Looking ahead, Insurance Europe believes the issue of the notice period being considered in the initial recognition date should be addressed.

Recalibration of mortality and longevity risks

Insurance Europe notes the EC's decision to maintain the 20% stress for longevity risk and the 15% stress for mortality.

Catastrophe risk (with reference to articles 90b, 90c, 121-125, 130-132 and annexes V-X)

Insurance Europe broadly welcomes the EC's proposed changes to the catastrophe risk submodules which should mitigate some of the unnecessary calculation burden for insurers and improve the risk sensitivity of the calculations.

On the positive side:

- The inclusion of **simplified calculations for the sum insured for natural catastrophe risks** is welcome. This will reduce the calculation burden for insurers where the mapping of individual exposures to the given risk zones is unfeasible or of an unjustified cost.
- Most of the proposed updated parameters for the natural catastrophe which provide a better reflection of the true risks facing insurers.
- Insurance Europe welcomes the inclusion of **a simplified calculation for the capital requirement for fire risk** provides a pragmatic and risk-sensitive alternative to the full calculation which was noted to create significant burdens for some insurers.
- The **extension of the Marine risk sub-module** to cover all vessels should improve overall risk sensitivity of the standard formula without increasing complexity.
- Similarly, improved risk sensitivity should be achieved through the proposed **alteration of the scenario-based calculations for the Marine, Aviation and Fire risk submodules** so that they are based on the largest exposure, after deduction of amounts recoverable from reinsurance or special purpose vehicles. However, it is unclear why the calculations net of reinsurance would be insufficient and a provision to calculate the scenarios gross of reinsurance is included in the proposals.
- The proposal to **remove the "disability that lasts 10-years" scenario** from the mass accident and accident concentration risk submodules will reduce unjustified calculation complexity.

On the negative side:

- The proposed changes to the natural catastrophe risk submodules which **attempt to better reflect contractual limits are expected to have a very limited impact** in practice. The contractual limits which are required to be in force for the "lower amount" to exceed the weighted sum insured are far below those seen in the market. In its final advice, Section 6.5.4.3 article 648, EIOPA stated: "In some cases, the contractual limits may vary more greatly within a given zone. In that specific case, such an 'ex-post adjustment' may be performed at a more granular level than for zones: for instance by group of homogeneous contracts." Including this option in the proposed amendments to the Commission Delegated Regulation might also help with the practical usability of the limits."
- Some of the proposed calibrations of the NatCat standard formula parameters are overly prudent, eg Italian Earthquake risk and Greece Earthquake risk country factors.

- The application of materiality thresholds for different perils has also resulted in a lack of consistency. For example, Slovenian windstorm risk parameters are proposed despite these not breaching the materiality threshold previously used by EIOPA.

Moreover, Insurance Europe recommends having in mind that the United Kingdom is unlikely to remain a member of the EU in the near future. As the United Kingdom is also not included in the closed list of regions in Annex XIII, "for which natural catastrophe risk is not calculated based on premiums", insurers in the EU will have to calculate the capital requirements for NatCat risks located in the United Kingdom as $SCR_{peril,other}$ based on premiums (according to Articles 121 (8), 122 (6), 123 (8) and 124 (8)). This is clearly inappropriate as the NatCat risk in the United Kingdom is well calibrated and has nothing to do with the withdrawal of the EU membership. Thus, the United Kingdom should be added to the mentioned list of regions for which natural catastrophe risk is not calculated based on premiums.

Look-through approach (with reference to Article 84 and Article 88)

Insurance Europe welcomes the Commission's proposed simplifications to the look-through approach and the EC's proposal to extend the application of the look-through approach to investment related undertakings, including real estate companies.

On the positive side, the simplifications to the look-through approach suggested:

- the carve-out of assets for unit/index linked products from the 20% limit.
- the possibility to use the last reported asset allocation of the collective investment undertaking or fund to calculate the SCR
- the permission to use groupings of exposures also when the target asset allocation is not available at the level of granularity necessary

On the negative side:

- Insurance Europe highlights that the reference to Article 88 on proportionality comes as an additional and unnecessary layer of burden, which should be avoided. Insurance Europe notes that, in the case of the proposed look-through simplifications, there are already safeguards for prudence, namely the 20% threshold and the requirement for testing the asset allocation criterion.
- While Insurance Europe welcomes the deletion of the mention "strictly" in Art 84(3) in the sentence "the underlying assets are managed according to that target allocation or last reported asset allocation", it notes unclarity remains as to what proof the supervisor could expect to allow undertakings to apply this simplification. Insurance Europe highlights it could result in a costly burden for applying the simplification, given that sufficient guardrails are already provided.
- While Insurance Europe broadly supports the conditions – introduced by the EC — for defining an investment related undertaking, it notes that on the requirement of 'following a specific and documented investment mandate' the role of the investment mandate could also be fulfilled by other indicators, such as the purpose outlined in the partnership agreement of the investment related undertaking, the context of its incorporation (as investment vehicle) or internal investment guidelines of the (parent) insurance company.

Relevant risk-free rate term structure (with reference to Article 43)

Insurance Europe welcomes the additional clarifications provided by the Commission regarding the derivation of the risk-free interest rate term structures and the process which should be followed to make substantial changes. These provisions should ensure any changes are thoroughly considered and, importantly. the impact of the changes is estimated and understood prior to their application.

Insurance Europe further welcomes the Commission's decision to postpone the review of the interest rate risk submodule until the Review of the Solvency II Directive in 2020. EIOPA's own initiative proposals would have unnecessarily and significantly increased capital requirements for many insurers and exacerbated the existing problems and concerns for long-term business and investment.

Looking ahead:
Given the fundamental importance of this risk module, a comprehensive and detailed impact assessment should be foreseen to test any proposals so that policymakers fully understand their impact and consequences.

Market risk concentration (with reference to Articles 182, 184, 186, 187)

Insurance Europe notes the proposed changes to the market concentration risk submodule which clarify the methodology which must be followed to calculate the risk factor for single name exposures (SNE).

On the positive side:
- The Commission's proposals should **remove ambiguity in the sequencing of the calculations** for certain exposures.

On the negative side:
- The existing restrictions in Article 184 (2)(b) (i), (ii) & (iv) should be deleted in order to remove all entities in a group from the calculation base of the submodule.
- Strategic participations and related investment undertakings should be included in the list of exclusions in Article 184 (2).
- The 0% risk charge applied to exposures to Member State's central governments and central banks under Article 187 (3)(b) should also be applicable to foreign currency obligations.
- The rounded-up average asset rating criterion of article 182 (4) is unduly conservative and may not adequately reflect the risk when calculating average rating for single name exposures. For example, in the case of one issuer with two issues, one of 100 million euros with an "A" rating and another issue of 1 million euros with a "BBB" rating, this rule establishes the average rounded up rating is BBB in the calculation of concentration risk, which is a clear penalty for the purposes of calculating this risk. In order to avoid this effect, the rounded-up average criterion should be deleted.

Currency risk at group level (with reference to Article 337)

Insurance Europe notes the alternative calculation proposed by the Commission to improve the risk sensitivity of the currency risk submodule for group who use the standard formula.

While the proposed formulation of the Article 337 should achieve its objective, Insurance Europe does not expect the amendment to be widely used in practice due to the prevalence of internal model usage amongst the groups which are eligible to make use of the proposal.

Insurance Europe is disappointed that the Commission did not use the opportunity to make more ambitious improvements to the currency risk submodule. At present, the currency risk submodule penalises good risk management techniques, both at a solo and group level, by applying a risk charge to all foreign currency exposures which are held to support the risk arising from foreign currency liabilities.

Unrated debt (with reference to Art 5a, 176, 176a, 176b, 176c)

Overall, Insurance Europe welcomes the EC work aimed at providing a more appropriate capital treatment for unrated debt that can receive, as a proxy, the credit rating of rated debt should a set of criteria be met.

Unrated debt represents not only an important investment asset for the industry, but also a key source of funding for SMEs in Europe. The industry therefore welcomes steps by the Commission aimed at removing barriers to investment in assets that are key for European growth and also at the center of the CMU project and its objectives.

On the positive side:

- Insurance Europe broadly supports the **own internal credit assessment** approach, which is viewed as overall adequate and not overly complex. This approach will particularly work in countries and for undertakings that invest directly in unrated debt and are already using similar criteria in their internal investment processes.

On the negative side, Insurance Europe highlights that:

- The financial ratios proposed in Art. 176a fit to credit quality step 2 but not to credit quality step 3. Therefore, suitable financial ratios should be added to Art. 176a for CQS 3. In this respect, the industry recommends:
    - a threshold value of 7.5% for CQS 3 especially for the financial ratio Art. 176a (3) g (vii)
    - a factor of 3 instead of 6.5 for the financial ratio Art. 176a (3) g (viii)
- The **approved internal model approach**, as proposed, is not reflective of market reality, is overly restrictive and will not work in practice. While in a number of member states insurers do co-invest with banks/credit institutions, the criteria foreseen by the Commission (eg 50% retention by banks, disclosure of all applications and details on all decisions to approve/reject applications for bonds and loans) are very difficult, if not even impossible, to meet in real life. In fact, the significant challenge of criteria difficult to meet in practice was acknowledged by EIOPA in its advice to the Commission of February 2018. Some markets **investing in unrated debt through funds** are concerned not to be able to benefit from this improvement in the capital requirement assessment because the costs of obtaining the information needed may outweigh the actual "benefits" in terms of capital reduction. When investing through funds, the application of the proposed method in the look-through approach will require collecting data and assessing the credit quality at the asset line level. In this respect, the sector notes that unclarity remains as to what proof the supervisor could expect to allow undertakings to apply this simplification. Insurance Europe highlights it could result in a costly burden for applying the simplification, given that sufficient guardrails are already provided.

Looking ahead:

- Insurance Europe calls on the Commission to **closely monitor** the extent to which these proposals will be used by insurers in practice according to the vehicle of investment (direct or indirect investment) and in terms of default rates of the two approaches. This information will help consider possible extensions to other asset classes and improve the conditions for financing the real economy while reducing dependence on ratings. Insurance Europe calls the European Commission to be more ambitious in its endeavors to enhance the risk-sensitiveness of the Solvency II framework, by more adequately measuring the actual risks that insurers are exposed to, especially in the case of long-term investments in bonds.

With respect to the second bullet point above, Insurance Europe asks the Commission to follow up on the related recommendations of the Final Report of the HLEG on sustainable finance[1], and in particular, which

[1] See page 72 of https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

explicitly recommends an investigation into *"how Solvency II could be adapted to facilitate further long-term investment while maintaining a strong risk-based nature:*

- *Assessment of alternative ways to deal with prudential concerns about forced selling of assets*
- *Assessment of alternative ways to set discount rates to avoid exaggerating liabilities and balance sheet volatility*
- *Examination of how long-term investment risk can differ from short-term trading risks and how this difference can be reflected in solvency capital charges"*

Unlisted equity (with reference to Articles 168 (a), 168 (c) and 171a)

Overall, Insurance Europe welcomes the EC work aimed at providing a more appropriate capital treatment for unlisted equity that can receive, as a proxy, the same capital treatment as listed equity, should a set of criteria be met.

Unlisted equity represents not only an important investment asset for the industry, but also a key source of funding in Europe. The industry therefore welcomes steps by the Commission aimed at removing barriers to investment in assets that are key for European growth and also at the center of the CMU project and its objectives.

While the proposal may work for insurers who invest directly in equity, it is significantly burdensome for insurers who invest in equity via funds.

On the positive side:

- Insurance Europe broadly welcomes the proposed criteria, and in particular appreciates that the Commission did not fully follow EIOPA's advice in this area, which would have actually made the entire proposal now workable/not applicable in practice.

On the negative side, Insurance Europe highlights that:

- The marginal impact of the capital reduction remains limited. The Commission should envisage more ambitious steps on reviewing the capital treatment of equity in general. **Markets investing in unlisted equity through funds** won't be able to benefit from this improvement in the capital requirement assessment because the costs of obtaining the information needed may outweigh the actual "benefits" in terms of capital reduction. Applying the proposed method in the look-through approach would require the collection of data and beta assessments per every asset line (and the number of lines can be very significant when investing through funds). The assessment process is very costly, with no straightforward possibility of anticipating a positive outcome (in the form of a capital reduction).
- With respect to Article 168(6)(c), the new inserted reference to the requirements of Article 8 of Regulation 231/2013 will have for consequence that in practice hardly any closed-end funds would be able to benefit from the reduced capital requirements provided for in Article 168 (6). This would not be in line with the Commission's objective to improve the funding conditions for European SMEs by higher investments of institutional investors in **venture capital or private equity**, which are often made through closed-end funds. To avoid this, this reference should only and expressly cover the use of derivative instruments. In regard with the general calculation of leverage, a clear reference should be inserted to article 6 (4) of the Commission Delegated Regulation (EU) No 231/2013 in order to clarify that borrowing arrangements the AIF entered into are not considered as leverage when they are temporary in nature and fully covered by contractual capital commitments from investors in the AIF.

Long-term equity investments (with reference to Art 169, 171a)

Insurance Europe appreciates recognition by the European Commission that action is needed to review the capital treatment of long-term equity investments in Solvency II. It further notes and welcomes that the three key European institutions (EC, EP and Council) appear to be aligned on the view that barriers to long-term equity investment need to be addressed, while maintaining the risk-based nature of Solvency II.

However, Insurance Europe believes that the technical proposal will not work in practice for any undertaking because of the way in which the criteria are defined. In particular, the following elements in the current proposal are preventing it from producing any impact in practice:

- The ring-fencing obligation is a clear disincentive from applying this proposal, as it would lead to loss of diversification, which is key to an overall portfolio risk assessment. This requirement is not needed and should be removed.
- The 12 years duration/ limitation is misleading and not justified. In fact, while the Commission indicates its intention to take steps for long-term investment, it proposes an extremely narrow perspective on how a long-term equity investment could be identified.
- Furthermore, the requirement that the holding period of assets is higher than that of liabilities does not make sense, as it suggests comparing a retrospective parameter (ie holding period of assets) with a prospective one (ie current duration of future liabilities).
- The limitation to EEA countries is not consistent with other similar provisions in Solvency II, which refer to OECD countries.

Insurance Europe therefore argues that the current proposal would not work in practice and calls on the EC to present its impact assessment of this proposal and present its analysis on the practical applicability of the new equity bucket and ultimate impact on capital requirements.

More detailed comments on the challenges of this proposal can be found in the annex at the end of this document.

Simplification of counterparty default risk (with reference to Articles 110, 111(a), 112(a) and 112(b))

Insurance Europe welcomes the Commission's proposals for the enhancement of existing simplified calculations and the inclusion of three new simplified calculations for the counterparty default risk submodule.

On the <u>positive</u> side:

- The enhancement and extension of available simplified calculations is welcome. These could reduce the calculation burden for some insurers and could be used to address some of the known issues with the existing formulae in Article 200.

On the <u>negative</u> side:

- The newly proposed simplification for Article 192 (2) and for Type 1 exposures in Article 200 result in additional unjustified prudence being introduced into the calculations which may restrict their use by undertakings.
- Insurance Europe is disappointed that, despite the evidence showing that the counterparty default risk is the most burdensome to complete relative to the resulting capital requirement, the Commission did not propose more comprehensive simplifications to the structure of the submodule, as foreseen in its Call for Advice to EIOPA.
- Furthermore, Article 192 (6) of the Delegated Regulation prescribes that the loss-given-default on cash at bank to be equal to its value. The recovery rate for deposits and treasury is therefore 0% which is arbitrary and unjustified. In most studies, the average recovery rate for certain corporate debt tends to be 30% - 40% and therefore for cash at bank assets should be at least similar.

Insurance Europe **highlights** the following typo in the draft regulation:

- "Section (50) – in Article 201 **(2)**, point (a) is replaced by……"

Looking ahead:

- The Commission and EIOPA should monitor the use of the available simplifications for the counterparty default risk submodule, and simplifications more generally, to assess if these are being used in practice.
- Insurance Europe encourages the Commission to be more ambitious in the application of the proportionality principle to seek to reduce unjustified complexity and remove unnecessary barriers.

Treatment of exposures to CCPs and changes resulting from EMIR (with reference to Articles 1, 189, 192, 192a)

Insurance Europe welcomes the Commission proposals aimed at better reflecting the post-EMIR derivatives regulatory environment in the calibration of the Solvency II capital requirements for derivative exposures. This is a good example of how targeted improvements can enhance the risk-based nature of the framework.

Comparison of own funds in insurance and banking sectors (with reference to articles 71(f), 73(5), 77(5))

Insurance Europe welcomes the Commission proposal to allow partial write down and conversion and to allow supervisors to exceptionally waive the triggering of the principal loss absorbency mechanism (PLAM). Insurance Europe highlights that for the majority of insurers which are non-listed and/or organised as a mutual, cooperative or public-sector company, RT1 instruments are the only way to raise Tier 1 own funds externally. As these undertakings do not have the possibility to increase own funds via capital increases, RT1 instruments are key for the industry. These instruments are also of importance to listed insurers.

Insurance Europe acknowledges that the amendments proposed by the Commission represent an improvement compared to the current conditions for issuance of RT1 with respect to waivers for the RT1 PLAM requirement to write-down or convert. However, it is concerned that PLAM waiver options are not available for all adverse scenarios.

On the positive side:

- Introducing permission to partially write down/convert RT1 instruments where mandatory trigger of 3 months SCR has been breached, but only as long as 75% SCR breach and MCR breach triggers have not been triggered. As a minimum, RT1 is written down on a straight-line basis so that full write down is reached at 75% SCR breach (and no MCR breach). Additionally, SCR coverage should be recalculated, and if necessary further write down should be performed.
- Supervisors are enabled to grant an exceptional waiver from the triggering of the principal loss absorbency mechanism, subject to conditions.
- The introduction of a provision allowing to redeem the instrument before 5 years from the date of issuance, subject to supervisory approval, in case there is a change in the regulatory classification or a change in the applicable tax treatment of the basic own-fund item.

On the negative side:

- The current PLAM waiver option for supervisors is not available for all adverse scenarios, for example
  - in case of group MCR (*used to describe the "minimum consolidated Group SCR" (Solvency II Directive Art. 230(2))* breach while the group SCR is still above 100%,
  - group SCR < 75%

- worsening of SCR ratio where PLAM reduces Tier 3 own funds, via a reduction of deferred tax assets.

  Insurance Europe notes that a PLAM waiver option should always be available whenever PLAM would lead to a reduction of relevant solvency ratios to allow supervisors to avoid crisis acceleration.

  In addition, the limitation of the waiver in Art 71(10) appears to contradict recital 8 of the draft delegated act, which states that '*losses of basic own funds due to tax effects when the principal loss-absorbing mechanism is triggered should be avoided*'.
- The new proposed Art 71(5)(a) and Art 71(6)(a) do not include rules for cases where PLAM application has to consider both solo capital requirements and group capital requirements. As a consequence, unclarity remains as to how partial conversion or the waiver can be applied if the different triggers would imply a different write-down or conversion amount.

Looking ahead:

Insurance Europe believes the shortcomings in this area should be addressed, and therefore it proposes to introduce an extension of PLAM waiver option.

Indeed, the PLAM waiver option should be available whenever PLAM would lead to a reduction of relevant solvency coverage ratios (ie group SCR or MCR ratio, solo SCR ratios), including in the following cases where:

- PLAM reduces solvency coverage via a reduction of deferred tax assets and thus via a reduction of eligible Tier 3
- PLAM reduces a relevant solvency coverage where PLAM is triggered by the breach of the Group MCR (in case of trigger inversion)

Therefore, Insurance Europe proposes the following amendments **to Art 71(10):**

- Condition (b) *[there have been no previous trigger events in the circumstances described in point (a) or (b) of the second subparagraph of that paragraph]* should be deleted.
- Condition (c) should be amended (text added) as follows: *the supervisory authority agrees exceptionally to waive the triggering of the principal loss absorbency mechanism on the basis of both of the following pieces of information:*
  - *(i) projections provided to the supervisory authority by the insurance or reinsurance undertaking when that undertaking submits the recovery plan required by Article 138(2) of Directive 2009/138/EC, which demonstrate that triggering the principal loss absorbency mechanism in that case would be very likely to give rise to a tax liability* ***or a tax asset*** *that would have a significant adverse effect on the undertaking's solvency position.*

Look-through approach at group level (with reference to articles 335f, 336)

Insurance Europe appreciates the proposed changes to the DA with respect to the look-through approach at group level. The changes ensure consistency between the treatment at solo level and at group level of collective investment undertakings and investments packaged as funds.

However, not all collective investment undertakings and investments packaged as funds are related undertakings within the definition of Article 212(1)(b) of Directive 2009/138/EC. To make this clear Insurance Europe suggests expanding the wording in Art 335(1)(f): "*…data of all related undertakings, including* ***<u>affected</u>*** *ancillary service undertakings, collective investment undertakings and investment packaged as funds…*"

Risk Margin

Insurance Europe welcomed, back in July 2016, the inclusion of the risk margin in the EC call for advice.

Insurance Europe is disappointed by the EC decision to follow EIOPA's recommendation not to change the 6% CoC.

On the negative side:

- The issues of size and volatility of the risk margin, and its inappropriateness for certain long-term products remain unaddressed.
- EIOPA and the EC have ignored the extensive arguments and evidence provided by Insurance Europe and the CFO Forum showing that the CoC is too high and a value of 2-3% would be justified.
- The industry input highlighted the following key weaknesses in the EIOPA analysis which, when addressed, support a reduction in the cost of capital:
  - Using an industry β without a deleverage adjustment is incompatible with EIOPA's 100% equity funding assumption for reference undertaking Stakeholders provided EIOPA with detailed proposals for a number of improvements to the risk margin framework. EIOPA has dismissed these with very brief, high-level comments.
  - Using an industry β without an adjustment to reflect minimal market risk is incompatible with the requirement to minimise market risk within the Reference Undertaking as set out in Solvency II Delegated Acts article 38(h).
  - ERP selected by EIOPA is backward looking, which is inconsistent with Dir Art 77(5) and is materially higher than the recommendation by expert studies due to a range of issues.
- So far it seems that no work has been done to assess the true transfer cost for different lines of business, and whether the risk margin genuinely simulates that in a reasonable way across a range of products. EIOPA has a duty to do this work.

The table below presents an overview of the inconsistencies in EIOPA's analysis of the cost of capital, which the Commission unfortunately endorses by following EIOPA's advice:

Inconsistencies in EIOPA's analysis	**Equity Risk Premium**	**β**	**Adjustment**	**Difference vs EIOPA *(per parameter)***	**Corrected Cost of Capital *(cumulative)***	**Explanation**
Technical error – **inconsistent assumptions behind parameters**	*[7.02%-8.09%]*	*0.90*	*0.80*	(1.68%-1.94%)	**5.05%-5.82%**	Using an industry β without a deleverage adjustment is incompatible with EIOPA's 100% equity funding assumption for reference undertaking (*see 2.1 below*)
Incompatible with SII Delegated Regulations - **no correction to β for minimal market risk**	*[7.02%-8.09%]*	*0.81*	*0.80*	(2.19%-2.52%)	**4.55%-5.24%**	Using an industry β without an adjustment to reflect minimal market risk is incompatible with the requirement to minimise market risk within the Reference Undertaking as set out in Solvency II Delegated Regulations article 38(h) (*see 2.2 below*)
ERP that is inconsistent with S2 regulation and ignores assessment from a range of	*[4%-6%]*	*0.81*	*0.80*	(4.15%-3.88%)	**2.59%-3.89%**	ERP selected by EIOPA is backward looking, which is inconsistent with art. 77.5 and is materially higher than the recommendation by expert studies due to a

expert studies						range of issues (*see 2.3 below*)

Looking ahead, Insurance Europe believes that the cost of capital should be reduced as part of the 2018 review, and the wider issue of the design of the risk margin should be addressed in 2020.

Strategic equity investments

While Insurance Europe welcomed the EC request for information on strategic participations to EIOPA, it is disappointed by the lack of any actions in this area.

As the EIOPA analysis showed, the current criteria for strategic participations are difficult to validate in practice, and this may be one of the reasons why the estimated allocation by the industry to this asset class (ie €155bn) is likely below the actual exposure.

In terms of criteria for the identification of strategic participations, Insurance Europe proposes:

- the removal of the forward-looking short-term volatility criterion, which is not only very difficult to test in practice, but it is also a flawed proxy for the actual risks of such assets for insurers who take a long-term strategic view.
- The change of the ownership & control threshold from 20% to 10%.

Capital instruments only eligible as tier 1 up to 20% of total tier 1

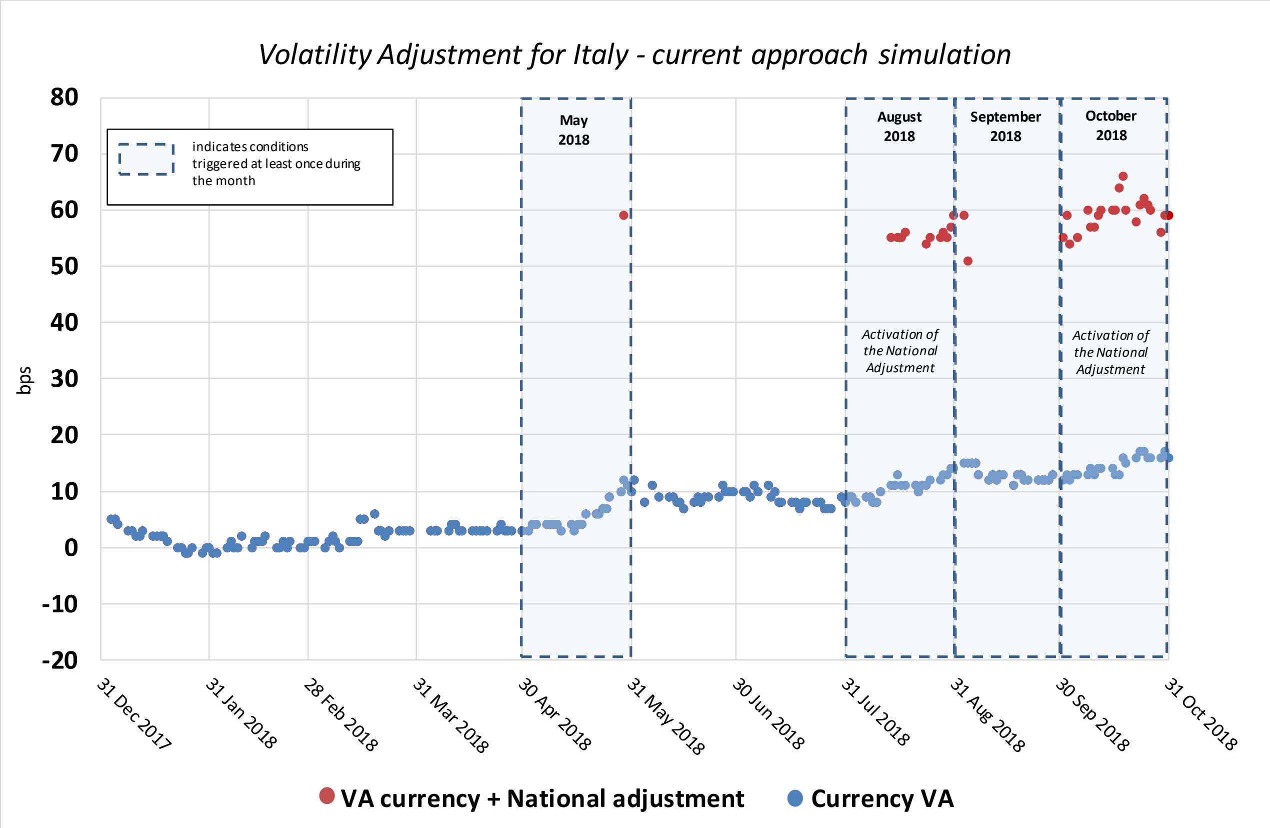
Insurance Europe welcomed the EC's request in the EC call for advice to assess how eligibility criteria could be modified if the 20% limit on restricted Tier 1 own funds were to be removed. Insurance Europe appreciates the Commission's decision to preserve the 20% limit, as the strengthening of the related criteria would only result in prohibiting most insurers from issuing Tier 1 instruments in the form of subordinated debt.

Volatility adjustment — trigger for country adjustment

Insurance Europe is disappointed that the EC has not proposed any improvements to the volatility adjustment. While the 2020 Review will provide the opportunity for a more fundamental review of the LTG measures, there is evidence that the existing trigger for application of the national market component is deficient and improvements are needed and justified as part of the 2018 Review. Improving the trigger in the Delegated Acts is also highly feasible while remaining fully within the text of the Directive.

Volatility in national sovereign and corporate markets experienced at the end of May 2011 and, more recently, from the end of May 2018, have confirmed that the VA does not work as intended. During these periods, the national component activated with significant delay and uncertainty. Analysis of daily data shows that the current trigger for application criteria of the national component, is in fact, creating volatility, uncertainty or cliff effects.

The chart shows that the VA national adjustment was triggered in August and October as the conditions were satisfied on the 31st of these months. In the other months (May and September) conditions were satisfied during the month and not at the end of the month.



Article 77d(4) of the SII Directive states that:

For each relevant country, the volatility adjustment to the risk-free interest rates referred to in paragraph 3 for the currency of that country shall, before application of the 65 % factor, ***be increased by the difference between the risk-corrected country spread and twice the risk-corrected currency spread, <u>whenever</u> that difference is positive and the risk-corrected country spread is higher than 100 basis points****.*

A simple but effective change which would help address the current trigger problem is to add text to the Delegated Acts so that it is clear that the country adjustment is applied at the end of the reporting period if the conditions specified in level 1 are met at any-time during the reporting period. This is entirely in line with the Level 1 text, especially given its use of the word "whenever".

To achieve this the following paragraphs should be added to the Delegated Acts (for example into Article 50 which contains the formula to calculate the spread underlying the volatility adjustment)

- *Conditions referred to in Article 77d(4) shall be considered as met if the specified criteria are met at least once during the reporting period, based on a daily calculation.*
- *Where these conditions are met during the reporting period, the volatility adjustment shall only be increased when the difference between the risk-corrected country spread and twice the risk-corrected currency spread is positive.*

Other comments

Insurance Europe highlights the following **typos** in the published draft:

- Recital 30 – There is a full stop missing at the end of the first sentence.
- Recital 32 – "*Insurance and reinsurance undertakings should not **be** disproportionately…*"
- Recital 33 – "*… in the Solvency Capital Requirement standard formula calculation with undertaking-specific parameters by laying down a standardised method to calculate an undertaking-specific parameter **which** should be laid down to replace the standard parameter for non-proportional reinsurance.*"
- Recital 38 – "*The complexity **of the** calculation of the…*"
- Recital 38 – "*Therefore the event type referring to disability that lasts 10 years caused by an accident should ~~no longer~~ be removed from this calculation*."
- Amendment (2) - There is an unnecessary comma at the end of the proposed Article 43 (3) "*ultimate forward rate**,** .*"
- Amendment (29) – There is a sentence in the concluding remarks which appears to be incomplete "*In determining the sum insured for a set of buildings, insurance and reinsurance undertakings shall only take into account reinsurance contracts and special purpose vehicles that would pay out in the event of **insurance claims related to building***"
- Article 71 (5)(a) and Article 71(6)(a) provide similar provisions and refer to the same paragraphs, however, different wording is used.
  - Article 71 *'5a. For the purposes of **point (i) of paragraph 1(e), the rules** governing the write-down of the nominal or principal amount of the basic own-fund item shall provide for all of the following:'*

Article 71 ''6a. For the purposes of **paragraph 1(e)(ii)**, **the provisions** governing the conversion into basic own-fund items listed in points (a)(i) or (ii) of Article 69 shall provide for all of the following:'

Annex: Additional comments on the EC long-term equity proposal (Art 171a)

We provide below further explanations of the specific elements in the draft article 171a that would prevent the text from being economically relevant and effective in practice. We further indicate the type of changes necessary to allow the article to be effective. Specifically:

> *'Article 171a*
> ***Long-term equity investments***
> *For the purpose of this Regulation, a sub-set of equity investments of the insurance or reinsurance undertaking may be treated as long-term equity investments if all of the following conditions are met:*
> *(a) the sub-set of equity investment is included within a portfolio of assets and liabilities corresponding to clearly identified businesses of the insurance or reinsurance undertaking which is ring-fenced, managed and organised separately from the other activities of the undertaking, without any possibility of transfer;*

Ring-fencing and no possibility of transfer are unjustified criteria. They would restrict the insurer's ability to carry out its duty of optimising risk and return, would restrict diversification and increase costs. Such criteria are inconsistent with a long-term investment framework and, in addition, unworkable in practice. The use of the term "sub-set of equities" also needs to be avoided and it should be made explicitly clear that the portfolio of equities qualifying as long-term can include both direct investment in equity by the insurer or indirect investment through collective investment funds.

In fact, insurers manage equity investments as part of diversified portfolios of assets including fixed income, property, etc which back liabilities. These assets are bought and managed based on insurers' ALM (asset liability management) strategies, and in line with insurers' risk appetite and internally set investment limits. This means that, from the outset, the long-term equity designation applies to a portfolio of equities and not to specific equity holdings. An insurer has a duty to both its customers and, where relevant, its shareholders, to optimise risk and return of its equity portfolio and this involves changing individual holdings over time based on the best information and forecasting available. The strategic asset allocation can be, and often is, long-term at portfolio level. This should be the focus of any criteria, while restrictions on changing individual holdings must be avoided.

Therefore, the text should refer to a portfolio of equities rather than a subset of equities. The term subset assumes that there is no situation where the entire portfolio of equities could meet the criteria for long-term equity treatment.

The long-term equity investment portfolio must be identified to ensure it is clear which portfolio of equities is designated as long-term for the purposes of Article 169. There is no need for a ring-fencing requirement beyond this portfolio identification requirement.

Ring-fencing has two objectives:

1. protect the policyholders in case of insurance undertaking's failure,
2. compel the insurance undertaking to redistribute technical and financial benefits exclusively to the policyholders within the ring-fenced portfolio.

The second objective of segregation in the redistribution of technical and financial benefits is clearly not an objective of the long-term equity calibration. The first objective is already at the core of the existing Solvency II framework and the supervisory process. In the context of long-term equity calibration, it can be strengthened through criteria to confirm the portfolio is not materially at risk of forced selling.

The ring-fencing proposal, underlined by the impossibility of transfer, is in many cases simply not possible because it would break mutualisation/sharing of returns requirements embedded in the business. Ring-fencing also limits diversification, which is a core feature of the business model and beneficial to customers.

Finally, to meet the ring-fencing requirement insurers would have to restructure existing products and asset liability portfolios, which in turn would require implementing new specific financial, accounting and underwriting rules as the ring-fenced portfolio would be "an undertaking in the undertaking". Insurers would in many cases not be able to restructure in this way; even if possible, significant initial and ongoing operational costs would be triggered by such changes, leading to an outcome that is not in the best interest of neither customers nor shareholders. Where ring-fenced assets and liabilities already exist in the balance sheets, e.g. as regards pension risks, there is already a possibility to benefit from a reduced shock for equities with article 304 of the directive, so that the proposal would have no added value in that situation. Finally, the legal framework of ring-fencing is not harmonized at EU level and could make the proposal non-applicable in some national jurisdictions, and this in itself would challenge the level playing field.

Insurers often invest through collective investment funds as well as or instead of through direct holdings. The text needs to clarify that equities held through such funds can be part of the equity portfolio qualifying for long-term calibration.

(b) the average holding period of equity investments in the sub-set is higher than the average duration of the liabilities held within the portfolio, and exceeds 12 years;

The average holding period of 12 years as defined in the draft text is not conceptually relevant and not practically workable. This criterion should be removed. Criterion e (see below) is sufficient.

Although insurers typically have investment policies and strategic asset allocations based on a long-term horizon, it is important to avoid requirements to hold specific equity holdings or equity funds for a minimum number of years – either related to the liability duration or a minimum of 12 years. Requiring minimum holding period per equity investment effectively imposes a "passive asset management system" without regard to actual risks and performance potential. Insurers need to be free to apply dynamic management of assets in order to optimise risk/return in the context of the customer needs, the insurer's risk appetite, the market information and assessment of the long-term prospects for the particular equity holding. There is no contradiction between a long-term investment strategy and dynamic asset management – in fact setting a requirement for minimum holding period for individual equity positions would contract the prudent person principle, fiduciary duty and the requirements on good risk management.

Then, further evidence that a requirement that holding period of equity investments be higher than the liabilities does not work can be seen by taking for example pension products whose duration is around 50 years – this would mean that buying new equity would be balanced by equity held for more than 100 years. Even reduced to a 12 years horizon, the threshold would imply a holding of assets for more than 24 years. This is clearly not an appropriate requirement and could have unexpected consequences on liquidity of equity markets, against the goals of CMU.

Finally, there is a technical flaw in EC's proposal. On the one hand, the EC proposes to compare a retrospective indicator (the average period of effective holding of assets) with a prospective indicator (the duration of liabilities, i.e. the future residual lifetime of the liabilities). However, the key requirement should be to assess whether an insurer can be subject to forced sales of assets. For this purpose, Insurance Europe advocates strongly for replacing this criterion by a liquidity test. A liquidity test seems to be the best way to deal with the issue as it allows for a holistic approach to confirm no material risk of forced selling. The liquidity test should focus on those scenarios which result in actual cash outflows and risk affecting the ability of insurers to pay out claims or provide contractually-agreed benefits to policyholders.

Insurance Europe suggests that an adequately designed liquidity test could work perfectly. The elements of the liquidity test could be the following:

- a given time horizon over which the insurer should demonstrate that it is able to remain in a situation of net positive cash flow even in adverse situations;

- consideration of the cash flows of assets, insurance obligations (including future premiums on a prudent basis for going-concern issues) and cash flows (e.g. dividends, debt coupons, etc.) rising from own funds (equity and debt);
- testing on the basis of a deterministic adverse scenario, combining both asset and liability distortions: these shocks could rely on the identified risks with a calibration on a time horizon consistent with financial cycles (e.g. from 5 to 8 years);
- full consideration of the management actions;

On the basis on the above, the exposure of the insurer to forced sales of long-term equity will be identified.

(c) the equity investments in the sub-set consists are listed or unlisted equities of companies that have their head offices in countries that are members of the EEA;

The scope should be extended to include OECD equities.

Insurance Europe welcomes that the scope of the proposal includes both listed and unlisted equities as this recognizes the benefit of diversification between different types of equities. Insurance Europe recommends that the EC also recognizes the geographical diversification between equities as key in risk mitigation. In fact, reference to OECD is already included in other articles relating to listed equity, infrastructure, STS securitisation and excluding it here is unnecessary and inconsistent.

(d) the insurance or reinsurance undertaking demonstrates to the satisfaction of the supervisory authority that its solvency and liquidity position, 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 hold equity investments for a period which is compatible with the requirements of point (b);

Insurance Europe calls for the deletion of the mention "*to the satisfaction of the supervisory authority*" as the assessment of exposure to force selling can be clear enough to avoid the need for prior approval.

Prior approval should be avoided as it creates additional work and can result in delays. And above all it does not bring any improvement to the supervisory process nor to policyholder protection. The legislator and the regulator make the rules *a priori* and the supervisor controls *a posteriori*. The application of the tailored long-term equity capital charge would become part of the supervisory reporting and dialogue, as is the case for qualifying infrastructure assets.

(e) the asset-liability management and investment policy of the insurance or reinsurance undertaking states the undertaking's intention to hold the sub-set of equity investments for a long period.

It should be clear in the text that this requirement applies at portfolio level, and not at the level of individual holdings.

Insurance Europe agrees with the EC that risk management and internal policies (both ALM and investment policies) must consider the challenges of long-term equity investment management. However, as highlighted above, these must be applied at portfolio level and reflect the intention to manage the equity portfolio, as a whole, for a long period.

Insurance Europe is the European insurance and reinsurance federation. Through its 35 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. 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 generate premium income of more than €1 200bn, directly employ over 950 000 people and invest over €10 100bn in the economy.