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From: Secretary-General of the European Commission,  
signed by Mr Jordi AYET PUIGARNAU, Director

To: Mr Jeppe TRANHOLM-MIKKELSEN, Secretary-General of the Council of  
the European Union

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Subject: COMMISSION STAFF WORKING DOCUMENT **Supporting insurers'  
investment in equity and unrated debt** Accompanying the document  
Commission Delegated Regulation amending Delegated Regulation (EU)  
2015/35 supplementing Directive 2009/138/EC of the European Parliament  
and of the Council on the taking-up and pursuit of the business of  
Insurance and Reinsurance (Solvency II)

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Delegations will find attached document SWD(2019) 146 final.

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Encl.: SWD(2019) 146 final



EUROPEAN  
COMMISSION

Brussels, 8.3.2019  
SWD(2019) 146 final

**COMMISSION STAFF WORKING DOCUMENT**

**Supporting insurers' investment in equity and unrated debt**

*Accompanying the document*

**Commission Delegated Regulation**

**amending Delegated Regulation (EU) 2015/35 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)**

{C(2019) 1900 final}

## 1. Introduction

Long-term investment is the key element to provide stable capital in order to finance tangible assets (for instance, energy, transport and communication infrastructures, industrial and service facilities, housing and climate change and eco-innovation technologies) as well as intangible assets (such as education and research and development) that boost growth, innovation and competitiveness. Many of these investments have wider public benefits, since they generate greater returns for society as a whole by supporting essential services and improving living standards.

In the Action Plan on building a Capital Markets Union (CMU Action Plan) of 30 September 2015<sup>1</sup>, the Commission announced the intention to unlock more investments and to mobilise capital in Europe to be channelled into funding for non-financial companies, with a particular focus on small and medium-sized enterprises (SMEs). The Communication on the mid-term review of the CMU of June 2017<sup>2</sup> reiterated this commitment, with a particular focus on facilitating access to equity and debt funding for European SMEs, so that they can have access to financing more easily and on better terms<sup>3</sup>. The provision of long-term financial resources to small companies will facilitate their expansion and help create new jobs.

With trillions of assets under management, the insurance sector remains a mainstay of the European financial industry and can contribute to the objectives of the CMU. However, in the first quarter of 2018, investments in equity represented only about 16.5% of insurers' total investments<sup>4</sup>. Therefore, in order to ensure that there is no unjustified impediment to insurers' investment in capital and debt instruments of SMEs, the Commission announced an assessment of the prudential treatment of insurers' investments in private equity and unrated debt in Solvency II.

For this purpose, the Commission issued a call for technical advice to the European Insurance and Occupational Pensions Authority (EIOPA) on 21 February 2017<sup>5</sup>, requesting the development of clear and conclusive criteria for identifying unlisted equity and unrated debt instruments that could benefit from reduced capital charges. EIOPA's technical advice<sup>6</sup> comprised recommendations on the treatment of alternative investment funds, unlisted equity and unrated debt investments, which has been taken up in a Delegated Regulation of the Commission<sup>7</sup>. In addition, this Delegated Regulation introduces a new asset class for long-term holdings in equity investments of EEA companies. In the broader context of long-term investments, the Commission services will continue their assessment on the need for further actions to attenuate any excessive focus on short-term investment in capital markets. This intention has been announced in the Action Plan on Financing Sustainable Growth<sup>8</sup>, which resulted from the Commission's work initiated under the CMU.

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<sup>1</sup> See the [Action Plan](#).

<sup>2</sup> See the [CMU mid-term review](#).

<sup>3</sup> See also the Commission proposal on the promotion of the use of SME growth markets ([COM\(2018\) 331](#)).

<sup>4</sup> Source: [EIOPA's Statistics](#) (S.06.02): total direct investment in equity and trough CIU, excluding investment relating to unit- or index-linked insurance products. There has been a long-term trend to reduced equity ownership by insurers. In particular, the share ownership of insurers and pension funds dropped from more than 25% of the EU stock market capitalisation in 1992 to 8% at the end of 2012. About 65% of the total equity investments actually correspond to holdings in related undertakings, including participations in other insurance or reinsurance undertakings or real estate companies of the same group.

<sup>5</sup> Available on the EIOPA website at [this link](#).

<sup>6</sup> Available on the EIOPA website at [this link](#).

<sup>7</sup> Hereafter, that Commission Delegated Regulation is referred to as "the Delegated Regulation".

<sup>8</sup> See Action 10 of the [Action Plan: Financing Sustainable Growth](#).

## 2. Investment strategies in the insurance sector

Insurers' investments follow a liability-driven approach. The composition and size of their investment portfolio is determined by the nature and volume of the business they write, whereby they follow the principle of matching between assets and liabilities cash-flow profiles. Relying on the estimation of liability duration and pay-out probabilities, insurers will in principle try to invest in assets with a corresponding maturity or holding period. This also means that depending on the cash-flow profile of their liabilities, insurers can hold assets to maturity and invest in a wide range of assets, which allows for portfolio diversification and enables them to match their liability needs.

The duration of liabilities determines the holding period of investments, while the probabilities of cash outflows of liabilities determine the investment liquidity. In the case of life insurance, pay-outs to policyholders are generally predictable and long-term, which allows insurers to invest in more illiquid, long-term assets. Other lines of insurance business, such as property and casualty insurance, or non-life insurance in general, are less predictable and have a shorter duration. This type of insurance business therefore requires more liquid investment portfolios.

When analysing the level of insurers' investments in equity, it is important to keep in mind that equity investments do not offer contractually fixed cash-flows. Further, unlisted equities are less liquid than listed equity and are more likely to be held for the long term.

Although life insurance companies are the main investors in equity due to their larger size, the share of equity investments in their portfolio is significantly lower than that of non-life insurers (less than 12% for life companies, 22% for non-life companies). The reason for that is that life insurers are more focussed on asset-liability matching than non-life insurers. Where life insurers do invest in equity, they do not depend to the same degree on (liquid) listed equity as non-life insurers.

In addition, as reported by EIOPA<sup>9</sup>, *“each insurance group may have different products, liability structure and potential vulnerabilities; each group operates in different (also national) markets and has different liquidity needs at different points in time”*. Hence, besides the structural reasoning, a shift towards more illiquid assets has been observed due to a search for better return. Similarly, in a context of increased uncertainty, a shift towards more liquid assets may be explained by the intention to keep a more flexible, liquid investment scheme, allowing companies to seize short-run opportunities.

The largest part of insurers' assets continues to be invested in debt instruments (70%), notably in fixed income securities; 16.5% are invested in equities, either directly or indirectly through funds<sup>10</sup>. Figures 1 to 4 provide further details on the composition of insurers' assets and on their equity investments.

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<sup>9</sup> See the [EIOPA's Investment Behaviour Report](#).

<sup>10</sup> Note that approximately two thirds of total equity investments correspond to holdings in related undertakings including participations.

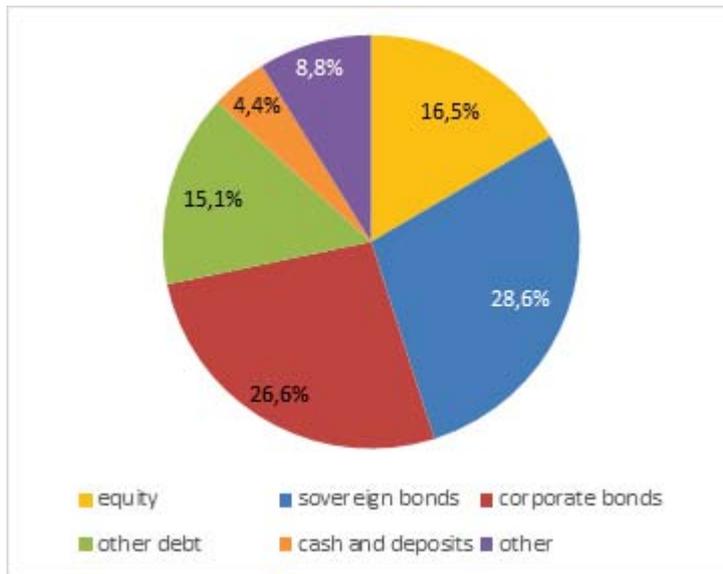


Figure 1: Total portfolio composition of the EEA insurance sector – Q1 2018<sup>11</sup>

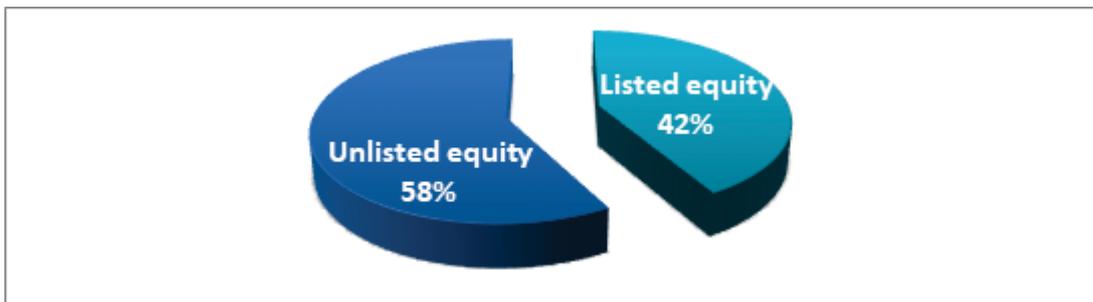


Figure 2: Share of listed and unlisted equities in insurers' equity portfolios at EEA level Q1 2018<sup>12</sup>

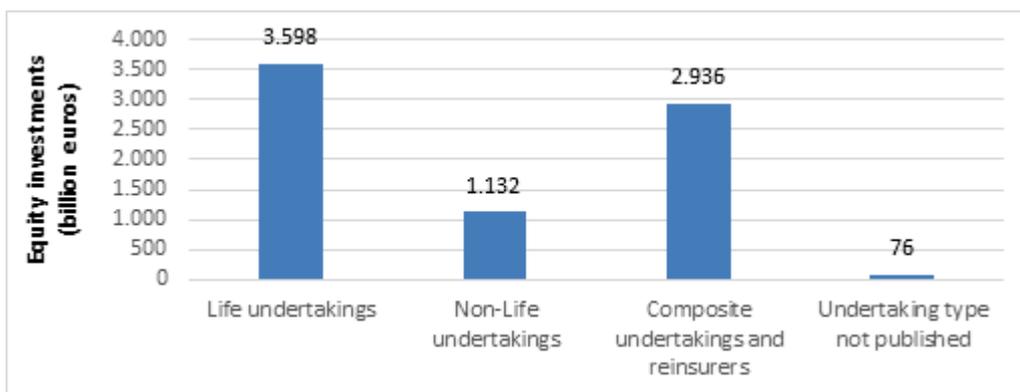
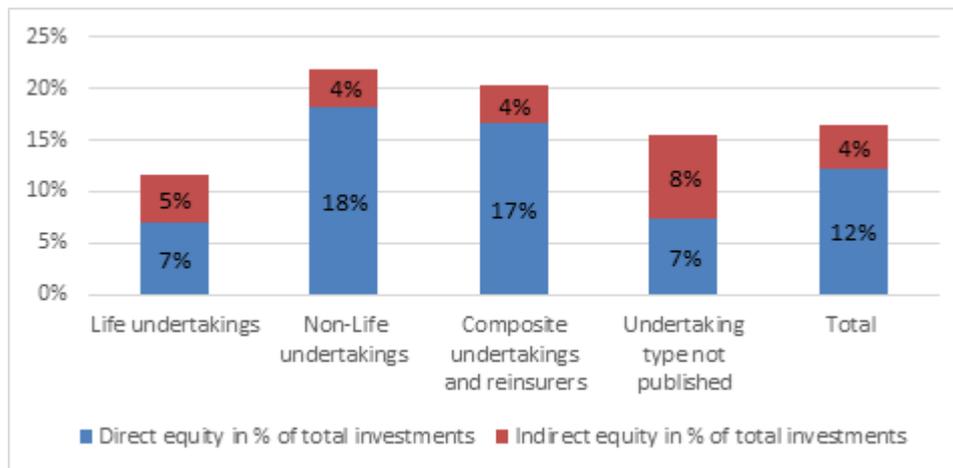


Figure 3: Equity investments by type of undertaking at EEA level – Q1 2018<sup>13</sup>

<sup>11</sup> Source: [EIOPA statistics](#) (S.06.02).

<sup>12</sup> Source: [EIOPA's Financial Stability Report – Spring 2018](#).

<sup>13</sup> Source: [EIOPA statistics](#) (S.06.02).



**Figure 4: Share of equity investments by type of undertaking at EEA level – Q1 2018<sup>14</sup>**

EIOPA's 2017 investment behaviour report has highlighted that some particular "trends" characterise the asset portfolio of insurers in the recent past, notably:

- a shift towards lower investment grade fixed income securities since 2011 (which may be traced back to downgrades related to the recent European debt crisis, as well as to the search for yield in the current economic environment);
- a small shift towards more illiquid investments such as non-listed equity and loans;
- Overall also the amount of 'other investments' as a percentage of total investment assets has remained broadly stable across the sample (mainly real estate, loans and derivatives).

The level of insurers' equity investments as well as investments in unrated debt has remained stable since 2011<sup>15</sup>, and overall no major reattribution of investment between asset classes has been observed before or after the full application of Solvency II in January 2016. Redirecting investment towards equity and unrated debt therefore requires facilitating new investment opportunities and markets. The regulatory toolbox can play a supporting role by ensuring that there are no unjustified obstacles to such investment from a prudential perspective, within the confines set by the primary goal of policyholder protection. The Solvency II standard formula for the calculation of capital requirements has been identified as one area where such obstacles may exist. Therefore, the Delegated Regulation will allow for a more differentiated treatment of equity and unrated debt asset classes, following previous initiatives in the CMU context that have already addressed similar obstacles, for example for investments in infrastructure and securitisation. Capital requirements for specific investments have been reduced where these are of sufficient quality or have a longer investment horizon than other investments within the same investment class. This removes unjustified disincentives to shifting more capital into equity and unrated debt without jeopardising the risk-sensitivity of the framework.

### 3. Initiatives supporting long-term investment in equity

Institutional investors, in particular life insurance companies, are natural long-term investors. However, in recent years they have been retrenching from long-term equity investments. Although equity investments

<sup>14</sup> Source: [EIOPA statistics](#) (S.06.02).

<sup>15</sup> Source: [EIOPA's Investment Behaviour Report](#).

have increased in absolute amounts between 2008 and 2015, the share of these equity investments in insurers' investment portfolios has been declining over that period. The share ownership of insurers and pension funds dropped from more than 25% of the EU stock market capitalisation in 1992 to 8% at the end of 2012<sup>16</sup>. Accordingly, there is a long-lasting trend which cannot be explained by the entry into application of the Solvency II framework (see also Figures 5 and 6).

Furthermore, there are differences between national markets in investment behaviour, leading to different levels of investments in equity. This suggests that there are factors other than regulatory treatment that are significant drivers of insurers' asset allocation to equity. Such factors might include the characteristics of the typical insurance products in that market and availability of investment opportunities.

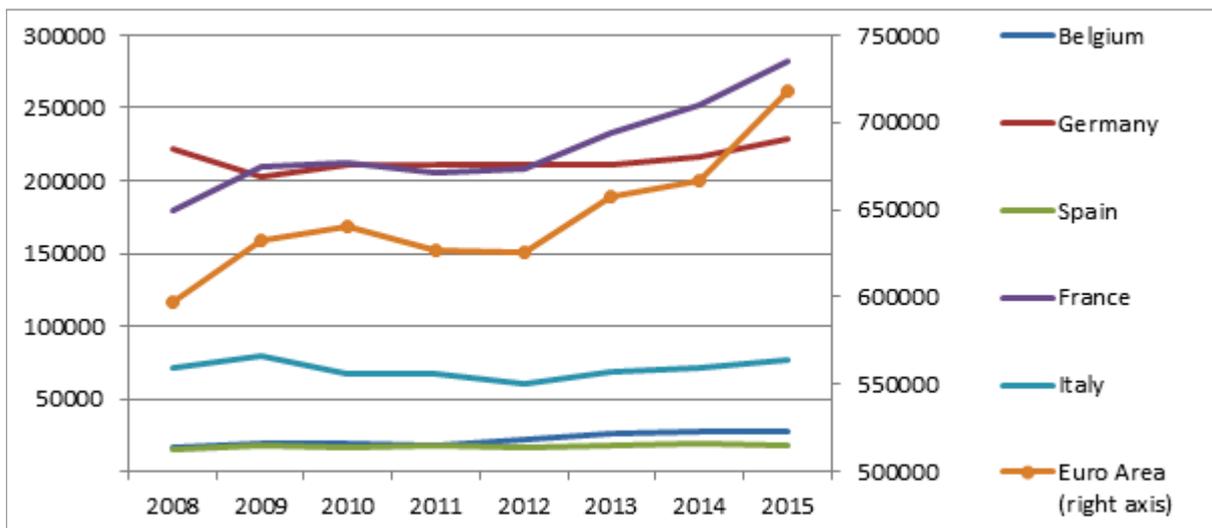
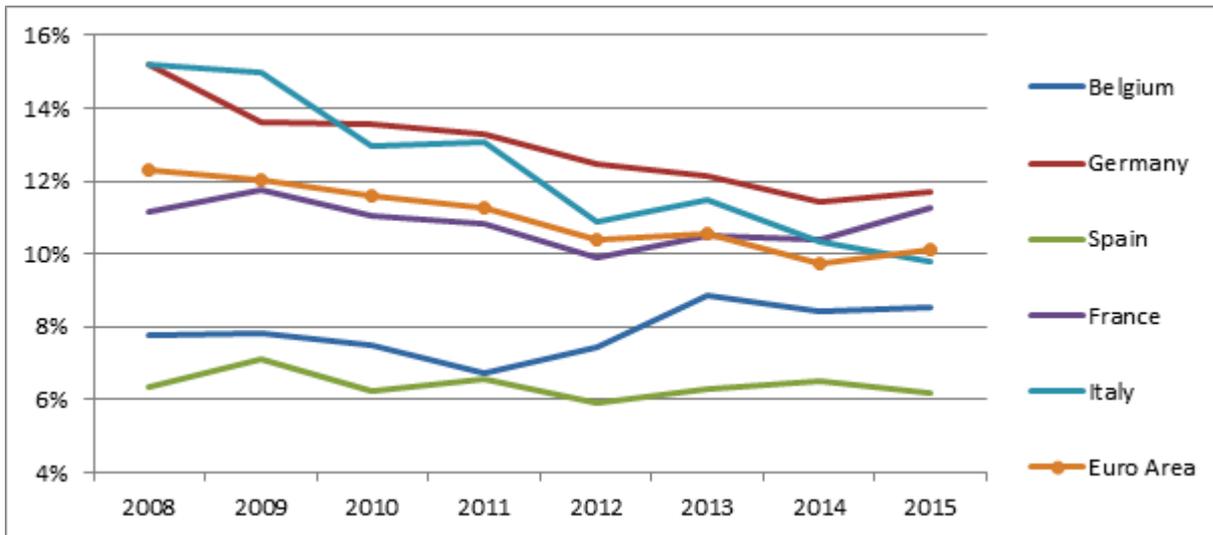


Figure 5: Equity investments by insurers between 2008 and 2015 (in million euros)<sup>17</sup>

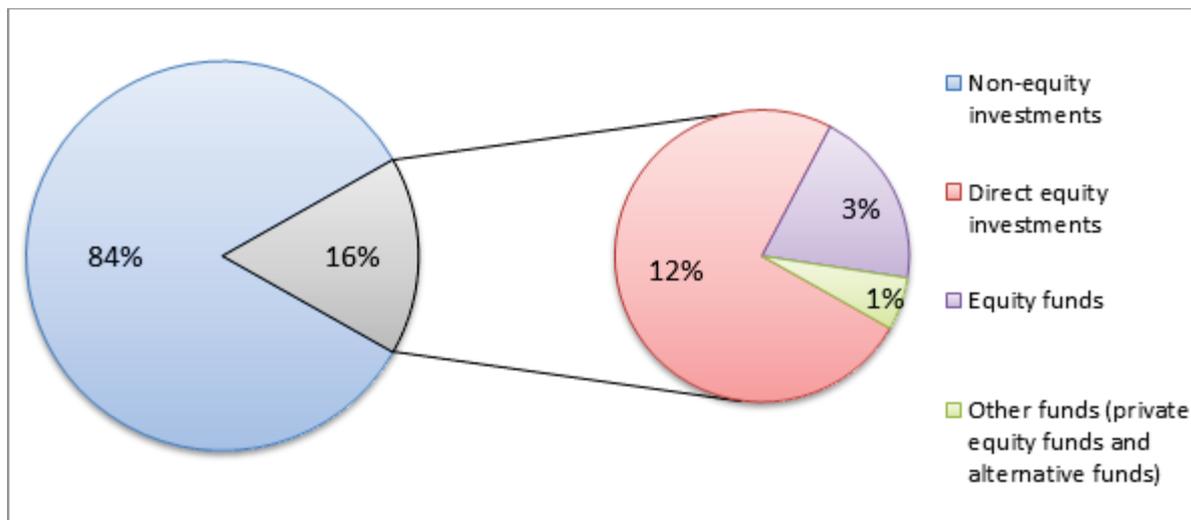
<sup>16</sup> Source: [Final Report: Who owns the European economy? Evolution of the ownership of EU-Listed companies between 1970 and 2012](#), by Observatoire de l'Épargne Européenne and Insead OEE Data Services, August 2013.

<sup>17</sup> Source: [ECB Statistical Data Warehouse](#). Note that non-unit linked investments cannot be isolated.



**Figure 6: Share of equity investments in insurers' portfolios between 2008 and 2015 (in million euros)<sup>18</sup>**

At present, insurers typically hold a large share of their portfolio in a relatively narrow range of assets. By the first quarter of 2018, only 16.5% of insurance companies' portfolios were invested in equity, among which 58% was unlisted<sup>19</sup> (see Figure 7). Private equity funds represent 0.5% of the investment portfolio (€ 42 billion)<sup>20</sup>.



**Figure 7: Overview of insurers' investment portfolio at EEA level – Q1 2018<sup>21</sup>**

Equity investment behaviour varies widely between countries. While insurers in Germany, France, United Kingdom and Italy are the main investors in equity (making up more than 77% of insurers' total equity investments in Europe), the insurers with the highest share in equities by proportion of their investment

<sup>18</sup> Source: [ECB Statistical Data Warehouse](#). Note that there is no possibility to isolate non-unit linked investments.

<sup>19</sup> Source: [EIOPA statistics](#) (S.06.02) and [EIOPA's Financial Stability Report – Spring 2018](#).

<sup>20</sup> Source: [EIOPA statistics](#) (S.06.02).

<sup>21</sup> Source: [EIOPA statistics](#) (S.06.02).

portfolios are headquartered in Sweden (40%), Iceland (39%), Finland and Norway (25% each), and Poland (24%) – see Figures 8 and 9 for further details.

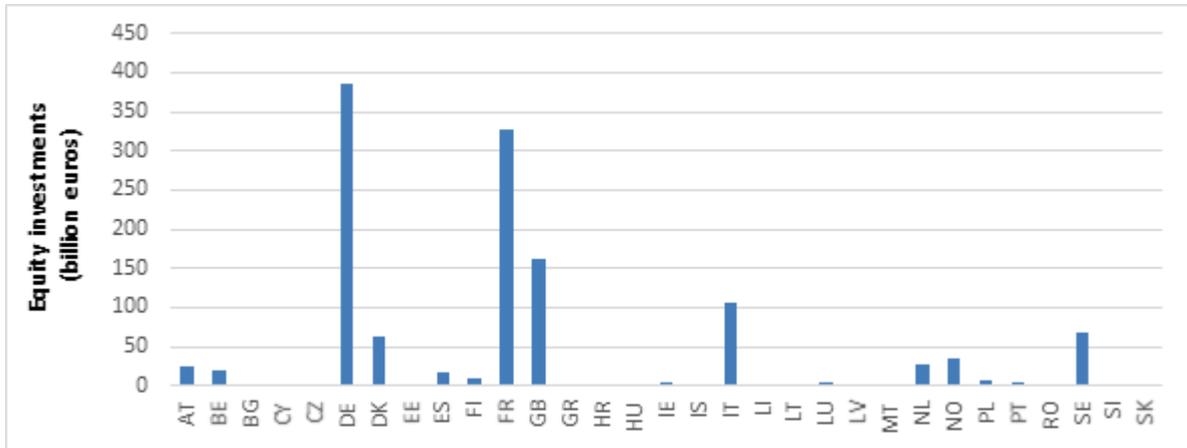


Figure 8: Equity investments by country – Q1 2018<sup>22</sup>

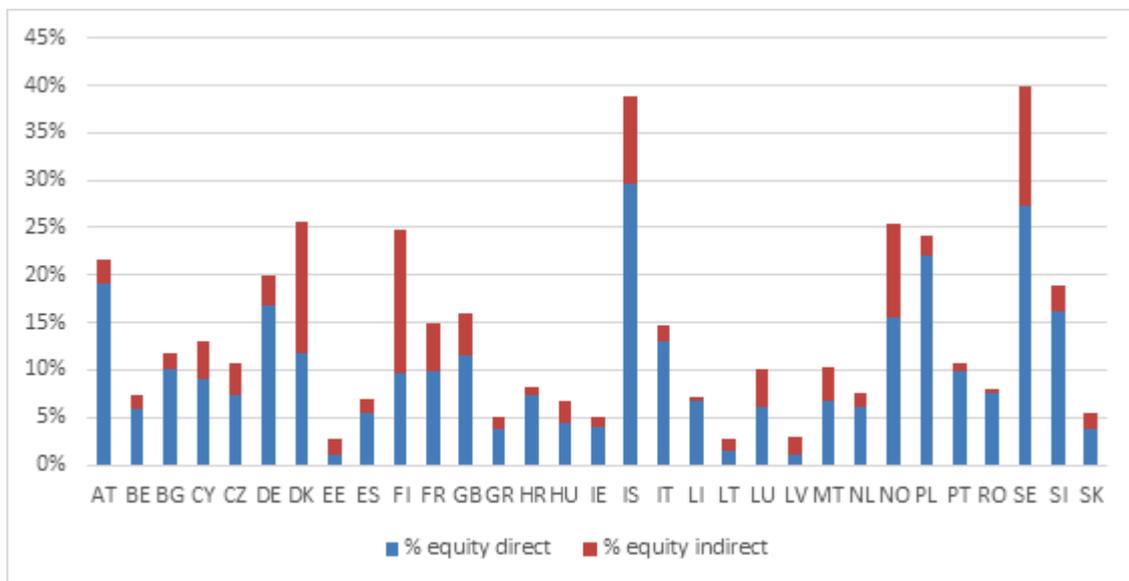


Figure 9: Share of the asset portfolio in equity investments, by country – Q1 2018<sup>23</sup>

Because of their long-term liabilities, life insurance companies should have the capacity to behave as "patient investors" who invest to match with the duration of their liabilities (close to 14 years on average for life insurers at European level)<sup>24</sup>. Therefore, life insurance companies are particularly well-suited to make long-term investments and satisfy long-term financing needs, even in the absence of liquid secondary markets.

<sup>22</sup> Source: [EIOPA statistics](#) (S.06.02).

<sup>23</sup> Source: [EIOPA statistics](#) (S.06.02).

<sup>24</sup> Source: [EIOPA's 2016 Stress-test report](#).

The definition of what constitutes a "long-term investment" is very broad, in general comprising all asset classes that generate steady cash returns over periods ranging from 10 to up to 50 years<sup>25</sup>. With regard to equity, it encompasses infrastructure investments, unlisted equity including private equity, venture capital and funds-of-funds, but may also cover listed equities held for a sufficiently long period.

The Solvency II Delegated Regulation contains a dedicated asset class for strategic participations in related undertakings that the insurer intends to hold for a long period<sup>26</sup>. In practice, in 50% of the cases, the average holding period of such investments exceeds 10 years<sup>27</sup>. The share of strategic participations amounts to 3% of total investments at European level. However, the reduced capital charges (22%) for strategic participations apply nearly exclusively to investments in the financial sector and real estate, and therefore are unlikely to support insurers' equity investments in SMEs, which employ two thirds of the work force across the EU and produce 58% in every euro of value added<sup>28</sup>.

Since 1980, a trend towards a declining average holding period of equity investments can be observed for all institutional investors<sup>29</sup>. Such short-termism in investment has a negative impact on the availability of long-term funding for the economy, and incentivises investors to evaluate companies' performance on a short-term horizon, with limited interest in the long-term prospects of the target companies.

A longer-term investment horizon may be a key enabler of responsible shareholder engagement that implies monitoring of companies on matters such as strategy, performance, risk, and ESG<sup>30</sup> factors, and having a dialogue with companies on these matters with a view to improve the long-term efficiency, performance, competitiveness and sustainability of the company<sup>31</sup>. Furthermore, successful firms need access to stable financing on attractive terms to fund their expansion. However, sustainable and long-term funding channels for growing firms seeking to raise capital are insufficiently developed in Europe.

Such strategies should be facilitated, with a specific focus on equity investment in SMEs, while maintaining sound and prudent asset-liability management.

### ***Improving the treatment of unlisted equity***

Because of their reduced liquidity, unlisted equities are naturally suited for long-term investment strategies. Therefore, a number of prudential criteria (see Figure 10) have been introduced, under which the standard formula capital charge for investments in unlisted equity of non-financial companies that are established in the EEA, can be reduced by 20%, i.e. to the same charge as that of listed equity. Based on EIOPA statistics, even if only 5% of all current unlisted equity investments were eligible for the preferential treatment, this would still represent close to € 35 billion of investments<sup>32</sup>.

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<sup>25</sup> See the [Commission Staff Working Document – SWD\(2013\) 230 final](#).

<sup>26</sup> See Article 171 of the Commission Delegated Regulation (EU) 2015/35.

<sup>27</sup> See [EIOPA's second set of advice to the European Commission on specific items in the Solvency II Delegated Regulation](#).

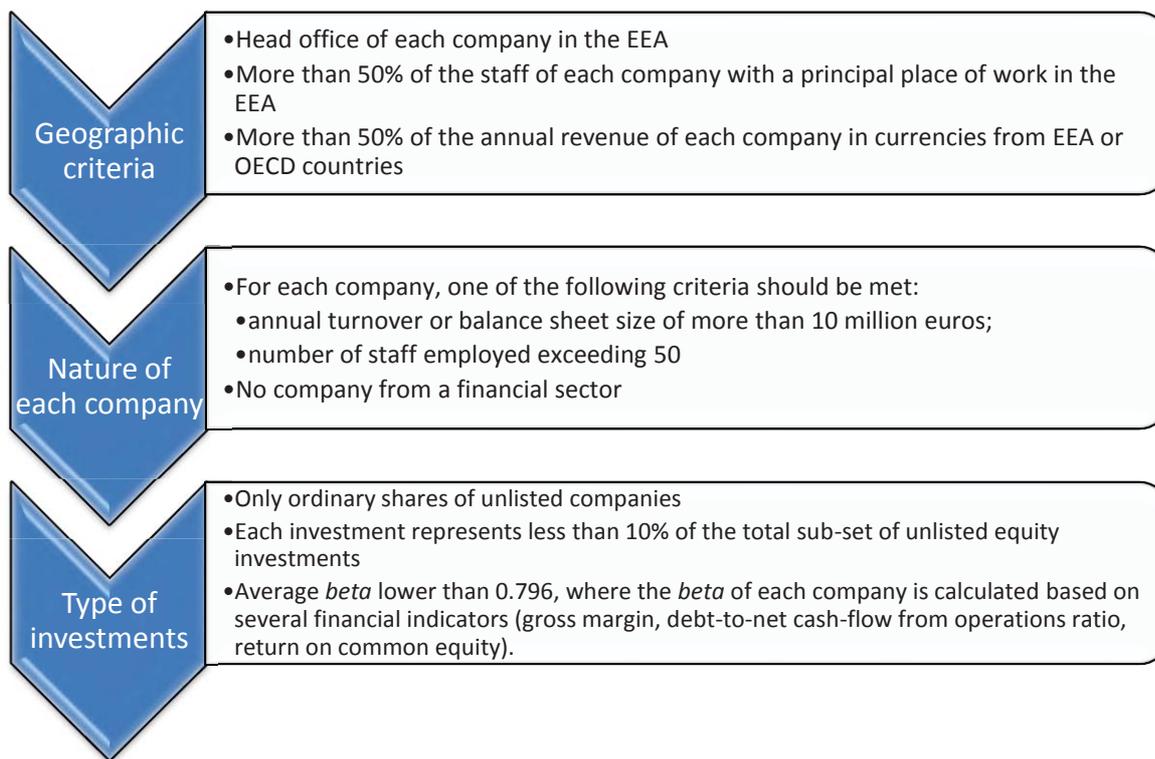
<sup>28</sup> For further details, see the [Communication on the Action Plan on Building a Capital Markets Union](#).

<sup>29</sup> Source: [Investissements et investisseurs de long terme](#) (2010) – Conseil d'Analyse Economique.

<sup>30</sup> Environmental, Social, Governance.

<sup>31</sup> See [Commission Staff Working Document – SWD\(2015\) 13 final](#).

<sup>32</sup> Sources: [EIOPA statistics](#) (S.06.02) and [EIOPA's Investment Behaviour Report](#).



**Figure 10: Criteria to be met for unlisted equity to be treated as listed equity<sup>33</sup>**

Insurers may also invest in unlisted equity through private equity funds. Currently, insurers' investments in private equity funds and alternative funds make up € 74 billion (less than 1% of insurers' total investment portfolio)<sup>34</sup>. The average holding period of private equity funds has been rising over the last 10 years, from 4.7 years before the financial crisis to close to 6 years in recent years<sup>35</sup>. Moreover, several large private equity firms have been launching buyout funds with longer lives (up to 15 years)<sup>36</sup>. Insurers' long-term investments in private equity funds should therefore be facilitated. To this end, the amended Delegated Regulation provides more clarity on the eligibility criteria that allow unleveraged Alternative Investments Funds (AIFs) to benefit from the same capital charge as listed equity. The approach suggested should allow extending the scope of private equity funds that may be eligible for a 39% capital charge, representing a 20% decrease in capital requirements for such funds.

### ***Facilitating insurers' long term holdings of equity investments***

Insurers that have long-term liabilities should have the possibility to further contribute to long-term funding in capital. In the report on the Call for Evidence on the EU Regulatory framework for financial services<sup>37</sup>, the Commission services announced that they would further explore incentives for long-term investments by insurers. As regards unlisted equity investments, in line with the commitment given in the Mid-Term Review

<sup>33</sup> In Figure 10, we use the term “*beta*”. Beta is a measure for the systematic or non-diversifiable risk of equity investments. In the identification of the investments that should benefit from a preferential treatment, it therefore seems desirable to avoid the inclusion of investments with too high beta. Under Solvency II, the beta will be calculated using a linear formula, which was derived via linear regression.

<sup>34</sup> Source: [EIOPA statistics](#) (S.06.02)

<sup>35</sup> Source: Mäkiäho, Juho and Torstila, Sami, [Prolonged Private Equity Holding Periods: Six Years Is the New Normal](#) (November 15, 2017).

<sup>36</sup> See for instance Bain's [Global Private Equity Report 2018](#).

<sup>37</sup> See the [Follow up to the Call for Evidence – EU regulatory framework for financial services](#)

of the CMU Action Plan<sup>38</sup>, a first concrete step has been taken by aligning capital requirements for qualifying unlisted equity with the ones applicable to listed equity, as discussed in the previous section.

Beyond this initiative, further actions are now being taken to allow all equity investments which are held for the long term to benefit from a lower capital charge, subject to sound prudential criteria related to the investment horizon, to the ability of the insurance to avoid fire-sale under stressed conditions, to the governance of the investment process and to a robust asset-liability management.

Taking into account the requests from some Member States and from the Committee on Economic and Monetary Affairs of the European Parliament, the reduced capital charges (22%) applicable to the duration-based equity sub-module<sup>39</sup> will be extended to long-term investments in equity of EEA companies meeting certain criteria. The calibration of this new asset class for “long-term equity investments” is derived from the CEIOPS's Advice for Implementing Measures on the duration-based equity sub-module<sup>40</sup>. Eligible investments in listed equity would benefit from a 44% decrease in capital requirements with the standard formula, and unlisted equity from a 55% decrease. This significant reduction in capital charges is expected to both incentivise insurers to invest for the longer term where appropriate, and allow insurers to invest a higher share of their asset portfolios in equity.

### ***Criteria for the long-term equity asset class***

Although the duration-based equity risk sub-module focused on a multi-year time horizon, its design had to ensure that it provided policyholders and beneficiaries with a level of protection equivalent to that set out in Article 101 of the Solvency II Directive<sup>41</sup>. During the consultation phase of the CEIOPS Advice in 2009, some stakeholders from the insurance industry had claimed that the duration approach was fundamentally *"not in line with the economic approach which the Directive aims to achieve. This is why the use of the duration approach must be authorised by Member States – and this is why there are restrictions to the use of the approach (...). If it were possible in practice to give policyholders the same protection under this approach as under the general risk sensitive approach, these measures would be redundant"*<sup>42</sup>. In reaction to such concerns, a number of prudential criteria, including the requirement for supervisory approval, frame the duration-based equity risk sub-module.

In order to limit obstacles to a quick implementation of the new asset class for long-term equity investments, the amendment to the Solvency II Delegated Regulation does not impose prior supervisory approval. Therefore, it is of utmost importance to define clear and robust eligibility criteria in order for long-term equity investments to benefit from the 22% capital charge, with the objective of ensuring an equivalent level of protection to all policyholders. The prudential criteria set out in the Delegated Regulation focus on the ability and intention of the insurer to invest for the long term, while ensuring sound asset-liability management by the insurer. The focus on asset-liability management is a fundamental element of insurers' strategies and operations, due to the liability-driven nature of the insurance business, with assets purchased to "match", in a risk-efficient manner, the estimated cash flows of insurance obligations<sup>43</sup>.

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<sup>38</sup> See the [Communication on the Mid-Term Review of the CMU Action Plan](#).

<sup>39</sup> See Article 304 of the Solvency II Directive.

<sup>40</sup> See [CEIOPS' Advice for Level 2 Implementing Measures on Solvency II : Article 111 and 304 – Equity risk sub-module](#). The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) was the predecessor organisation of EIOPA.

<sup>41</sup> See Article 304 of the Solvency II Directive.

<sup>42</sup> Source: [CEIOPS' Comments and Resolutions Template on CEIOPS-CP-69-09](#).

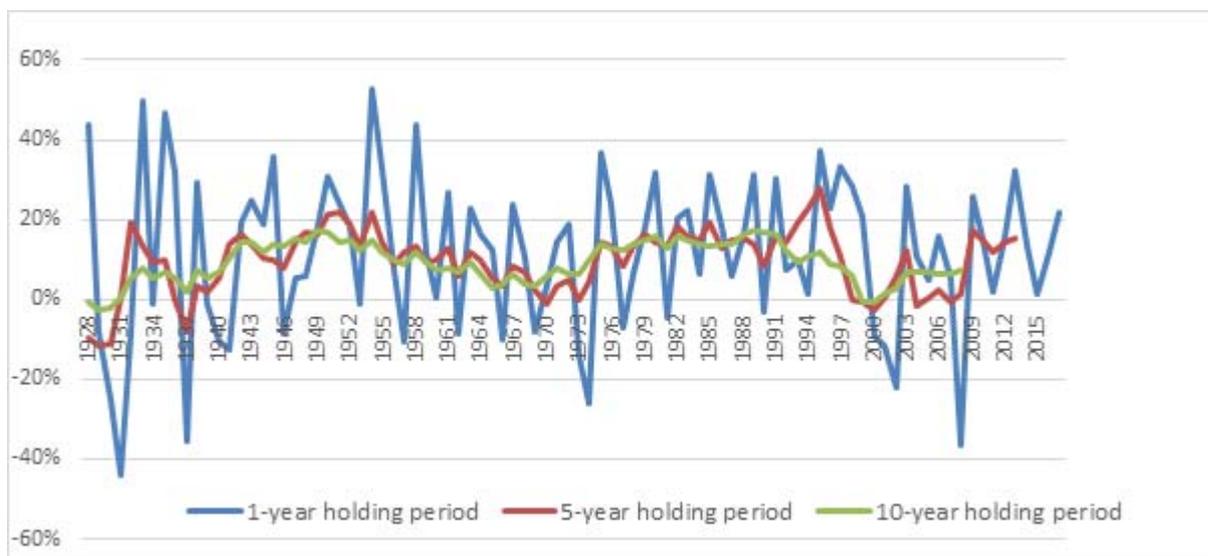
<sup>43</sup> For more details on the importance of asset-liability management, see for instance the [International Actuarial Association Risk book – Chapter 13 – Asset Liability Management](#).

Only long-term equity investments which are to be held for a sufficiently long period of time will be eligible for the new asset class for long-term equity investments, provided that insurers are able to demonstrate to the satisfaction of the supervisory authority that even under stressed conditions, they will still be able to avoid any fire-sale of those equity investments.

In addition, equity investments have to be included in a portfolio of assets and liabilities corresponding to clearly identified businesses that are managed and organised separately from the other activities of the insurance undertaking, with no possibility for the long-term equity investments to cover losses arising from other activities of the company. This contributes to a sound asset-liability management where insurance undertakings identify the appropriate liabilities with sufficient illiquid characteristics, and the most suitable assets to back those liabilities. This requirement also ensures that even under stressed conditions which increase cash outflows stemming from liabilities outside the portfolio, equity investments within the portfolio cannot be sold to absorb losses stemming from those stressed liabilities.

Long-term holding of equity may be seen as reducing the likelihood of significant negative returns on investments. For instance, the Dutch National Bank demonstrated that under the assumption of mean-reverting behaviour of stocks, the variance of stock returns increases less than proportionally with the holding period<sup>44</sup>. Under such a hypothesis, equity investments are relatively less risky over longer investment horizons, which may allow institutional investors to allocate a larger share to this asset class. The degree of mean-reversion will affect the degree to which a longer holding period translates into lower relative risk. Since there is no conclusive evidence on the degree of the mean-reverting behaviour of stock markets, the authors propose “conservative assumptions regarding the mean-reverting behaviour”.

Figures 11 and 12 display the mitigating impact on financial losses of longer-term holdings in equity.



**Figure 11: Annualized total return on the S&P 500 Index between 1928 and 2017<sup>45</sup>**

<sup>44</sup> Source: DNB Working Paper (No. 343 / April 2012) – Mean Reversion in Stock Prices: Implications for Long-Term Investors.

<sup>45</sup> Source: Damodaran, 2018 - [http://pages.stern.nyu.edu/~adamodar/New\\_Home\\_Page/datafile/histretSP.html](http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.html)



**Figure 12: Frequency of losses in the DAX 30 index between 26/11/1990 and 16/11/2018 over different time horizons<sup>46</sup>**

### *Calibration of the capital charge for the long-term equity asset class*

Long-term equity investments should be those investments which are held on average for a period of at least five years. Such a holding period is consistent with Kitchin business cycles<sup>47</sup>. This minimum holding period is also consistent with the preliminary results from an EU-wide analysis of Solvency II quantitative data conducted by EIOPA which suggests that under the assumption of random trading behaviour, the average holding period of equity investments by insurers is currently around 4.5 years<sup>48</sup>.

However, this requirement may limit the ability of insurers to establish a portfolio of long-term equities in the short term. It may also not offer sufficient incentives for insurers to add new long-term equities to a pre-existing portfolio<sup>49</sup>. Therefore, insurers will be allowed to benefit from the 22% capital charge even where the average holding period goes below 5 years, provided that the undertaking does not make any further sales of long-term equity investments which would further decrease the average holding period. However, the insurer may decide at any time to add new equities to the portfolio.

The calibration of the long-term equity asset class relies on the work conducted by CEIOPS for the duration-based equity risk sub-module. Based on this analysis, the results of which are displayed in Figure 13, a capital charge of 22% can be considered prudentially justified where the insurer is able to demonstrate its ability to hold its equity investments under stressed conditions for a further 10 years<sup>50</sup>.

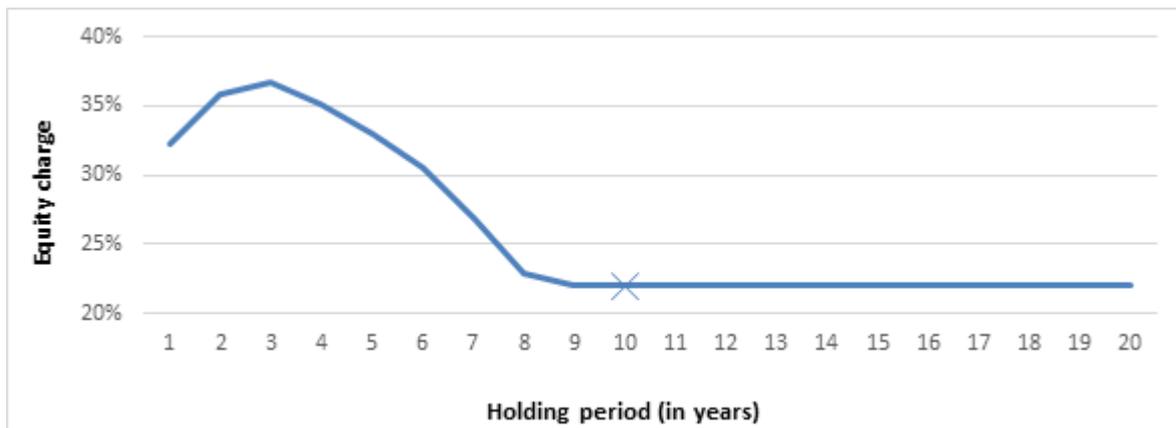
<sup>46</sup> Source: [www.macrotrends.net](http://www.macrotrends.net). Note that this graph is not retreated for serial correlation of returns.

<sup>47</sup> See [Cycles and Trends in Economic Factors, Joseph Kitchin, 1923](#). According to this research paper, the movement of economic factors are mainly composed of minor cycles (3.5 years in length) and major cycles (7 years in length).

<sup>48</sup> See [EIOPA's request for feedback on illiquid liabilities](#)

<sup>49</sup> Adding one new equity to a pre-established portfolio of equities with an average holding period of 5 years would make the new portfolio have a holding period lower than 5 years.

<sup>50</sup> Note that the calibration of the duration-based equity risk sub-module was based on the assumption that the holding period of equity investments referred to in Article 304 of the Solvency II Directive is consistent with the average duration of liabilities pursuant to that Article (see Recital 58 of Commission Delegated Regulation (EU) 2015/35), which states that the average duration shall exceed 12 years.

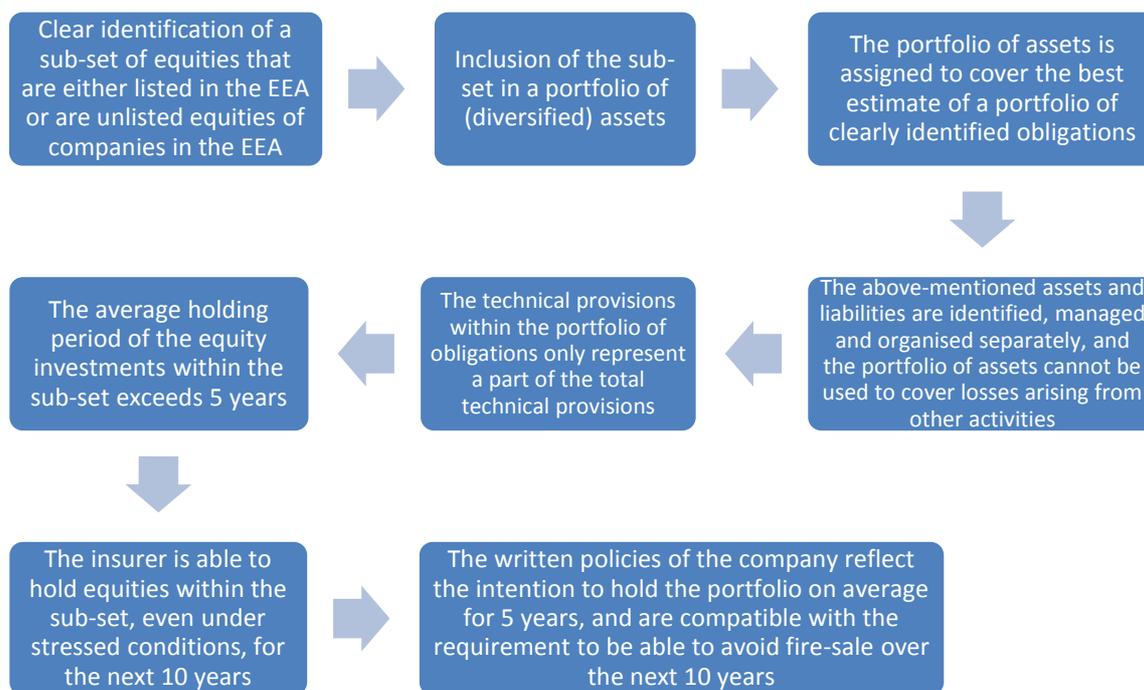


**Figure 13: CEIOPS' calibration for the duration-based equity risk submodule<sup>51</sup>**

As to the current investment portfolio of insurance firms, the new asset class for long-term equity investments is particularly suitable for equity investments in European infrastructure<sup>52</sup> and long-term holdings of unleveraged closed-ended Alternative Investment Funds. However, the design of the asset class is also suitable for a much broader portfolio of equity investments that are managed with a long-term holding perspective. Figure 14 provides the list of criteria to be met for investments in equity to benefit from the 22% capital charge.

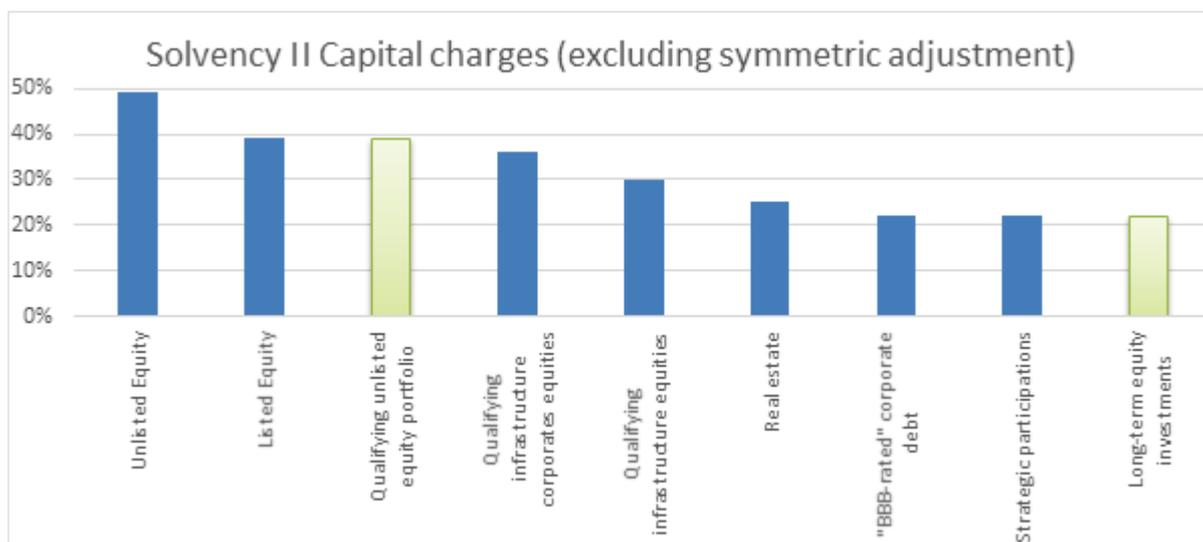
<sup>51</sup> Source: [CEIOPS' Advice for Level 2 Implementing Measures on Solvency II : Article 111 and 304 – Equity risk submodule](#).

<sup>52</sup> Note that in the context of the Capital Markets Union Action Plan, the European Commission already created dedicated asset classes for qualifying infrastructure equities and qualifying infrastructure corporate equities, which benefit from a reduced calibration of 30% and 36%, respectively. However, where some additional conditions are met (including the requirement for the equity investments to be included in a portfolio of assets and liabilities that are managed and administered separately from the other activities of the insurer, with no possibility of transfer), the capital charge for such investments may be further decreased to 22%.



**Figure 14: Criteria to be met by a sub-set of equity investments to benefit from the 22% capital charge**

Taking into account the absence of prior supervisory approval, it is important to ensure that insurers apply in a consistent manner over time the requirements for long-term equity portfolios. To this end, it seems appropriate to provide that where an insurer no longer meets the above-mentioned criteria, it cannot apply the 22% capital charge for long-term equities to any of its equity investments.



**Figure 15: Summary of undiversified capital charges<sup>53</sup> under Solvency II for market risks**

#### 4. Initiatives supporting investment in unrated debt

Privately placed debt (PPD) instruments have become an increasingly relevant source of funding for European companies in recent years<sup>54</sup>. At the same time, the European Commission's Action Plan on building a Capital Markets Union identified the prudential treatment of privately placed debt in Solvency II as a potential impediment to investing in these asset classes.<sup>55</sup>

The engagement of insurance and reinsurance companies in the private placement market is heterogeneous across Europe. In France, the Euro-PP market is specifically designed to cater to the needs of institutional investors, and insurance companies account for about 80% of the investments. In Germany, non-bank institutional investors in total make up only 5%-15% of the investment base in the predominant PPD market (the "Schuldschein" market). Other EU Member States have less developed private placement markets but exhibit growth potential<sup>56</sup>. Due to the comparatively small size of European PPD markets, they currently play a minor role in insurers' asset mix. For example, in the most mature market (German Schuldschein), the total volume of PPD issuance in 2016 amounted to about 1% of the asset portfolio managed by German insurers.

The amendments to the Solvency II Delegated Regulation will help to support the development of private placement markets, and to incentivise insurers and reinsurers to allocate more assets in these markets. The investment potential of the European insurance industry is significant. About 70% of their total investment is held in debt instruments, of which about half is invested in corporate debt and loans. Channelling even a minor proportion of these funds into unrated investment could give EU private placement markets a considerable boost (see Figure 16 for further details).

<sup>53</sup> The undiversified capital charge does not account for diversification and other loss-absorbing effects in Solvency II. The actual capital charge on an instrument is on average ca. 50% of the undiversified capital charge.

<sup>54</sup> European Commission 2017: [Identifying market and regulatory obstacles to the development of private placement of debt in the EU](#).

<sup>55</sup> See the [Action Plan](#).

<sup>56</sup> See the study: [Identifying market and regulatory obstacles to the development of private placement of debt in the EU](#).

At this stage, there is no evidence suggesting that Solvency II capital requirements prohibit the growth of European private placement markets. Nonetheless, by removing disincentives to reattribute more of insurers' investment in PPD instruments, the further development of PPD markets may get a welcome boost. Improving the treatment of unrated investments in the prudential framework would also contribute to reducing the mechanistic reliance on external ratings, because a more targeted treatment implies that alternatives to ratings offered by an External Credit Assessment Institution ('ECAI') must be set out to assess the credit quality of an asset. To this end, three amendments to the Solvency II Delegated Act have been adopted. Two of those amendments (based on an internal credit assessment approach and an internal model approach) set out quantitative and qualitative criteria for alternative credit assessments. The remaining amendment introduces a simplified approach under which a portion of unrated assets can be assigned to credit quality steps.

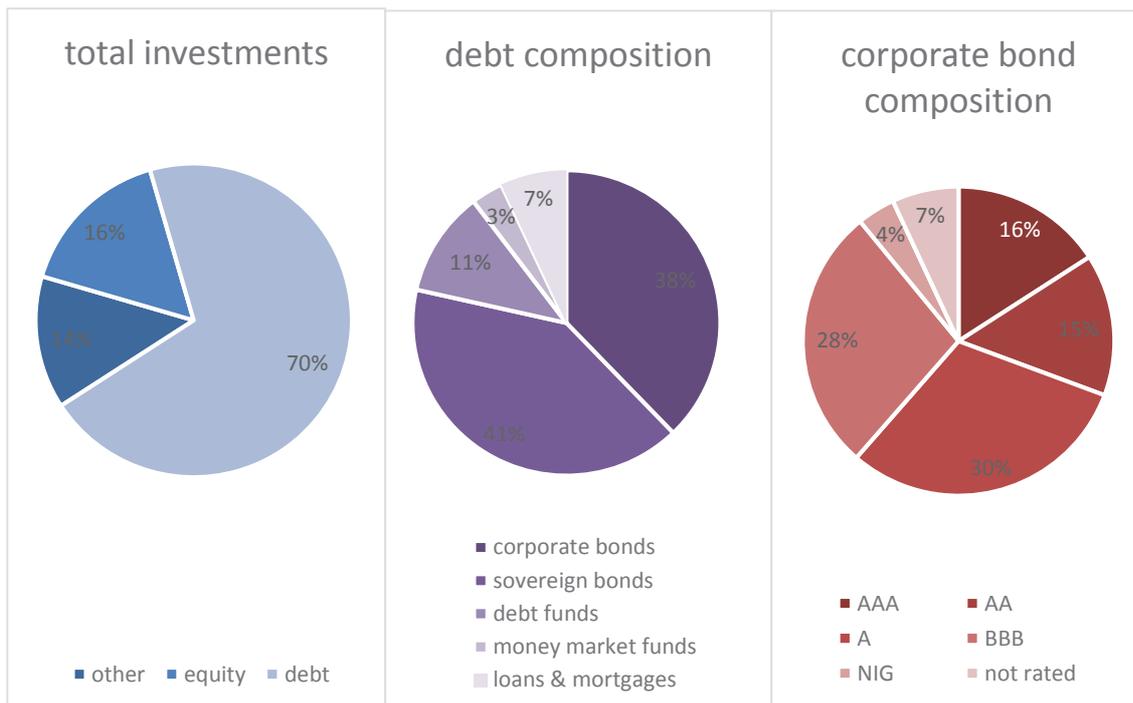


Figure 16: Debt composition – Q1 2018<sup>57</sup>

### Current treatment of unrated exposures

Solvency II is a risk-based framework with a capital requirement that should capture all quantifiable risks. Where insurance undertakings invest in debt instruments, they are exposed to fluctuations of the credit spreads on those instruments. The standard formula calculation of the capital requirement for spread risk takes into account not only the duration of the instruments but also their credit quality. For this purpose, insurance undertakings may use ratings issued by ECAIs provided that the ECAI is authorised by ESMA<sup>58</sup> and that the insurers have access to such data<sup>59</sup>. Ratings from ECAIs are mapped to a scale of seven credit

<sup>57</sup> Source: [EIOPA Statistics](#) (S.06.02) and [EIOPA 2017 LTG Report](#).

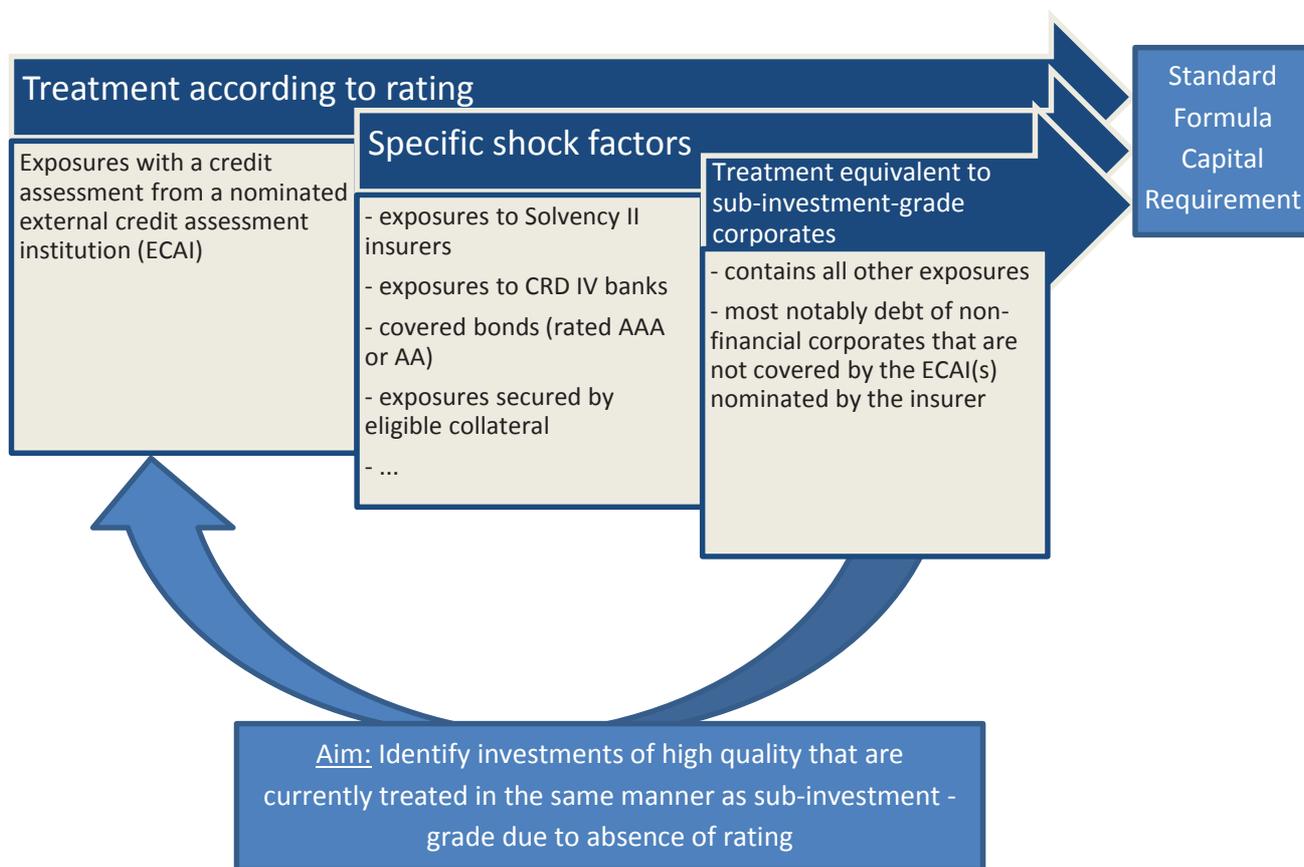
<sup>58</sup> Eligible ECAIs can also be entities exempted from Regulation (EU) 1060/2009. Currently, only Banque de France has been exempted by Commission Decision 2010/342.

<sup>59</sup> In the remainder of this document, we refer to rated exposures as exposures held by an insurance undertaking where the insurance undertaking has purchased the services of one or several ECAI(s) and the exposure is rated by that or one of those ECAIs. “Unrated” exposures can therefore also be exposures that are rated by some ECAI, but not by the ECAI for that the undertaking holding the exposure has purchased the rating services.

quality steps where lower credit quality steps indicate higher credit quality. The capital requirement for spread risk increases with both duration and credit quality step of the exposure.

The standard formula provides for a tailored treatment for a list of exposures<sup>60</sup> (hereafter “*specific exposures*”). This list includes certain asset classes with a rating, such as securitisations or covered bonds, but also exposures without a rating, namely where the counterparty is an insurance undertaking, a credit institution or an investment firm and the credit quality can be measured by reference to sectoral capital requirements. Where unrated exposures are secured with a collateral that meets a set of qualitative requirements<sup>61</sup> they can also benefit from a tailored treatment.

Where bonds or loans are neither rated nor specific exposures, they are assigned to a ‘*residual*’ category that receives capital requirements equivalent to rated corporate bonds that have a credit quality below investment grade<sup>62</sup>. The initiatives fostering investment in unrated debt target this residual category, by ensuring a better treatment for those investments that fall within the residual category but by their nature and risk structure can be considered comparable to investment grade debt (see Figure 17).



**Figure 17: Overview of the treatment of debt**

<sup>60</sup> See Art 180 and 176 (5) of Delegated Regulation (EU) 2015/35.

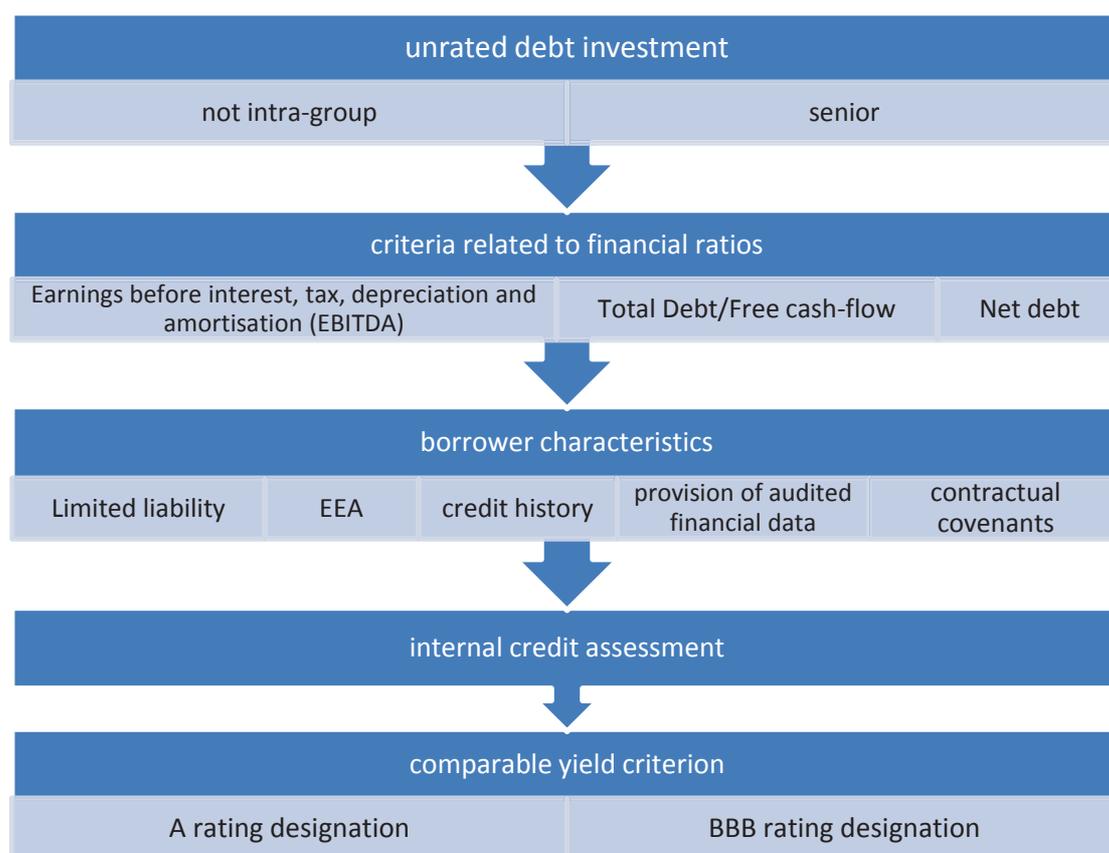
<sup>61</sup> See Art. 214 of Delegated Regulation (EU) 2015/35.

<sup>62</sup> See Art. 176 (4) of Delegated Regulation (EU) 2015/35.

### Using internal credit assessments to assess the credit quality of unrated debt investment

The amendments to the Solvency II Delegated Act introduce criteria under which unrated debt investments subject to an insurance and reinsurance undertaking’s internal credit assessment can be subject to the same risk charges as BBB- or A-rated debt (see Figure 18). The development of these criteria made use of best practices on the market, and builds on established tools used by credit rating agencies and the insurance industry to assess the credit quality of debt<sup>63</sup>.

As a consequence, capital charges for unrated debt eligible for the internal rating approach will be reduced (see Table 1), and investments in such instruments will be made more attractive. For example, the asset charge for a 5-year unrated loan whose credit quality is assessed to be comparable to a BBB-rated exposure is reduced by 17%.



**Figure 18: Criteria for the internal credit assessment of unrated debt**

**Table 1: Standard capital charges for debt with 5-year maturities**

	Credit quality step 2 (A)	Credit quality step 3 (BBB)	Unrated
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<sup>63</sup> See for example the [“Kreditleitfaden” of the German Insurance Association](#).

Undiversified <sup>64</sup> capital charge for an investment of 5-year duration	7%	12.5%	15%
Undiversified <sup>65</sup> capital charge for an investment of 10-year duration	10.5%	20%	23.5%

### *Using internal model derived ratings to assess the credit quality of unrated debt investment*

Solvency II allows for the use of internal ratings that are derived with an insurance or reinsurance undertaking's approved internal model. Internal models are subject to strict validation standards, require an ongoing monitoring effort, and their maintenance is more resource-intensive than using the standard formula approach. For that reason, they are predominantly used by larger firms.

Due to the close interaction between the prudential capital requirement assessment and the firm's risk management in Solvency II, an internal model, its scope and its limitations, must be fully understood by the user. A firm's internal model is proprietary and not subject to the same public disclosure requirements as a methodology used by an ECAI. For that reason, Solvency II in principle does not allow the use of internal model results derived by a different firm in the prudential capital requirement assessment, and prescribes the use of ECAI ratings for the standard formula approach where they are available.

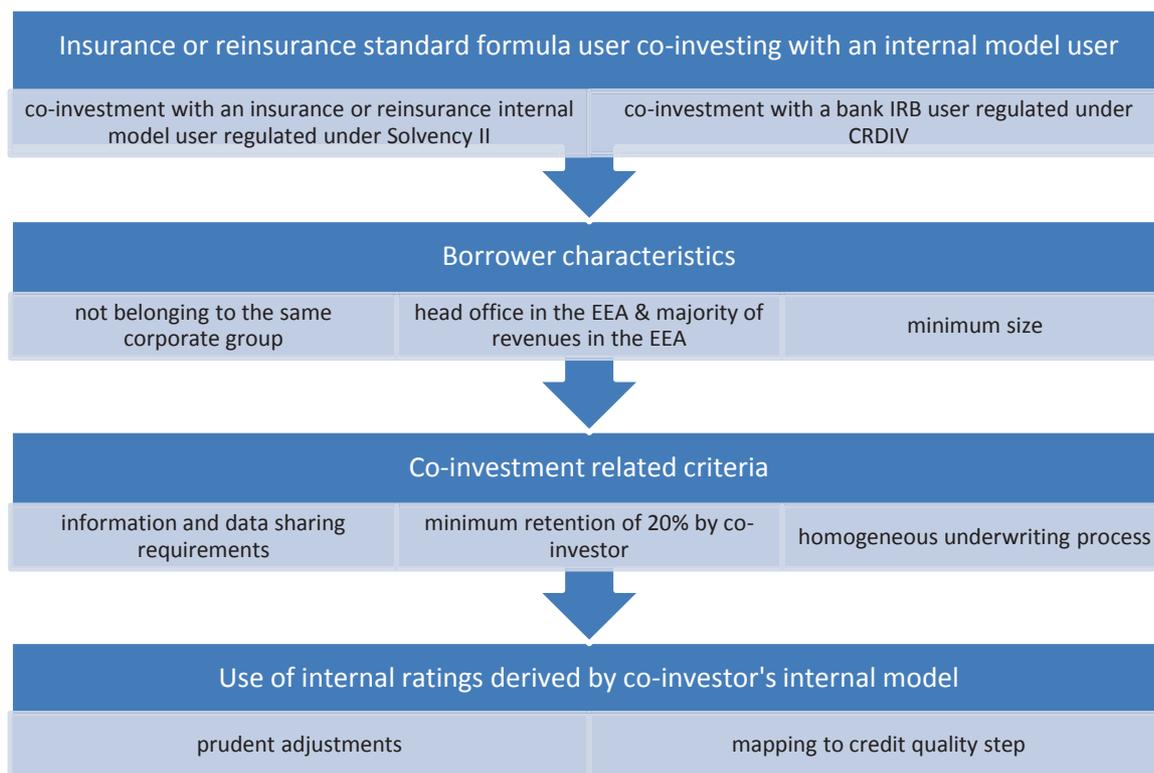
However, where no ECAI rating is available for an investment, the rating information derived by another firm's model may still be useful to assess its quality, in particular in situations where that other firm has control over the debt underwriting process and is therefore in possession of in-depth information on the investment. For that reason, a new rating approach has been introduced in Solvency II under which it will be possible to use such rating information in the standard formula approach where the internal model used to derive the credit assessment information is subject to prudential regulation under Solvency II or CRD IV. Additional qualifying criteria to secure the risk-sensitivity and prudence of this approach have been introduced (see Figure 19 for details).

Like the internal rating approach, the internal model rating approach will secure lower capital charges for unrated debt with investment grade quality, and contribute to the reduction of reliance on external ratings in Solvency II. However, compared to the internal rating approach, the contribution of the internal model approach to the development of private placement market may be smaller, because typical borrowing arrangements do not meet the 20% retention criterion<sup>66</sup> (according to stakeholders, the usual retention rate is between 5% and 10%). The introduction of this criterion was nonetheless necessary to ensure a prudentially sound response to the moral hazard incentives created by the fact that the arranger of a debt contract is at the same time assessing its credit quality.

<sup>64</sup> The undiversified capital charge does not account for diversification and other loss-absorbing effects in Solvency II. The actual capital charge on an instrument is on average ca. 50% of the undiversified capital charge.

<sup>65</sup> Id.

<sup>66</sup> An insurer can only use the results of a bank's IRBA or of another insurer's approved internal model, where that bank or that insurer (the 'co-investor') retains at least 20% of each investment where that IRBA or internal model is used to assess the credit quality for the purposes of the SCR calculation of the insurer.



**Figure 19: Criteria to be met for co-investments in debt instruments with a bank or an insurer to be treated as rated debts**

### *Avoiding excessive cost for acquiring external ratings*

As described above, where insurance companies invest in debt instruments of non-financial corporates that are not specific exposures, insurance and reinsurance undertakings are subject to the lower capital requirements where they invest in investment-grade debt. A pre-requisite is the access to a rating for the investment, which means that the insurer has to pay ECAI fees. An analysis by EIOPA has shown that where an insurer acquires the services of one or several ECAIs, the ECAI with the largest scope will cover on average 73% of the insurance undertaking's investments in 'plain vanilla corporate bonds'<sup>67</sup>. An insurer can purchase the services from more than one ECAI to cover a larger universe of debt investments, in order to benefit from the lower capital charges of investment-grade rated exposures under Solvency II. However, especially for small insurers, the purchase of rating services from several ECAI-rating providers may not always be cost-effective. Those small insurers may also not have the resources to conduct internal credit assessments or benefit from co-investment agreements necessary for the use of the internal model approach.

While also small insurers should have the capacity to identify, measure, monitor, manage, control and report the risks of their investments, they should not be forced to pay ECAI fees to an excessive extent. In order to ensure a proportionate treatment of small and medium sized insurers' investment in such debt that carries no rating under the services of one ECAI provider, a comparable treatment to investment-grade bonds or loans is introduced. Under this treatment, a subset of insurers' investments in plain vanilla bonds for which no rating is available will receive a capital charge comparable to BBB-rated debt.

<sup>67</sup> See [EIOPA's first set of advice to the European Commission on specific items in the solvency II Delegated Regulation](#). The term 'plain vanilla' bond refers to the more common types of bonds, without complex payment structures. Those bonds offer fixed redemption payments and regular fixed or floating interest payment.

In order to strike a balance between risk-sensitivity and the potential for investments that foster growth, the investment-grade treatment should only be available where it is ensured that the ECAI covers at least 80% of the undertakings' investment in plain vanilla bonds. Furthermore, undertakings making use of that treatment for their unrated plain vanilla bonds will have to determine whether the treatment is proportionate to the nature, scale and complexity of their spread risk.

## 5. Outlook

The Delegated Regulation contains a range of measures designed to remove barriers to insurers' long-term investments in equity and privately-placed debt. Capital requirements for groups of investments in unlisted equity, alternative investment funds, long-term equity and unrated debt are being reduced. The reduction of capital requirements is accompanied by criteria that ensure the quality of the investment and the prudential soundness of the measures.

The Commission services will continue working on completing the Capital Markets Union by supporting insurers' investment in funding the economy. Notably, reflections on the prudential treatment of equity will continue. In addition, EIOPA has been asked to provide an opinion on the impact on sustainable investments of prudential rules for insurance companies, by September 2019<sup>68</sup>. This will help to understand the criteria for insurers' investment decisions and to further identify the potential disincentives to equity investments that the prudential framework may create.

Beyond work on sustainability and equity investment, the Commission services have asked EIOPA to report on the asset management of insurers and its link to the illiquidity of their liability portfolio, with a view to gain insight on the long-term nature of insurers' investment decisions. This aspect will continue to be monitored, as well as following elements: the long-term guarantee measures (including the volatility adjustment) and their efficient functioning; the availability of guarantees in insurance products; the risk margin and interest rate risk (on which EIOPA already provided analyses); and financial stability implications more generally.

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<sup>68</sup> See the [Commission's request to EIOPA for information related to Directive 2009/138/EC](#).