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INVESTMENT MANAGEMENT

A Summary of Solvency II Treatment of Equities under the Standard Model

INSIGHT | MSIM INSURANCE SOLUTIONS TEAM | April 2024

Since the implementation of Solvency II in January 2016, EIOPA have implemented several amendments to the Delegated Acts[1] regarding the capital treatment of equities under the Standard Model. This note summarises MSIM's Insurance Solutions Team's interpretation of all the current rules pertaining to the Solvency Capital Requirement ('SCR') for various equity asset classes.

Type 1 equities

A fund only investing in equities listed in regulated EEA/OECD markets will receive a capital charge of 39% (plus symmetric adjustment).

Type 2 equities

When Solvency II was originally introduced all unlisted equities and private equities and non-EEA/OECD equities as well as investments into funds not providing look-through to underlying assets (of any asset class), and also commodities, were treated as Type 2. However a number of amendments have refined some treatments, such as 'Qualifying infrastructure', 'Long-term equities' and 'Qualifying unlisted equities' for potential better treatment.

Note that when looking through a global equity fund, EEA/OECD proportion will receive a 39% charge (plus symmetric adjustment) and non EEA/OECD a 49% charge (plus symmetric adjustment), hence a charge somewhere between 39% and 49% (plus symmetric adjustment).

AUTHORS

RICHARD SARSFIELD, CFA
European Head of Insurance

CHRISTIAN LUNDSTEEN, FIA
Insurance Specialist

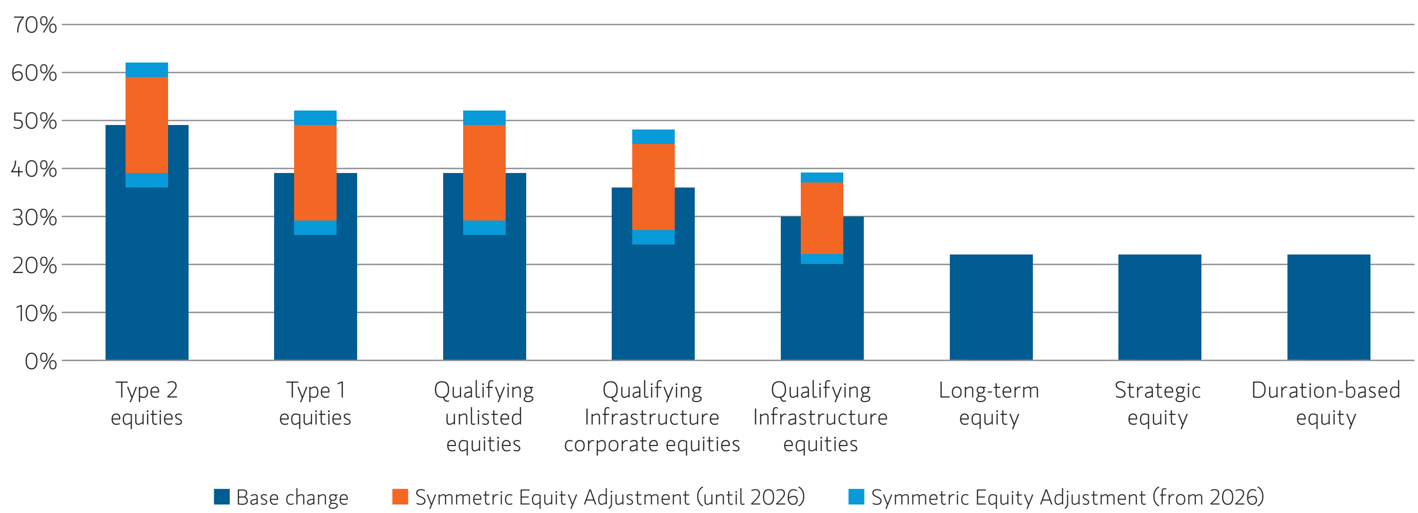
[1] Commission Delegated Regulation (EU) 2015/35 Of 10.10.2014 incl. Amendments as of 30.09.2015, 08.06.2017 and 08.03.2019

Status, changes, and potential impact

TYPE OF EQUITY	CHARGE	SYMMETRIC EQUITY ADJUSTMENT	INTRODUCED	IN-FORCE FROM	PREVIOUS TREATMENT	DESCRIPTION
Type 1 equities	39%	Yes	Original DA as of 10 Oct 2014	1 Jan 2016	N/A	Equities listed in regulated EEA or OECD markets.
Type 2 equities	49%	Yes	Original DA as of 10 Oct 2014	1 Jan 2016	N/A	Non-OECD listed equities, unlisted equities, private equity, commodities and all other assets where look-through is unavailable regardless of underlying (eg hedge funds without transparency).
Strategic equities	22%	No	Original DA as of 10 Oct 2014	1 Jan 2016	N/A	Includes equity holdings in subsidiaries of a strategic nature.
Duration-based equities	22%	No	Original DA as of 10 Oct 2014	1 Jan 2016	N/A	Only applicable for equities held for some types of pension business within a life insurer where it can be demonstrated that the equities can be held for a period consistent with the liability duration. Treatment requires pre-approval from regulator.
Qualifying infrastructure equities	30%	Yes: 77%	30 Sep 2015 and 8 Jun 2017 amendments	2 Apr 2016	Previously Type 2 equity i.e. 49% charge	Equity in e.g. SPV's with sole purpose of owning, financing, developing or operating an infrastructure asset located in the EEA or OECD (see below for qualification criteria).
Qualifying infrastructure corporate equities	36%	Yes: 92%	8 Jun 2017 amendment	15 Sep 2017	Previously Type 1 or 2 i.e. 39% or 49% charge	EEA or OECD infrastructure corporate equities, having majority revenue from owning, financing, developing or operating infrastructure assets (see below for qualification criteria).
Qualifying unlisted equities	39%	Yes	8 Mar 2019 amendment	6 Jul 2019	Previously Type 2 i.e. 49% charge	A portfolio of unlisted EEA equities meeting prescribed criteria (see below for further details).
Long-term equities (Until 2026)	22%	No	8 Mar 2019 amendment	6 Jul 2019	Previously Type 1 or 2 i.e. 39% or 49% charge	A subset of EEA equities permanently assigned to a specific line of insurance business and held for at least 5 years (see below for qualification criteria).
Long-term equities (From 2026)	22%	No	23 Apr 2024 amendment	Expected early 2026	Previously Type 1 or 2 i.e. 39% or 49% charge	Overall exposure to OECD and/or EEA equities to be held for at least 5 years

Source: MSIM's Insurance Solution Team, Solvency II Directive[2] and Delegated Acts incl. amendments

Solvency II Equity Charges



Source: MSIM's Insurance Solution Team, Solvency II Directive[2] and Delegated Acts incl. amendments

[2] Directive 2009/138/ec of the European Parliament and of the Council of 25 November 2009 incl. Amendments to the Solvency II Directive (P9_TA(2024)0295) as of 23 April 2024.

Strategic equities

Category regards holdings in subsidiaries of a strategic nature. It is required that:

- The investment is likely to be materially less volatile over next 12 month than other equities
- A clear decisive strategy as well as ability to continue holding the investment for long term exists
- There are policies in place guiding or limiting the actions of the subsidiary

Duration-based equities

An alternative equity risk sub-module defined in the Solvency II directive.[1] Only applicable for some pension business held by life insurers meeting the following requirements (but not limited to):

- Pre-approval from regulator required
- Ring-fenced portfolio
- Liability duration exceeds 12 years,
- The life insurer can demonstrate with high confidence their ability to hold the equity investments for a period consistent with the duration of the liabilities.

When an insurer receives approval from the regulator they can use the duration-based equity risk sub-module rather than the standard equity risk sub-module. Category appears to be rarely utilised.

Qualifying infrastructure equities

Category regards infrastructure investments via e.g. SPV's with sole purpose to own, finance, develop or operate an infrastructure asset. In order to qualify for this reduced capital charge the investment must meet qualification criteria including (but not limited to):

- Infrastructure asset and entity located in EEA or OECD
- Predictability of revenues e.g. rate-of-return regulation, a take-or-pay contract or availability based
- Funding of revenues by a large number of users a government or an IG rated entity
- Protection against losses from termination of project e.g. via security in all assets and contracts
- Investor has history of overseeing infrastructure projects, low risk of default and using tested technology

This category was initially introduced just months before Solvency II came into force but were further amended in June 2017.

Qualifying infrastructure corporate equities

Category regards companies with substantial majority of revenues from owning, financing, developing or operating infrastructure assets. In order to qualify for this reduced capital charge the investment must meet qualification criteria including (but not limited to):

- Substantial majority of revenues from assets located in EEA or OECD
- Predictability of revenues e.g. rate-of-return regulation, a take-or-pay contract or availability based and diversified
- Revenues funded by a large number of users, a government or an investment grade-rated entity

This category was introduced in an amendment June 2017. Before then corporate infrastructure was treated as either Type 1 or Type 2 equities.

Qualifying unlisted equities

Category introduced as a separate equity class in the March 2019 amendment. Before that, unlisted equities would in general have been treated as Type 2 equities.

In order for a portfolio of unlisted equities to qualify for the reduced capital treatment, prescribed qualification criteria should be met including (but not limited to):

Ordinary shares of unlisted EEA company

- Annual turnover or balance sheet > €10m, or number of employees > 50
- Not financial sector
- Each qualifying unlisted equity investment cannot be more than 10% of all qualifying unlisted equity investments
- Meet certain 'beta' threshold

Long-term equities*

Category of equities assigned to cover specifically identified lines of business receives a 22% capital charge (reducing from 39% or 49% for Type 1 and Type 2 respectively) with no symmetric adjustment. Qualification criteria includes (but not limited to):

- An average holding period of at least 5 years and when average holding period is lower than 5 years no equities can be sold
- The insurer must ensure that it is able to avoid forced sale of the investments on an ongoing basis including in stressed scenarios, for a period of at least 10 years
- Head office in EEA
- Listed and unlisted equities
- When investing via collective investment undertakings, these criteria may be assessed at the fund level

Long-term investing into European private equity may be included here reducing the SCR charge (from 49% to 22%) and may increase appetite in this asset class. When Solvency II originally entered into force many insurers divested from private equity (and other equity) due to the high SCR.

This category was introduced as a separate equity class in the March 2019 amendment.

Symmetric equity adjustment*

For some equity classifications, the capital charge is not constant. The maximum deviation from the base charge listed above will be plus/minus up to 10% points. In raising equity markets, the charge increases and in falling equity markets, the charge decreases. This symmetric adjustment feature is an anti-cyclical buffer, and is determined as half of the difference between the average return over last three years (of a basket of indices) and 8% i.e. actual equity returns are measured to 8% which can be interpreted as a benchmark expected return over 1.5 years (1.5 years being the average duration in the three years averaging period). The adjustment is calculated and published by EIOPA on a monthly basis.

* Review of Solvency II Directive

On 23 April 2024, The European Parliament voted by a large margin, in favour of adopting a set of amendments to the Solvency II Directive including amendments to the Long-Term Equity criteria and to the Symmetric Adjustment.[3] It is widely expected that the rules will come into force early 2026.

Herewith a summary of key impacts relating to equity investments:

Long-Term Equities

Five years after LTE was firstly adopted, the much-awaited revised criteria is finally here. LTE in its previous version was never a huge success most likely caused by the previous criteria being inhibiting and too complex for most insurers to utilise according to the EC[3]. In particular, ring-fencing was a significant challenge in many jurisdictions and the minimum holding period of five years before any trading in the LTE portfolio was problematic. New rules aim to relieve these issues, encouraging broader adoption of the LTE rule. Highlighting the key changes:

- **RING-FENCING RULE DELETED:** The requirement to ring-fence assets and liabilities to apply LTE has been a significant hurdle for adoption of LTE. The requirement is deleted.
- **TURNOVER WITHIN LTE PORTFOLIO ALLOWED:** Current rules prevent an insurer from selling any positions within an LTE portfolio until the average holding period exceeds five years. This rule is relaxed significantly such that an insurer simply commits the overall exposure to LTE for a minimum of five years. This means that the insurer is free to turnover the LTE portfolio within the five-year period.
- **SCOPE EXPANDED FROM EEA TO INCLUDE OECD:** Since the LTE was firstly introduced five years ago, the insurance industry has lobbied for expansion of LTE from EEA to OECD arguing this would lead to greater diversification. This has paid off. The universe of EEA-only funds is negligible—funds tend to be for example European i.e. including non-EEA countries like UK and Switzerland. Conversely, OECD funds are common and hence now in scope. Various MSIM public and private equity funds are now in scope for this rule.

[3] Less than 1% of European insurers' equity allocation benefits from the LTE provision. See Commission Staff Working Document Impact Assessment Report 22.9.2021.

- **'NO FORCED SALE' RULE SIMPLIFIED:** This rule, requiring an ALM[4] process that demonstrates an insurer can avoid forced sales of any equity in LTE portfolio in stressed conditions for at least 10 years, has been revised. The ALM process is no longer an explicit requirement and the period where forced sale should be avoided is shortened to five years. How exactly an insurer should satisfy a regulator that a forced sale can be avoided is not made clear, but might be clarified in level 2 or 3 text i.e. in Delegated Acts (DA) or Guidance.
- **A NEW DIVERSIFICATION REQUIREMENT** is introduced to avoid overreliance on particular names in a LTE portfolio. Insurers diversify investments for risk management purposes; hence we expect an explicit diversification requirement for LTE portfolios to be straightforward.
- **FUND LEVEL CRITERIA:** The option to consider the LTE criteria at fund level has been restricted to apply only to funds with a lower risk profile. Exactly how to define a low risk profile will be laid out by the Commission in the DA. If a fund does not have a low risk profile, the insurer may look through the fund to apply the LTE criteria on a line-by-line basis, hence we don't expect this change to present any challenge to utility.

As many European insurers' equity exposures are located within EEA and/or OECD,[5] we believe insurers should consider applying the LTE treatment. Additionally, and at least from a capital perspective, the revised LTE criteria is a tangible opportunity for adding or increasing exposure to public or private, EEA or OECD equities.

Symmetric Adjustment

The Symmetric Adjustment's (SA) maximum deviation from the base charge is currently ±10%. During the start of Covid-19 equity markets fell sharply which resulted in the uncapped SA reaching -18% (18 March 2020) and the SA was capped at -10% for nearly three months limiting the SA's anti-cyclical absorption support. The SA corridor had been proposed to be widened to ±17% but settled on ±13%, increasing the anti-cyclical impact of the SA, but not fully addressing the Covid-19 equity stress scenario.

Widening the SA corridor supports equity investments. We note that SA is not applied to LTE investments.

CONTACT US FOR MORE INFORMATION

The Insurance Solutions Team is available to discuss with clients the treatment of these different types of equity and other related Solvency II topics – please be in touch at **msim_insurance@morganstanley.com**

[4] Asset Liability Management

[5] EIOPA's Insurance asset exposure statistics show that more than 95% of General Account equity exposure is located within EEA or OECD (as of 30 September 2023).

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Insurance Asset Risk Awards 2022 — Multi-asset manager of the year

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Insurance Asset Risk Awards 2021 — Multi-asset manager of the year

Insurance Asset Risk Awards 2021 — Equity manager of the year

Insurance Asset Management Awards 2020 — Winner — Fixed Income Manager of the Year (up to €100bn AUM)

Insurance Asset Management Awards 2020 — Winner — Multi-Asset Manager of the Year

Insurance Asset Risk Awards 2020 — Equity manager of the year

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